Conference Call transcript

23 March 2020

FY 2019 RESULTS

Operator
Good day ladies and gentlemen and welcome to the Co-operative Bank of Kenya 2019 results. All participants will be in listen-only mode. There will be an opportunity to ask questions later during the conference. If you should need assistance during the call please signal an operator by pressing * then 0. Please note that this call is being recorded. I would now like to turn the conference over to James Kaburu. Please go ahead, sir.

James Kaburu
Good morning, good afternoon, good evening ladies and gentlemen. This is the Cooperative Bank of Kenya and today we want to discuss our full year 2019 results. With me I have Mr Patrick Nyaga, who is group CFO, Mr Anthony Mburu, our group Director Credit Management, I have Anthony Muli, our bank Economist, and I also have Robert Aloo, our bank Treasurer. And I am James Kaburu, Head of Investor Relations and Strategy. We are going to start with a discussion of the macro which Anthony Muli is going to take us through. Then from there we can go to other issues and financials. We did release the results last week on the 19th and we have already shared with you, so I trust that you have had ample time to look at them so that we can have a good discussion. I hand over to Anthony Muli.

Anthony Muli
Good day everyone. This is Anthony Muli. I will take you through an update on the operating environment. Then after that I will hand over to Patrick Nyaga. What we have seen is that in 2019 Kenya has remained resilient in terms of economic growth. We saw support from the services sector on most of the GPD numbers. However, agriculture suffered from low commodity prices and a bit of delayed rainfall especially in the last season. Looking into 2020 we have started off with favourable weather which is positive for both food production and also on the inflation number, which is within controllable range. However, what we have seen in the last couple of weeks is that due to the coronavirus pandemic I think most of these sectors have been hit. We have seen for example our flower exports almost collapsing. We have also seen the fact that the tourism sector will miss this year's peak period, which is July to October. Obviously on the ground some of the hotels have started shutting down and mostly operating below 20% occupancy.

Given what we've seen in Europe and also North America we expect the diaspora remittances to also fall significantly in 2020. Domestically we've seen a bit of the activity certainly in tourism and education starting to fall significantly. In terms of the interest rates 2019 was quite stable, especially on the short end. That is from 91 and 92 days treasury bills. The interbank was quite stable also except for some temporary liquidity swings. And what we've seen is that looking at the start of 2020 banks are still liquid. However, that might have an impact from what we've seen on the [unclear]. Inflation has been quite stable in 2019. Looking at 2020 the country is food secure in terms of maize up to 2020, so I think the only significant risk we have on the inflation numbers is that the second round of the locust invasion which remains unquantified.

On the exchange rate 2019 was quite stable. However, in the last couple of days the currency has really depreciated. Today banks are quoting about KSh 106 to KSh 107 to the Dollar. And I think most of the reason lies in the fact that most of the FX inflow channels have been adversely affected. Looking at 2020 most of the FX inflows, especially tourism, agri exports and diaspora remittances remain significantly impacted. On the private sector we saw the numbers up to January 2020. That is picking up to a number of 10.3% year on year growth. However, looking at what lies ahead that might stabilise still within the single digit level. Most of the credit in the last couple of weeks and also months has grown into personal loans, then SMEs and a bit of manufacturing. I think the outlook here is still uncertain given the COVID-19 pandemic.

In South Sudan we are a bit hopeful now that on the 22nd February the parties there signed a peace agreement, and we hope that this will hold into the coming months. We've also seen a bit of technical assistance from the IMF in a bid to improve the fiscal policymaking. And I think looking into 2020 we've seen the government clear all the government salary arrears, which is positive. However, what is likely to hold this country together is keeping the peace and also having budgetary allocation to the priority sectors. At this point I will invite Patrick Nyaga to take us through the financials.

Patrick Nyaga
Thank you Anthony. Good day ladies and gentlemen. I think we sent you a couple of slides. Anthony has probably gone up to slide number eight, so I will skip through a number of slides just so you can read. But I will emphasise a bit on the financials. In terms of slide number nine, the regulatory environment, you are aware that in 2019 we were implementing IFRS 16. In 2019 we saw the rate cap effectively being removed, although the lending rate still remains low. We saw in 2019 the implementation of the Banking Sector Charter and then the Data Protection Act. There was strict enforcement of the AML KYC with a few banks having been audited by external parties guided by central bank.

In terms of slide number 11 and 12, 13 and 14 I think those are slides that you are familiar with. I will go to slide number 15. This is making mention of something you have seen in the media that Co-operative Bank Group is proposing to acquire a 100% share of Jamii Bora. Jamii Bora is incorporated under the Kenyan Companies Act. It has about 350,000 customers and 17 branches, a balance sheet of about KSh 12.5 billion and [unclear] in SME banking, micro finance and insurance agency. Obviously we will do the correct procedures in terms of due diligence and the various approvals to see whether the transaction will be fruitful.

In terms of our Soaring Eagle transformation initiative we have a number of slides there which I will not go through, number 16 and 17. It is just focusing on how we continue to drive this and some of the areas especially in credit are giving us a very significant boost in terms of income in 2019. We continue championing our socio-economic environment and I think the numbers are increasing in terms of the students that we are supporting and also the consultancies that we are doing for the various SACCOs. So I if go to number 19 I think you can read there a number of accolades that we got within 2019.

In terms of regional business – that is our business in South Sudan – we still have four branches and as Anthony mentioned we are probably going to see some light at the end of the tunnel. Other than the coronavirus I think the peace agreement in Sudan will end up turning around the business there. In terms of performance our profit before tax for Co-operative Bank of South Sudan declined from a loss of KSh 31 million to a loss of about KSh 352 million in 2019. The business in SSP terms made a profit of about KSh 368 million, but again because of IAS 29 the translation into Kenya currency in a hyperinflationary economy we registered that loss. So in our group profitability we are recording a loss of KSh 352 million for that business. However, there was growth in total assets and also customer deposits as well as shareholder funds. Therefore we feel the business is continuing to do well, other than for the inflation which we will probably see the end of with the signing of the agreement and already the government working together. We are looking at a positive environment going forward.

In terms of slide 22 our digital channels continue to perform very well with MCo-op Cash growing from 37 million transactions to 50.6 million transactions, agency banking from 43.6 million to 46.7 million transactions. Branch banking a slight growth. Internet banking a slight growth, and ATMs again dropping slightly. Probably with what we are seeing currently in the market we might see some transactions increasing at ATMs.

On slide 23 we are looking at our e-credit, a significant growth. In 2018 we were looking at 1.3 million customers. As at the end of 2019 we had 4.1 million customers who had utilised the e-credit platform. In terms of loans cumulatively in terms of disbursement in 2018 we did KSh 20.2 billion. As at full year 2019 we had done KSh 63.8 billion. Mobile banking in terms of transactions, again 51 million compared to 37 million. Commission income had a significant growth from KSh 1.9 billion in 2018 to KSh 5.1 billion in 2019 full year, and that represented the growth in the number of loans and disbursements out there. Deposits through the mobile grew from KSh 85 billion in 2018 to KSh 128 billion. So in a nutshell I think we are saying that our alternative channels continue to grow very significantly. And what we are doing in terms of encouraging more transactions especially with the coronavirus you may see that continuing to be a preferred method of transacting for the customer.

In terms of agency banking we continued increasing our number of agents from 12,200 to 16,700. Total revenues grew from KSh 407 million to KSh 500 million. The number of transactions increased from 44 million to 47 million. Again a good growth in terms of the number of agents and also the transactions going in there.

If I go now to some financial highlights specifically on slide number 28, you are looking at our balance sheet and our financial position. We were able to grow our total assets from KSh 413 billion to KSh 457 billion, loan book from KSh 245 billion to KSh 367 billion, and total deposits from KSh 306 billion to KSh 333 billion. Shareholders' funds grew from KSh 70 billion to about KSh 79 billion. So we continue to grow. Maybe from a percentage perspective our total assets grew by 10.5%. Government securities grew quite significantly by about 47%. Shareholders' funds grew by about 14%.

In terms of the loan book we continued being diversified. No significant change between corporate, mortgage, asset finance, SME, micro and personal banking. As you can see there was a bit of growth on personal banking, and probably that growth is coming out of lower growth in corporate and in mortgage. Those were the sectors that were quite affected with the banking environment the way it was. On slide number 31 again it's a diversified book. This is in percentage form. On slide 32 we are looking at the liability portfolio. No significant movement in terms of the category. The distribution remains relatively the same. On slide number 33 we are looking at how our balance sheet is funded from a foreign currency perspective, and it relatively remained the same between 2018 and 2019 in terms of local currency vis-à-vis foreign currency.

In terms of liquidity of the loan book our total gross loans are at about KSh 283.6 billion which grew from KSh 259.6 billion. And you will note that between substandard, doubtful and loss the percentages remained relatively the same. So no material deterioration of the book in 2019. This is probably mainly because of the amount of support that we have put in to make sure that the book is not deteriorating. And I think also based on what Anthony mentioned earlier there has been a bit of payment of arrears by county governments, so a bit of that has supported. In terms of slide number 35 I think this is where we are looking at the various stages of our book. We are noting that the total book was KSh 288 billion [?] in terms of growth. You can see the different stages in terms of the exposure and the provisions. Currently we are holding provisions of about KSh 18.37 billion in terms of IFRS 9.

Sector by NPL I think remains relatively the same where we saw manufacturing even in 2018 accounting for a slightly higher portion than the other books in terms specific NPLs by the book of that sector. In terms of slide

37, portfolio trends, this is sector NPL by total bank NPL. So when you take the NPL of a sector out of the total NPL trade accounts for the highest, then manufacturing, then personal consumer. But you will note that there has not been any major change between 2018 and 2019. In terms of coverage in 2019 we improved our coverage in all areas. CBK we moved from 54.7% to 63.2%. IFRS from 48% to 52%.

Capital in terms of the various capital ratios we have enough buffers other than for total capital to risk weighted assets which is probably at a margin of about 1.3%. However we are looking at that and probably by the time we report Q1 and Q2 all factors constant we would have boosted that by tier two capital. In terms of capital assets and funding mix, the table on slide number 40 looks at both 2018 and 2019. Some changes there in terms of the funding capitalisation. All the information is on that slide. Slide number 41 from a liquidity perspective 41% in 2018 and 46% in 2019. In terms of loan to deposit ratio not much movement, 74% in 2018 and 74% in 2019.

In terms of the contribution by the subsidiaries Co-operative Bank grew by 16% and provided most of the profit for the group. Co-op Consultancy and Insurance Agency did quite well, grew their profit by 50% from KSh 475 million to KSh 714 million. Co-op Trust Investments grew by 102% from KSh 45 million to KSh 90.8 million. Kingdom Securities declined their profitability, actually a loss position. So the loss was KSh 7 million in 2018 and now in 2019 it was KSh 26.8 million. I think I had mentioned Co-operative Bank of South Sudan mainly because of the inflation rate. We have seen a loss of KSh 351.5 million. Share of profit from associates is both CIC Insurance and Co-operative Bank Fleet Africa Leasing Ltd, that contribution dropped from KSh 171.4 million to KSh 40 million. And therefore our group profit before tax is KSh 20.7 billion compared to KSh 8.157 billion, a 48% growth.

Various ratios there in terms of profitability growth. I think most of the ratios went up other than profit or share from associates which declined and also FX income which declined slightly. So in a nutshell all our ratios were growing. Various other key ratios, ROE, return on average assets increased slightly from 3.2% to 3.3%. Return on average equity increased from 18.3% to 19.2%. Earnings per share increased from KSh 2.14 to KSh 2.44. NIM on earning assets declined slightly from 8.8% to 8.2%. Cost to income ratio at 54.6% compared to 54.8% in 2018. Both the ratios dropped to 57.4% and 52.1% respectively in terms of [unclear] provisions and reserve provisions. NIM dropped slightly to 8.8% mainly on CBR considerations within the year.

From a financial outlook as Anthony has said earlier it is very uncertain environment especially given the coronavirus ravaging the world. Therefore we have not given many projections. We think by the time we are reporting Q1 or Q2 we should be able to continue guiding you on our projections going forward. So thank you very much. I think those are the key highlights. We can probably go for questions and answers and discuss the numbers. Thank you very much.

Operator
Ladies and gentlemen, if anyone would like to ask a question you are welcome to press * then 1 on your touchtone phone. If you however wish to withdraw your question you may press * then 2 to remove yourself from the question queue. If anyone would like to ask a question please press * then 1. Our first question is from Adesoji Solanke of Renaissance Capital.

Adesoji Solanke
Hi everyone. Can you hear me?

Patrick Nyaga
Yes, we can hear you.

Adesoji Solanke
Hi. This is Adesoji Solanke from Renaissance Capital. Thank you for the call. I understand the uncertainty about the outlook, which is why you haven't given guidance. But I have a couple of questions nonetheless. The first is with respect to net interest margins. I just want to understand what exactly happened in Q4. You had a 30% plus increase in net interest income in the fourth quarter of the year. What exactly was behind that? And also just talk a little bit about the repricing since the rate caps were removed. I understand no one has repriced. Do you think it still happens, and how do you balance that given the outlook that the bank rate is uncertain?

Patrick Nyaga
Sorry Solanke, the last question is not very clear. What did you ask?

Adesoji Solanke
The second question was about what you think with respect to the repricing since the rate caps were removed. Do you think that still happens going forward? And try and balance that with the outlook you know looking ahead is quite uncertain. The second question is with respect to non-performing loans and restructurings which the central bank has permitted the banks to do. What is happening so far with your customers? Are you seeing a pick-up in customers coming to ask for restructuring etc.? And should this become the status quo going forward what sort of implications would it have on your financials? If you have to restructure a lot of loans does it simply mean they are taking a turn down the road? At the same time under IFRS 9 you have to provide based on an expected loss basis. So I would like to get your thoughts on those two things, and I have two more questions.

Patrick Nyaga
Okay. Maybe we can take a few more questions so that we answer all of them together.

Adesoji Solanke
Okay. So let me ask all my questions then. The other question I had was Anthony mentioned what is happening to the Shilling and the fact that the Shilling is under pressure at least as at today. Can you talk us through what you think the implication of a weaker Shilling is for the bank? I see the numbers don't look that significantly, but if the Shilling depreciates 10% or 20% what does it mean for your numbers and your capital adequacy ratio? Then my final question is on the coronavirus. I get you about how uncertain the outlook is, but if everything really does go to zero, so you are not exporting, your customers can't do business, people are sitting at home, how bad could the picture really look? Or would you say we are panicking too much? Help us get some comfort around what you are thinking about coronavirus. What have you done today? What are you seeing so far? Thank you.

Patrick Nyaga
Okay. Thank you very much. I think we can start with the issue of repricing on loans and the NPLs, and Anthony will handle that.

Anthony Mburu
Thank you for your questions. This is Anthony Mburu. I will start with your first question around the NIMs. Towards the end of the last quarter last year the MPC met and reduced the CBR. So for the loans that were connected or pegged to the CBR we saw a 0.5% reduction in the interest revenue especially towards the end of the year. And then also the element of having a bit of loans out in Dollar terms. The mix between those two affected the NIMs in that fourth quarter. Repricing after the caps have been removed, the banks have all signed up to a Banking Services Charter. One of the things in there is the issue of risk-based pricing so we don't just put

a finger in the air in terms of pricing methodology. All banks were put on a schedule starting from January all the way to end of March for banks to present their formula of how they would be using the risk pricing models. As we speak we have submitted our formulas and we are just waiting for final feedback as regards permission to implement as per the formulas that we've all come up with. We expect that other than there is now this new crisis issue that has come up we were expecting clear guidance before the end of the month, and then we proceed. So you are right. No banks have really repriced their loans in line with new risk pricing models, but we anticipate that by the second quarter of the year we should be much clearer as to acceptability of the methodology that we've come up with.

Your third question was on NPL and restructuring and the impact on expected credit loss. It is early days. This circular just came out last week. Yes, we are beginning to see one or two customers make requests, but it is still early days in terms of what way forward. The few who have come are looking for short-term accommodation, three to four months. And if what we've seen in some of the other countries of the impact of this health crisis is anything to go by, somebody who is asking for three to four months break should be able to catch up after that should the economy swing back into activity. So at the moment it is still early days. The number of customers who have requested for restructure are still very few, not more than a handful so far across the entire network.

But yes, we anticipate that there will be those who will come, especially businessmen, not so much the salaried people because we are on a model of check off largely to civil servants and parastatal employees who are less vulnerable as far as layoffs are concerned. But obviously for the businessmen with purchasing power affected and the slowdown in activity we anticipate will be those who will come. The only silver lining is that already there was a little bit of slowdown before, so there wasn't as much of loans out there to the business segment. If you look at the growth of our book last year a lot of it was more in the personal loans. Hardly much in trade and hardly much in manufacturing. In fact those reduced. Even real estate and building and construction reduced. The growth in our books was largely in personal consumer and a little bit into SACCOs, the financial services who are again linked to government-based organisations and parastatals. If I summarise it is early days but we think that we should be able to absorb some of the shock there.

I don't want to say too much. Number four I can't add anything. I'm sure someone will talk about the impact of the Kenya Shilling and the issue of capital adequacy. Number five, the export/imports and worst case scenario, so far the government has allowed cargo in and out. Around the world that seems to be the trend, that at least cargo moves. What is not moving are people. With the interconnectivity people are able to meet, talk and do business without having to meet face to face. The sectors we see being most affected are conference tourism and a little bit for a while the element of gatherings and events, those who organise events and things like that may take a hit, as well as the transport sector because people are not moving around. But cargo transport is still free moving. The borders are still open. So tough times ahead, but as long as commerce continues chances are that it will not be as hard. What is not moving is people, and people are finding ways now to communicate and to do their business without moving.

Patrick Nyaga
Okay, just to add on that. What we've seen also in the last seven or so days is tea trading at Mombasa. We still saw exporters able to offload almost 90% of what they had. So we haven't seen much impact as such. On coffee what we've seen is that prices have fallen by about 8%. On the diaspora flows I think that is still unquantified. However, as a bank we have a very negligible loan book on our diaspora clients. For flowers that's a huge impact. But looking at our loan book our exposure is under 2% on the flower sector. Thank you.

Adesoji Solanke

I asked about the Shilling, and the second question I asked which I don't think was properly addressed fully was if you look at your net interest income quarterly in Q2 and Q3 versus what you made in Q4, your fourth quarter net interest income was 50% higher. So I'm trying to understand what was behind this. You tried to explain that it was because of lower interest rates. But I can see that your asset yields were actually much higher in Q4. So your net interest margin in the fourth quarter of the year was significantly higher. Why is that the case?

Patrick Nyaga
I will start with the question on the Shilling. I think generally when you have prices like this most people have flight to safety. So we have seen a bit of that in the market where some companies are buying their requirements ahead of time. Of course that is putting a bit of pressure on the shilling. We hope that that will settle out as we get a better picture of what the future looks like. But also we are constant touch with our regulator who has said they will support the currency in case there is a lot of volatility. I think for us it is to wait for the next few weeks and see where we settle. Of course if you look at the stock market we can see a few of the foreign investors who are also exiting the market in terms of flight to safety. But we hope that settles in the next few weeks. I think we have had a fairly strong currency and stable for the last three or four years. The depreciation also should not be looked at too negatively given that it is just about 4% or 5% that has happened in the last few weeks. Other markets have actually declined by 15%. So I still think Kenya is in a good space and the Shilling is still well priced in the market. Thank you.

Anthony Mburu
The question you are asking on NIMs, I think this is consistent if you look at our 2018 numbers with the IFRS adjustment on stage three interest income. So we have not been on a quarterly basis making that adjustment. We always make it at the end of the year. Probably there was a bit of increase in interest income out of IFRS 9 stage three adjustments.

Adesoji Solanke
What is this IFRS stage three adjustment? If you can just talk about it very briefly. That's my last question.

Anthony Mburu
So what happens is when you are looking at IFRS 9 and you do [break in audio].

Operator
James, are you still there?

Anthony Mburu
So it compares Q4 2018 and Q4 2019.

Adesoji Solanke
Sorry, your line went dead for about 20 seconds so I didn't hear any of your responses unfortunately.

Anthony Mburu
Oh sorry. You can hear me now?

Adesoji Solanke
I can hear you clearly now, yes.

Anthony Mburu

What I'm saying is IFRS 9 requires that we look at the stage three book and look at the suspended interest from that book and work out using your effective interest rate what would be the earning capability of that interest in suspense and do an adjustment back to income. That's why I'm saying that is what we did, and we also have done the same in December 2018 so comparatively year on year you will see the NIMs impacted the same.

Adesoji Solanke
Okay. Understood. Thank you very much.

Operator
Our next question is from Ronak Gadhia of EFG Hermes.

Ronak Gadhia
Good afternoon Patrick and team. Thanks for the presentation and taking the time. Just a couple of questions. You will be able to guess what I'm going to ask, but it is mostly on NPLs. I see that the NPL ratio is still a bit high. Could you just update us where you stand on the legacy NPLs particularly within the manufacturing and the real estate segment? Sticking to the NPL theme, your exposure to the personal loans segment is relatively high. Given that we might see a significant increase in unemployment within the economy could you talk about what your potential concerns are within this space? And then the third question is on Jamii Bora. You've indicated that they've got a very good niche that the bank is seeking to acquire. Could you just highlight what those are, because on face value it's difficult to see what they could bring to the table? And the final question is on your fees and commission income. A big increase last year obviously being driven by the MCo-op Cash loan product. Could you talk about the sustainability in this year given the disruption we're seeing in the economy? Thank you.

Patrick Nyaga
Thank you Ronak. Let me start with the last items on fees and commission last year because of mainly our e-credit platform. You were asking about the sustainability. I think this is one of the things we have looked at in terms of going forward. It has been a very good earning book. If you look at the book outstanding it is quite small, and therefore the risk is quite low. In any case we always do provisions on a monthly basis based on [unclear]. However in terms of sustainability we are aware that there are one or two issues that are coming through CBK and treasury, and therefore probably over time we will see some controls around that area. But given that we now have interest rate caps removed there will be a replacement effect. So if we are lending with high rates on the mobile network then of course with coronavirus, assuming that is done within three or four months, we will then be able to sustain our growth of income, not necessarily from the e-credit book but also from other sources of income like the loans and advances and also lending to government securities. That is already something that we have set ourselves in 2020.

Ronak Gadhia
Sorry, Patrick. I take your point on the medium-term view that this might not be sustainable because the CBK or treasury might clamp down on it. More the immediate term would you be comfortable providing loans at 8% for a three month period in the current environment where a lot of people are losing jobs?

Patrick Nyaga
These are things that we are reviewing on a continuous basis, because as we are talking right now nobody has really lost a job in Kenya at the moment. And even looking at the class of people that we target with the e-credit these are still people that are not on the lower end of the market. They are people who are employed by the government and stuff. So we may not necessarily continue lending to the volumes that we have been, but this is

something that we will monitor as we go by. We may not be so sure of what happens in the next two weeks, but for now there is a bit of a slowdown on that.

In terms of exposure to personal loans I think it is a similar answer because most of our personal loans, almost 90%, is on check off. Being on check off mainly to the government agencies, even if there were layoffs in some of the sectors, which would take a bit of time – it wouldn't just happen in one day even if coronavirus was to continue for another two or three months. We also have insured the book. And also maybe from a perspective of [unclear] benefits you can also get something. So we will continue reviewing the situation as it develops, but again we are not too worried because we haven't got to a point where there will be a critical mass layoff by the government especially. We are talking about teachers here. We are talking about military and security forces. By the time all those are rid of I think it would take a bit of time. Most of our personal loans are not to private sector individuals, and maybe that's where the greatest exposure would be.

In terms of the NPLs and what we are seeing, I think the whole of 2019 has been quite a bit of time to support especially the real estate. Manufacturing we are not very much exposed. Even though the percentage out of sector by sector is high I think we have mentioned in the past that that is one customer who has actually now turned back some production. So we are not too worried there. But in terms of the real estate there have been quite a number of strategies that we have used there to support the real estate guys including rescheduling some of their payments. The good thing is all these properties are there, they are finished, and therefore the security is there. As long as you can support the guys to reschedule their loans then we don't see a very big problem. I think we've already gone through the worst phase in 2018 and 2019. The only thing I cannot be so sure about is the exact impact of the current coronavirus pandemic. Again we will review that as go by.

You asked a question on Jamii Bora. Yes, that is a decision the bank has made. Jamii Bora is a small institution. They are quite good in terms of SME customers, micro and LPO financing and stuff like that. So again maybe what I'll say here is it's a buyer's market, so as long as the price is right then we are in business. Thank you very much.

Ronak Gadhia
Sorry, just a couple of follow-ups on that. Firstly on the real estate space what is your total exposure in terms of mortgages and those in the construction sector, developers? And on Jamii Bora it seems like they do have a decent franchise in terms of SMEs. That's what they're known for. But when you look at their loan book, at least the number that I'm seeing in 2018, 60% of that was NPLs. So the question is are they really good at banking these guys or do they really have a sustainable business model to begin with? Thanks.

Patrick Nyaga
Okay. So in terms of real estate our exposure is out of the total book in 2019 full year we are at 10%. Even if you combine that with building and construction which is about 2% probably you are looking at a total book of 12%. But again as I said, given that this lending is fully secured. The properties are there. Properties are finished. It is probably just a demand issue. The only thing is you probably might get the repayments extended for a longer period, but ultimately we will get the money back. In terms of Jamii Bora you are right in terms of the size of the book. Even if you look at our book in terms of SME and micro we are not as big. So any addition to that book will be positive. And in any case they have 300,000 customers which we can tap into. So that's why we are looking at it in that direction.

Ronak Gadhia
Okay. Thank you.

Operator
The next question is from Timothy Wambu of Absa.

Timothy Wambu
Hi Patrick and team. Just a couple of questions that I hope you will clarify. The first one is about the growth in mobile loans. You've seen a tremendous growth year on year. I have a question which might sound a bit dumb, but I want to find out do you consolidate this in your balance sheet. Is this part of your balance sheet loans? Tied to that is the increase in your credit related fees. So on these mobile loans because you are charging interest are there other fees which are associated with this lending rate, or is this the actual interest that you charge on those loans that appears under the credit related fee charges? Lastly to get a view on the payment of pending bills. How does that sit with Co-op Bank's bad loan book? I just want to get a sense. We have had figures being mentioned by treasury that they've been able to reduce the amount of outstanding pending bills. I think roughly it is about KSh 31 billion. How does that sit with Co-op Bank's book? And also maybe just speak about the trade exposure. If I'm not mistaken is it still linked to Nakumatt and Uchumi and what are your plans with those bad loans going forward? Thank you.

Patrick Nyaga
Thank you Timothy. I will start your second question. Now, our e-credit is not charged interest. It is charged commission and there are no other fees on that. So when we report in our financial statements we will report any income out of e-credit loans as commission income. But the e-credit book whatever balance is there at the end of the month is a loan book, so it is still consolidated as part of our loans and advances. However, what you will note is that although this book has a potential of giving quite a bit of income the quantum of the net book is very small. I think right now we are talking probably about KSh 9 billion for individuals and SMEs because we also have a small e-credit book on SME. So even though we have disbursed probably KSh 6 billion on a monthly basis the net book is total KSh 9 billion, so it would not bring a very significant impact on the balance sheet. It would not bring an impact on the P&L. In terms of the payment of pending bills I think Anthony will answer that.

Anthony Mburu
Timothy, thank you for the question. On the issue of the pending bills we have felt the impact in terms of liquidity but not in terms of loan repayments. Our loan book when we talk about building and construction and real estate it was largely to do with offices, residences and shopping facilities. We do not do roads and other government related infrastructure. That is where the bulk of the pending bills have gone. Where we felt it a bit is in liquidity because some of the SMEs and other corporates that had supplied goods to the government, those we have seen them get paid and get a little bit more liquid. And some of the trading loans have also seen a benefit in terms of repayment on the NPL front. But the majority of the money went into paying the infrastructure providers and we were not part of those who had financed the infrastructure.

The trade exposure in terms of Nakumatt and Uchumi, our exposure was only to Uchumi, KSh 200 million, and we were not exposed to Nakumatt. What you are seeing as trade facilities they are largely SME and the bigger issue for us was the issue of SME supplied who had supplied county government and also supplied the national government. And with the pending bills that were paid in December and January, and the ones that they are planning to pay now, we have seen those ones who have received money begin to service their facilities. And we anticipate that they will go back. Unfortunately priority-wise it looks like the money might have gone to the bigger players. I don't know whether it is first or what the other priority is in terms of the way the payments were done. But we have seen traders also get paid at the national level, and we are beginning to see that happening also at the county level. But as you are aware there is a verification exercise going on in counties.

Some have finished. Some have not. Also in the national government there is also a verification exercise. So as and when those finish – you can imagine there are many, especially SMEs, and they are not as good at putting their papers together – we are getting paid. So the impact there is slower. Those are the comments I would make on the trade exposure and the pending bills.

Timothy Wambu
All right. Thank you. Just looking at the breakdowns of your NPLs you mentioned that real estate, building and construction and those ones probably just account for not more than 15%. In terms of the outlook what are you seeing so far? Has the removal of the caps been positive? It might be too soon to tell, but I just want to get a sense of your real estate book exposure going forward and what you sense is changing currently. Thank you.

Anthony Mburu
Okay. One, in the last two to three years we have not done new projects. So the building and construction side of things the projects we have we are ensuring that they are viable, they are paying and we are getting our money back. You will see that book just reducing and whatever the expected credit loss that we had already taken provisions for on that book hopefully should start getting released as we move along as opposed to increasing the exposure there. The second question is around the real estate mortgages. This is the element of retail mortgages and those sorts of things. In that we are starting to grow. And yes, the removal of caps is starting to show demand beginning to come up especially around affordable housing and that sort of sector. So we are hopeful that once we have the risk models agreed we should be able to fulfil some of that demand. This is a more diversified book to create the demand side so that whatever supply is in the market can be taken up.

Timothy Wambu
All right. Thank you.

Operator
Our next question is from Anne Kahure of SBG Securities.

Anne Kahure
Good afternoon. I just have two questions. My first one is on what proportion of your fees are actually impacted by the bank to MPESA and PesaLink fee waivers. The second one is on your cost of funds. I actually noted that there was a slight improvement, and my question is what have you done differently from before? And is this the new norm or could it go lower, and what would that entail?

Patrick Nyaga
Thank you Anne for the question. I will start with the last question on cost of funds. I think we have been really keen on trying to manage our cost of funds in the past one year. Of course that has also had an impact on the growth of our deposits, because some of deposits that we were getting were expensive and we had to turn them away. So we also had a balance in terms of growth on deposits vis-à-vis the interest that we were paying. And we think we struck a good balance in 2019 given that there was also not too high growth in terms of credit. We expect that to continue subject to the economic conditions. And with a decline in interest rates which we are seeing in the market currently we expect to be bigger beneficiaries given that we still have a bit of headroom to work on compared to some of our peers who look like they are really at rock bottom.

So from our perspective it is something that we think will play out in Q1 and Q2 of 2020 subject to liquidity conditions and of course the market. But it is something that we are really keen on internally to see how we can get some benefits from the cost of funding. We are really trying to be competitive but at the same time not giving away too much value in terms of pricing. We are also keen to grow our deposits, especially the current accounts and transactional accounts which are benefitting the bank in terms of balance sheet growth, but at the same time we are not paying too much for that. So a lot of the actions that are happening across the enterprise are to build up our accounts and make sure that we are gaining a lot of traction in terms of lower cost of funds by offering all our channels to our customers who are then able to support us with average balances in accounts which are growing year on year. And we perceive that that will be a big benefit into 2020. Thank you. And you asked about our fees and commissions in terms of MPESA transactions, bank to MPESA, MPESA to bank and all that. I think on an annualised basis we are probably looking at about 4%. Sorry, 5% to 6%. Thank you.

Anne Kahure
Thanks for that. Just to confirm, Patrick, it's 5% to 6% of your fees and commissions, total commission income.

Patrick Nyaga
Out of total commission income.

Anne Kahure
Okay. All right. I think that's it from me.

Operator
Does that answer your questions, Anne?

Anne Kahure
Yes it does, thank you.

Operator
Our next question is from Bernard Kiarie of African Alliance.

Bernard Kiarie
Hi Patrick. Thank you for the call. Mine are just two quick questions. The first one is around your personal lending. I just wanted to understand given the significant jump in personal lending could you give us more colour in terms of what the nature of these customers are maybe in terms of how you see them deploying the funds. Where exactly do you see them deploy the funds? Then the second question is around your mobile loans. We saw a huge jump on that. What are your currently NPLs on the mobile loans? Thank you.

Patrick Nyaga
Bernard, thank you for the questions. I will start with the issue of deployment on personal loans. By and large, Bernard, the personal loans are deployed into development. Most of these are customers who are employed and are trying to develop themselves. So the money ends up in various areas. One of them is into land. Maybe somebody wants to put up a house, so they buy land. And after some time once it is clear, that loan, they will take some more money and build a home and all that. That is why it competes to some extent with the whole issue of mortgages. A survey was done by a mortgage finance company that indicated that there is a lot of that sort of borrowing, this money that is ostensibly for consumers but it goes into development of homes. That is why our mortgage market looks so small. It is just a question of borrowing in a different manner for the same purpose.

The second area where this money goes into is business. Many people who are employed have what is known colloquially as a side hustle. So a lot of that money goes into those side hustles. You find that the same person who we are seeing on the salaried side is also on the SME or micro side as a businessman and he probably has capitalised his business from this sort of personal loan. So they are able to pay them because they've got the salary and ability to pay, and they are able to generate additional income. And so the stability of the personal loans is reasonably good. You have seen even from an NPL point of view that book has been relatively stable.

Your second question was about the mobile loans and NPLs. We started with a very low NPL of 1.8%. Currently we are trading at around the 6% or 7% mark as far as NPL on this book is concerned, which mirrors to some extent what we see in the personal loans. The structure we gave for our book is that we are lending to our loan customers as a form of an advance who already have a salary account with us and most likely already have another relationship with us either as a personal loan customer or as a business loan customer under the SME. So because of that structure we've seen the NPLs there have mirrored to some extent the NPLs we see in personal loans which are less than 5% and in the SME book which is averaging around 6% or 7%.

Bernard Kiarie
Just a follow-up on that mobile lending. Given what you registered in terms of growth in 2019 do you see the same growth trajectory going forward or was that just a one-off spike in the lending on mobile loans?

Patrick Nyaga
I think to be honest the first year you start something there is always that huge quantum growth or quantum leap. So we don't expect that 2020 will have the same rate of growth as in 2019. To some extent we still think that there is room for growth, but not at the same rate that we saw in 2019.

Bernard Kiarie
And the NPL ratio, do you feel the 6% to 7% is the normalized range for that book?

Patrick Nyaga
As long as we stick to the formula of working with the customers we already know and don't get too aggressive in terms of going outside the people we know we believe we should be good as far as this is concerned. Yes, we have thought of being a bit more aggressive and buying customer data and stuff like that, but we appreciate that it will come at a cost. So for the time being we are sticking to our own known customers. And if we grow, we grow organically by growing the salary based customers and the SME customers, which is why you see us interested in growing our customer base even through an acquisition.

Bernard Kiarie
All right. That's all from me. Thank you.

Operator
We have a follow-up question from Ronak Gadhia.

Ronak Gadhia
Thanks. Just a final one. I guess in the last few minutes as we've been talking the central bank has reduced the CBR rate by 100 basis points and the cash reserve ratio also by 100 basis points. Can you highlight what percentage of your loans is linked to CBR, and early thoughts on what the reduction of CRR could have on your business? Thank you.

Patrick Nyaga

Ronak, I was hoping the phone call would end before that question came up. On a lighter note, are you good, Ronak?

Ronak Gadhia
I'm good. I hope you guys are safe.

Patrick Nyaga
We're safe. We're trying our best. Let me say that the reality is that when the interest rate caps were removed the law removed linking of loans to CBR. So as it stands today no loans are linked to CBR. And that is our position and that is our interpretation of the market condition. So banks obviously have been desperately trying to put in place other mechanisms or other ways of linking their loans. And the loans that were outstanding at that time were then fixed at a specific rate, which is 13% per annum. In our case depending on market conditions we have sometimes given a gesture of goodwill and reduced our rate of interest for those old customers that were with us as a sign of where we have got benefit of reduced costs and things like that we pass on the benefits. But for the new loans we are strictly sticking to risk based pricing. We are just waiting for a signal that we may go ahead with our risk based pricing for the new loans.

Strictly speaking none of our loans are linked to CBR directly, but there is that element. Given the market conditions even the statement talks about COVID-19 every other line almost. So it is not a technical decision. There is a technical [unclear] into it, yes, but there is also the reality of the situation which must be taken into consideration. Our committee will be meeting on Thursday and we will be assessing the statement and situation much more closely in a lot more detail, and then we make decisions as we go ahead just to put a bit more detail and colour to this issue. Yes, there was already an anticipation that this could happen based on the circumstances we are in. We will be debating that in a lot of detail on Thursday.

Robert Aloo
Ronak, thank you. This is Robert. I will just a point in terms of CRR internally. I think as has been pointed out it is positive for the market in terms of more liquidity. Given that these are extraordinary times I think more liquidity will at least help the markets to float and hopefully money can still move around. I think for us as an institution it is positive given that it will also release more funding for us to utilise for many of the emergency needs, plus also our customers who may be coming for various accommodations during this time. So I think in the next few weeks we will see how that KSh 35 billion moves around. For us of course as a ratio it has given us a headroom of about 100 basis points on our CRR account. And hopefully that will be liquidity that can be utilised to fund various other clients who come on board, and we are able to then sustain ourselves during these trying times. Thank you.

Ronak Gadhia
Thanks a lot, guys.

Operator
Our last question is a follow-up from Adesoji Solanke.

Adesoji Solanke
Thank you for your comments. I just have two quick follow-ups. Did you say the cash reserve costs were KSh 35 billion for you? Is that what you were implying? My second question is just to clarify what happens when you restructure a facility. Can you just run us through what that process is? Do you have to classify it as stage two, and if so, what sort of provisions do you need to take on both your stage one and stage two loans? Thank you.

Robert Aloo
Okay, this is Robert. I will go first in terms of the CRR. The CRR has just been reduced from 5.25% to 4.25% across the industry. As per the governor's statement that releases about KSh 35 billion for the industry. Now, for us as a bank of course we are about 10% of the industry, so you can do the math. It would be about KSh 3.5 billion for Co-op Bank specifically. I think for us it's to see how that will pan out and how liquidity will behave in the coming days. Liquidity is something that people cherish in times of tightness, so we will wait and see how the industry plays out. It's a positive move and we will see it being done across the world. But as our director said, it is something many people were expecting and hopefully it will give the economy a boost and we are able to see some positive times ahead. Thank you.

Patrick Nyaga
Solanke, on the issue of restructures there are two interpretations. From a CBK perspective they have made it very clear that if the restructure is because of the current situation we are in, in terms of COVID-19, as we are able to get in and out of the situation within the next 12 months, then the impact as far as additional provisions is expected to be minimal. We are not going to be doing restructures that are beyond 12 months. Largely it will be a three or six month window, and after that we expect things to bounce back. And once they bounce back then there would be no additional provisions required on that portfolio. But when it comes to IFRS 9 and the models that we run, yes, already the book had very aggressive transition matrices in terms of grade movements because when we did those models we were working with a period when NPLs had risen very rapidly. We worked with those models during the 2015 to 2017 period when the rate of growth of NPLs was in the region of about 40% or 50%. So that is already inside the models.

Even if we talk about restructure the issue is has the grade changed, and if the grade is changing what is the probability of default, which had already been factored very much earlier on in the model. So we don't see a massive increase in NPLs over the next 12 months. Obviously the models are remaining the same, but obviously as those matrices pan out, as the actual happens, we will begin to flow that data back into the models. But just very off the top of my head because of how we did those matrices at that time, the models at that time, I think you might not find it having a very significant difference for now. So that's the situation as far as stages one and two are concerned. We expect that yes, there will be some higher expected credit loss, but not as aggressive because we already have taken a very aggressive stance as we designed the models.

Adesoji Solanke
Okay, understood. Thank you very much.

Operator
Thank you. James, do you have time for one more question?

James Kaburu
Yeah, we can take one more.

Operator
Thank you. The last question is from Kasee Mbao of Old Mutual Investment

Kasee Mbao
Hi James.

James Kaburu
Hi Kasee.

Kasee Mbao
Thank you for allowing me to ask my question. My question is mainly on the NPL book. [Break in audio] from watch to substandard of about [break in audio] year on year between [break in audio] as a result of that. Another question would be in terms of [unclear] securities that you are holding in terms of discounted value of securities, what percent of it [break in audio] and what is the average discount rate applied to those properties or land in terms of value as at 2019? And the NPL ratio for mobile lending, I think I got cut off. I did not hear the number for that one. Kindly just [break in audio] three months lending [break in audio] the mobile lending.

Patrick Nyaga
Kasee, we are obviously always happy to have a discussion regarding NPLs. Unfortunately you kept breaking up as you were speaking, so I may have missed one or two things. I guess you will clarify if I missed something. But I heard you ask about the issue of NPLs, the move from watch to substandard. What are the provisions? Is that what caused the provisions to increase? And secondly around that it sounded like you were asking what are our discount ratios for the securities we are holding.

Kasee Mbao
Yes.

Patrick Nyaga
Kasee, as you are well aware, the discount ratios we do is the minute you declare an account non-performing every year we do a 20% discount. So most of these loans went back in 2015 or 2016 so at the moment we are holding many of them at close to about 50% to 60% discount to the market value of those properties. 2019 was three or some of them four years later. So there have been pretty heavy discounts as far as our securities are concerned that are property related. Obviously where they don't have property the securities are discounted 100% within the first year and you immediately take the provisional hit as far as that is concerned as far as IFRS 9 is concerned. But for CBK, which does not drive the financials you see, clearly there we are allowed to take a lower provision figure as far as that is concerned. That is the principle that we have used to determine our security discounting. So on average 40% to 50% is the discount ratio on most of our securities.

The third question I heard you ask seemed to be around mobile lending, the NPLs. I think what I said earlier on is that we are at about 6% to 7%. The personal loans are less than 5% NPL. That is the mobile loan lending to individuals who are salaried. Part of our product is to individuals who are salaried whose salaries come through us. The other part of the product, which is a smaller part of the product, is to businessmen who bank with us whose turnovers are with us. And we lend against those turnovers. There the NPLs are slightly higher at about 7%. So overall we are averaging at around 6% as far as NPL ratio on the mobile loans is concerned. Our loans are between three and six months. We do have products at one month, two month and three month. And then for the businessmen we have a product for them up to 12 months. But the average then comes to about three and a half, almost four months across the board. I don't know if that's exactly what you asked, but I've tried my best. Some of it broke. Maybe you can clarify if there is anything I've missed.

Kasee Mbao
You have answered most of the questions. I have a follow-up and a clarification in terms of the switch from watch to substandard. Is it possible to get the…? [Overtalking]. There was KSh 3 billion. 2018 to 2019 you find

that substandard [break in audio] and watch had a decrease of KSh 3 billion. So there is a loan that went from watch to substandard

Patrick Nyaga
Okay. I got your question. [Overtalking].

Kasee Mbao
What are the risks of that? What effect will that have on the provisions, if you can give a figure? [Break in audio].

Patrick Nyaga
Kasee, your phone is really not clear. We are not able to hear exactly. Can you repeat again?

Kasee Mbao
Can you hear me now? Hello?

Operator
Apologies. Kasee, unfortunately your line is extremely bad. The quality is not good at all. James, is there a possibility that he can email his questions to you?

James Kaburu
I think that would be much better.

Kasee Mbao
I will follow up with James then. Can you hear me? I will email the questions to James.

Patrick Nyaga
Kasee, the line is really breaking so we are only hearing bit by bit. I think it's okay if you can email us the questions and then we can respond. We can even call you on a line which is clearer.

Operator
Thank you. Sir, those are all the questions we have. Would you like to make any closing comments?

James Kaburu
I want to take this opportunity again to really thank you for your participation this afternoon. We are available for any extra telephone conference or even email communication. So again we will still be engaging with you even to discuss the ongoing events which are happening in the country and in terms of the bank as we look at the year going forward. Thank you very much and have a good day.

Operator
Ladies and gentlemen, that concludes today's conference. Thank you for joining us. You may now disconnect your lines.

END OF TRANSCRIPT