Conference Call transcript

21 November 2016

Q3 2016 RESULTS

Operator
Good day ladies and gentlemen and welcome to the Co-operative Bank of Kenya third quarter 2016 results conference. 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 James Kaburu. Please go ahead.

James Kaburu
Good morning, good afternoon, good evening everyone. Welcome to Co-operative Bank of Kenya's conference call to discuss the third quarter 2016 financial results. With me is Mr Patrick Nyaga, our Group Finance and Strategy Director. I also have Mr Anthony Mburu, our Group Director Credit Management. I also have Mr Robert Aloo, our Group Treasurer, and I also have Mr Anthony Muli, our Group Bank Economist, and my name is James Kaburu, Head of Strategy and Investor Relations. I now invite Mr Patrick Nyaga, our CFO, to take over from here.

Patrick Nyaga
Thank you James. Good day ladies and gentlemen. As James has introduced us we are here to go through the quarter three announcement of our financial results. Before I say anything I think we took this opportunity to give you a few days to review the papers that we had sent to you. Our investor briefing locally was on Saturday morning and we decided to do this conference call today so that the PowerPoint presentation and the write-up that we sent you could have read them a bit, and I hope you have. So I will probably not go through the PowerPoint presentation slide by slide, but I will give some highlights completely away from the slides and then we can have probably the bigger session being questions and answers.

So in terms of the group performance the group was able to do a profit before tax of Kshs 15.2 billion from Kshs 12.2 billion in the same period last year. And that was 25.2% growth. And from a PAT perspective that was Kshs 10.5 billion compared to Kshs 8.6 billion same period last year. And that was a 22.3% growth. As you are all aware I think earlier this year we saw the interest rate cap, but that has not deterred growth in business at least for this year. And as a bank one of the key things that has helped us make these good results I the fact that we have continued with our transformation. As you are aware it has been targeted on various fronts and we are continuing to pursue those fronts even now, mainly branch transformation and channel migration. And now we are looking at about 85% of our customers now using the alternative channels.

We have been focussing on enhancing the front line productivity and sales force effectiveness. This is probably where we focus most of our staff within the business to sales. And as we are talking 63% of our staff are now focussing on front line or in terms of selling. We continue with our digitisation and automation and we are currently running a big project in terms of data management or data organisation. And we have actually invested quite heavily in terms of some skills in that area.

So we will continue pursuing this strategy. We have also seen a bit of benefit, for example our cost to income ratio has reduced from 53.2% in December 2015 to 47.1% as at September 2016. That is excluding provisions. We are hoping that as we continue doing this we will see us maintain the cost to income ratio despite the hit on the top line out of the capped interest rates.

So basically that is where we are. You have seen our NPLs maintained at about 4%, meaning quite a bit of work is being done on the credit side. And generally we are projecting that we will close this year 2016 at relatively a good growth of about 22%. In terms of going into next year probably a bit of projection. Of course we will be starting January with a bit more depressed PBT compared to the same period this year of 2016. But again we have been doing quite a number of things to make sure that that gap is not as huge. And towards the middle and end of the year we expect to have closed that gap, and therefore report at worst the same profitability like 2016, maybe a small growth of about 10% of thereabouts.

So basically that's where we are as a business. The key thing is to continue with our transformation because it is bearing fruit, both building the top line in terms of income and managing the operating expenses, and therefore trying to at least maintain our PBT. I think with those highlights I request that we get into questions and answers. Probably we can explain a few things more as we get the questions. Thank you very much.

Operator
Thank you very much, sir. Ladies and gentlemen, at this time if you 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. Again if you wish to ask a question please press star and then one now. Our first question is from James Starke from SBG Securities. Please go ahead.

James Starke
Good afternoon everyone. Thank you for the call. My questions relate to deposits. Firstly in your presentation you have guidance and it looks like the deposit growth guidance has been revised down from the 10% to 15% range to 8%, which was the guidance from Q2 results. So if you could talk us through what has changed in your business that has caused you to revise down your deposit growth? And on slide 39 also relating to deposits we can see government deposits are down to 16% from 22% of the mix while corporate deposits are up from 2% to 9% of the mix. If you could talk us through some of the activity underlying this and what is driving the shift in the deposit base. Are there perhaps reallocations and that sort of thing? And then lastly it looks like you shed deposits in the institutional retail and corporate and SACCO sector quarter on quarter from Q2 to Q3. If you could just talk us through what is going on there. Thank you.

Patrick Nyaga
We can take a few more questions so that we respond together.

Operator
Thank you, sir. Our next questions would be from Ronak Gadhia from Exotix. Please go ahead.

Ronak Gadhia
Thank you. My question is more or less in the line of James, but apart from that if you could just provide details on the first month or first two months of operations since the interest rate cap has come into effect, how that has affected your average lending rate and your average deposit rate. The second question is to do with opex.

Patrick Nyaga
Sorry Ronak. We didn't hear the first question. There was a bit of interruption. Just repeat it please.

Operator
Gentlemen, while we try and get that line sorted let's move on to the next person, Steve Motsi of BPI Capital Africa.

Steve Motsi
Hi. Thanks for the call. Just two quick questions from my side. Beyond 2016 what sort of ROEs do you see for the business and secondly how do you see your NPL ratio holding given what has happened to the interest rates? Thank you.

Patrick Nyaga
Thank you. I think we can answer those three questions, the first one being from James on deposits. Yes, we revised our deposit projection to 8%, and this is mainly because if you look at our balance sheet quarter one, quarter two and quarter three you will notice… Maybe I should start from 2015. We had quite a bit of deposits in 2015 and quite a number of them were very expensive. Come into 2016 we realised that the growth in loans was not as much. And therefore what we decided to do is make sure that we maintain a level of deposits commensurate to our loans, and therefore shed most of those deposits that were expensive. And in any case there was no need of keeping very expensive deposits in the balance sheet if you are not lending those.

And the only opportunity was to do government securities. A number of those deposits have really been up there to the tune of 20%. At the time then the government securities came down to the levels of 11% or 12%. So that's one of the main reasons that as at quarter three we hadn't grown our deposits much. In fact we had grown our deposits by about 1.2%. Therefore although we are now picking up pace towards the year end going to 15% was going to be impossible even from a statistical perspective. So that is why we have revised our projection to 8% for end of this year.

In terms of slide number 39 looking at the deposit mix there I think probably this is another issue of statistics. If you consider the overall deposits roughly the same if you shed some segments then the percentages will vary a bit. But again if you look at it, it is not any significant change. It is probably very minimal change that has happened. It is just a bit of realigning. I think probably our treasurer can shed a bit of light on that.

Robert Aloo
I just wanted to rehash what Patrick has mentioned in terms of the cost realignment that has happened on our balance sheet in terms of 23% on government dropping to 16%, mainly on account of the deposits we were shedding off which were highly priced which were maybe in the bucket of one year. And we had to release some of those because of the cost. But now again we are picking up that deposit growth. That is why we are saying our growth might not be 15%, slightly less as we approach the end of 2016. Thank you.

Patrick Nyaga
The other question was from Steve Motsi in terms of ROE. I think as a bank we have maintained ROEs that are on or about 25%. I think we are projecting ROEs of about 23% by the end of this year. But in 2017 we are looking at anywhere between 20% and 22%, again mainly because of the interest rate cap. We have shed a bit of our income even though we are trying to replace those as we go by. In terms of NPL we are current at about 4%. We don't seem to… Because of some of the strategies we put in place – and I think an additional comment will be given by our Director Credit Management – we have been managing our book very well. And actually our projection for NPL for 2017 is at most 4.5%. So that is the projection we have at the moment.

Anthony Mburu
Let me add to what Patrick has just said. At the moment given where we were when interest rates were high in the region of an average of 18% or thereabouts, there was an element of risk in terms of NPL going up. But now that interest rates have come down the impact has been positive with customers having a better or an easier repayment situation. And therefore we have seen improvement in what we call the portfolio at risk, which is before NPLs in terms of those who had delayed payments, those who had short payments, those who had challenges with paying. We have seen a much better improvement in terms of the repayment history and the repayment experience.

So barring issues to do with a slowdown of the economy in an election year – which is what we are factoring in to an NPL of 4.5% from an average of 4% in the last year – we have seen an improved overall position. But we have factored in a higher situation arising out of possible slowdown of the economy given the fact that when we have had an election the economy tends to slow down. So we have factored that across the retail in terms of possible attrition from jobs in the private sector and across the business segment a possible drop in demand that might arise. So that is the only thing we have factored in, which is why we have taken a more conservative position of 4.5%.

James Kaburu
Chris, you can go ahead.

Operator
Thank you, sir. Ladies and gentlemen, again if you wish to ask a question please press star and then one on your touchtone phone. Our next question is a follow-up from James Starke. Please go ahead.

James Starke
Hi. Thank you. Just turning to IFRS 9 for 2018 can you give us a sense of what your internal modelling indicates around what kind of increase you expect on your provisioning as a result of your migration to IFRS 9? And the second question, unrelated to the provisioning, is your opex growth excluding credit losses was pretty aggressive year on year up 22%. I know there are issues relating to the staff bonus accrual which may have base effects, but what else is driving your opex and what is the outlook? What kind of tempo can we expect for opex growth going forward both into the end of this year and on into 2017? Thank you.

Patrick Nyaga
Thank you James. On the first question I think it is a bit too early to give you that number. Currently we are actually engaging a consultant to help us with IFRS 9 modelling and this whole issue of the gap analysis and the implementation of what is the likely impact into our books. I think by next week we will have probably agreed on the consultant and probably by January latest that's when we are expecting to have at least a fair idea of the gap. So at the moment we have not analysed that. Probably we will be discussing that as we release the end of year results.

In terms of opex, yes, there has been an increase in opex but this is mainly because there have been several one-offs. One of the key things that have increased that at the moment is that we have had a bit of write-offs around some charges that had been accumulated over time. We realised actually they are not correctable. This is to the tune of about Kshs 800 million. Therefore once you start providing for those because we are cleaning up that's the main reason why the opex has come in for this year. We do not expect that to recur next year. We have also changed our policy now that any surcharge that is not recovered n the next one month is reversed. Therefore we will not be having a problem. Of course the Kshs 800 million has been an accumulation for a period of time, actually more than a year. So I think once we do that clean-up we will not see such an increase. However, business is still growing to some extent and therefore we would probably expect a 5% to 8% normal growth in opex. Thank you.

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

Ronak Gadhia
Hi again. Apologies for earlier. I guess you have provided some guidance on this, but can you just provide some detailed numbers on the first two months since the interest rate cap has come into effect? Can you just provide the numbers in terms of what the average loan yield has been, how it is has declined, and likewise what the average cost of deposits has been and how that has changed compared to the first nine months of the year? My second question is to do with growth. Do you have some growth estimates for next year in terms of deposit and loan growth given the interest rate cap and also the upcoming presidential elections? Then the third question is more in line with what James was just asking. You mentioned that there has been a once-off cost of about Kshs 800 million. That would bring down your other expenses quite a bit once you take that out. But even you staff expenses are growing quite significantly. We would have thought given the investments you made in alternative

banking that staff intensity or the growth in staff intensity should reduce. Can you just guide as to why staff expenses are growing so significantly? Thank you.

Patrick Nyaga
Thank you Ronak. Very good questions. Thank you for that. I will start answering the questions from behind. In terms of staff expenses one of the things we did as explained earlier in the other call is we changed the way we accounted for staff bonuses. Instead of having staff bonuses debited in the P&L in the year they are paid we are now accruing them in the year they are earned. So in effect what that means is 2016 has two bonuses in it, one bonus that was paid for the 2015 performances and an accrued bonus that is going to be paid early 2017 but relating to 2016. So basically if you remove that impact staff expenses would not grow at more than 2% or 3%. In fact looking at the number of staff as at end of last year between last year and now on normal natural attrition we have reduced our staff numbers by about 400. So our costs will not be increasing on account of that. it is purely because of this accounting change that we made earlier in the year where we started accruing bonus in the year it is earned as opposed to the year it is paid.

In terms of growth estimates I can shed some light on that. Normally on a year that there will be a general election in Kenya the growth in balance sheet especially the assets drops by about 5% to 6%. Therefore the kinds of projections we are looking at next year for us is 15% on loans, mainly because even though there may be an impact on direction I think the fact that interest rates are lower and more people could afford loans there could be a positive impact of that. So we are looking at 15% growth. Deposits we are looking at about 14%. Again with a bit of opportunities on loans we project that will grow by about 14%. This time we are closing the year with a relatively good deposit mix. And the fact that they are not expensive at all we should be able to grow deposits to an extent in 2017.

We are projecting a 4% growth in total assets. That is our balance sheet. In terms of PBT as I had mentioned earlier we are looking at best maintaining the same position as this year given the impact on income. NPL I spoke about 4.5%. Cost to income ratio again our desire is to be at 45% but from a projection perspective we are saying anywhere from 45% to 48%. Net interest margin we are looking at about 8.5%. We were able to grow this year at about 9% as we get the full year impact of the interest rate cap. Cost of risk is likely to remain at about 1.2%. And I had mentioned ROE at about 20% to 23%. And return on assets at about 3.5% to 4%. Those are the kinds of projections we have done. We are looking at our numbers for 2017 more critically. We are stress testing them. But I think we will confirm them around those parameters I spoke about. I think I can ask James to confirm the yields after interest rate cap. Thank you.

James Kaburu
Yes, Ronak. Just like Patrick has just indicated, what we have seen in the last two months since the interest rate capping we have seen our yield come down to 13.7%. That is the average we have. We have seen a stable cost of funds. In the last two months our NIM has been around 9%. So as we project going forward we are looking at an average of between 8.5% and 9% NIM.

Ronak Gadhia
Okay. James, you mentioned a yield of 13.7%. Where has it come down from?

James Kaburu
It came down from 16.2%.

Ronak Gadhia
16.2%. Okay. Just as a follow-up question Patrick mentioned 15% loan growth, which is very good especially given it is an election year. But can you just maybe talk a little bit about the risk appetite around that? Interest rates have clearly been capped but it seems despite that banks are willing to continue growing their risk assets.

James Kaburu
Ronak, before our director answers that let me just reflect on terms of the yields before. It was 16.2% but actually the yield itself was around 14.6%.

Ronak Gadhia
14.6%. Okay. So you have seen a 90 basis point decline.

James Kaburu
90 to 100 basis points.

Ronak Gadhia
Okay. Okay.

Patrick Nyaga
Ronak, can you repeat your second question on the risk appetite?

Ronak Gadhia
It seems the effect isn't as pronounced as initially feared, but nonetheless it would be interesting to get your perspective on how you perceive the risk reward dynamic of the sector following the introduction of the rate caps.

Anthony Mburu
Thank you for the question. This is Anthony. Let me just say that in terms of the first impact of the interest rate capping we have seen an increase in demand especially in retail loans. That is the consumer loans. And there has been a huge impetus in terms of volumes and values at the retail loan end. What we are now seeing is secondary demand is beginning to come in at the business side where we are beginning to see an increase in demand for business loans. Now, from a risk appetite point of view we remain at the same level. Our credit policy has not changed in terms of the parameters for taking on risk both at the retail and the business and corporate and cooperative side. Those are the segments that we focus on.

Our credit policy has not changed. We still remain at the same level of risk appetite. The only area we are focussing on is on the operational side how to reduce the operational cost of delivery. We still think that the risk costs will remain the same, but we are trying to find different ways to reduce the operational cost of delivery of the lending especially into retail and the micro end of the business. So we have adopted e-channels or electronic banking channels for delivery purposes starting with the mobile channel where we have transferred some of our micro lending onto the mobile channel. Some of our retail lending.

So we have had some good pilots as far as that is concerned, and we now want to ramp up the volume of business that we then do through the electronic channels after having tested some of the algorithms that is moving away from judgemental to formula-based decision making, and in that way increasing efficiency on the decision making and allowing us to do more volume at lower cost per transaction. So on the risk side as I said – I am just repeating myself – we have not changed the policy but we are focussing a lot on the operational side.

Operator
Thank you very much, sir. Our next question is another follow-up from James Starke. Please go ahead.

James Starke
Thank you. Just to revisit your presentation from the second quarter in it you had guidance of 28% for your ROE. In your latest presentation that guidance has now dropped to 25%. And I'm gathering in the presentation it says 25% but on the call you mention a 20% to 22% range for ROE. Perhaps can you just clarify? Has all of that changed solely due to the interest rate cap, or what is the source of the discrepancy in those three ROE guidance numbers?

Patrick Nyaga
James, I think you have answered it because if you look at the profit projections we had done that has been impacted a bit by the fact that there was interest rate caps. As at end of August our PBT came down in September by about Kshs 500 million per month. That is purely the reason why we are revising those. And even looking into next year the fact that if you look at the monthly profit that we are doing in a full month after interest rate cap, which is November and December, then that informs us into January next year. And most likely even though we have done a lot of work to try and make sure we close that gap. Anthony will talk about very good growth in terms of loans. Those are the things that are making us revise the ROE and especially into next year. Thank you.

Anthony Mburu
James, the only addition I can make – this is Anthony – one is that when we did the ROE in quarter two clearly our margins were on the up and up because we were beginning to get better cost of funds. On the lending side we were at 19% with the same sort of lending margins, and if anything they were starting to increase. So the interest rate cap obviously there was a sudden shift in direction. And we factored that into the equation and that's why in the numbers we had indicated 25% based on the numbers as at quarter three. The numbers in quarter three have less than half a month of impact as far as the interest rate cap is concerned.

Now in projecting we are a little bit more informed after the end of the month because as we are speaking we have seen the October and half November numbers. So we are a little bit more able to speak about a projection of 20% to 22% which is what I think Patrick was alluding to. Every day we are getting information and so we are able to speak more to the numbers based on slightly later information.

But let me say that those are conservative positions that Patrick is taking. We have seen volume growth in terms of loans and we believe that that volume growth will compensate some of the margin decrease that we've seen. Conservatively we are talking about 15% growth in loans into next year. But if the volume growth we have seen out of the interest rate reduction can hold, I'm sure the economist will say more about it in terms of the other factors that could affect it. But our view based on what the economist has estimated is that that 15% we could beat by a little bit. So we are hopeful that will then change the scenario in terms of the ROEs.

Then the second is that the other transactional incomes arising out of initiatives we have going on around business banking, which is the SME space. We have got other initiatives around transactional banking and initiatives around trade finance that we think should also come in to compensate for that. So yes, the range is 20% to 22%. We are hoping to close closer to 22% than 20%. And the reason for the three sets of numbers is one was with quarter two only, 25% is with some information on caps but only a very short period of history, only 14 days of history by the time the numbers were coming through. And now 20% to 22% is with the October and half November numbers as a base. Maybe Anthony can talk a little bit about the economic fundamentals.

Anthony Muli
Okay, James. Thanks for that question. This is Anthony Muli. Our projections especially in 2017 are also based on the parameters around the industry. Key among them is where nominal GDP might be in 2017, and also CBK is projecting the level of private sector credit growth. If you look at the latest projection you notice especially for the period up to June 2017 – half year of next year – [unclear] is expected to grow at about 15.5%, overall private sector at about 13%. So historically if you look at our numbers most of the quarters beat the general industry level. So we are almost confident that we are likely to grow at about 15% into 2017. Thank you.

James Starke
So if I could clarify on the ROE is this 20% to 22% range what you are currently achieving at the moment on a month on month basis, or is that your guidance for the full year for 2016 based on what has gone before and where we are now?

Patrick Nyaga
James, it's a guidance.

James Starke
For the full year?

Patrick Nyaga
For the full year of next year.

James Starke

For next year. Okay. And for 2016?

Patrick Nyaga
2016, James, we projected that we are likely to be at 25%.

James Starke
Thank you.

Patrick Nyaga
We have eight months of having done that without the interest rate cap.

James Starke
Okay. Thank you. If I could just move quickly then to your coverage and what you are targeting for the end of this year, and then on into next year for 2017 bearing in mind IFRS 9. I understand you may not yet have a clear picture, but what level of coverage are you targeting on both the regulatory format basis and on an IFRS basis?

Patrick Nyaga
Thank you James. The coverage as at Q3 in terms of IFRS we are looking at 42.9%. In terms of CBK we are at 71.7%. I think the coverage in terms of IFRS by the end of 2016 will probably not change significantly, probably at maximum 45% because we are doing the provisions almost uniform to what we did in September 2016. In terms of CBK we would probably maintain around the same figure of 72% to 75%. But into next year because we have not really done the IFRS numbers I may not be able to comment fully on that. I think we should be able to give that confidence around quarter one when we have done that model with the consultants.

James Starke
Thank you.

Operator
Thank you. Our next question is from Godfrey Mwanza of Absa Asset Management. Please go ahead.

Godfrey Mwanza
Hi. Thank you for the call. I just have a question about loan growth into 2017. I mean the increase in loan demand since the interest rate cap seems to me – and please tell me if I'm wrong – to have come from two different sources. One is existing customers of the bank where you basically keep the same monthly payments but increase the face value of the loans because the interest rates have come down. And second is other banks' customers, tier two and threes, who are struggling with liquidity and/or profitability and getting that market share. So these are the two sources. My question is about sustainability of those things because before the rate cap there was a very clear decline in loan growth. And then of course in any election year there is naturally a decline in loan growth. So it seems to me it is not necessarily that this loan growth that you have seen since the rate cap is driven by underlying economic dynamism. And if anything it should be lower than normal given the elections. The question is how sustainable is this existing customers having the face value of loans increase and increase in

market share from tier twos and threes? How sustainable is that, because surely if I'm someone who was in that position I would do it immediately. How much more is there in the market to actually gain market share and also have your existing customers increase their face values?

Anthony Mburu
May I respond? Are you done?

Godfrey Mwanza
Yes please. Yes, I'm done.

Anthony Mburu
Thank you very much for that question. I think it is something that we have also been asking ourselves exactly what you are raising. You are correct. We have seen demand from existing customers. We have also seen demand from new customers. Let me say initially the first increase in demand we saw was in the retail space. And in the retail space there was a period where the demand reduced because of where the rates were. And when we look at previous patterns in terms of demand you could see clearly the rates were the biggest driver to the slowdown in demand.

So we have got markets that we normally service around the retail space and we know what the demand levels are. And we also know what the patterns are in terms of demand during the course of the year as people get increments in salaries, as people get bonuses. We know what the ups and downs are on a retail basis in terms of demand and the pattern has been affected by the higher rate of interest. So we think if those interest rates sustain where they are we think the demand patterns will go back to normal. That is part of our confidence in terms of the sustainability. Yes, there will be a windfall gain for a while and then we go back to a normal pattern, which is why in that space we think a 15% growth is doable.

The second area is on business banking. These are customers who are in the productive sector, whether they are traders or they are manufacturers or transporters, who again because of where interest rates were their returns in terms of the business proposals that they had, some of them are people who had looked at proposals and then maybe not taken up the facilities because of where returns were. So we are seeing them coming back, dusting off their proposals and coming back and saying can we go back to the projects that we had in mind, obviously with an eye on sustainability of the interest rates.

But since these are now legal and by law they are a bit more confident and are taking up their proposals. Now, that demand takes a little bit longer to actualise because we are talking about a book that will have to then be secured, and the security process and revisiting of the proposals takes a little bit longer. So that demand we going to start to really see the benefit of this three or four months from when the rate change occurred, which means December, January going onwards is when we will actually see that demand kicking in.

The third source of our confidence on the sustainability is the corporate side of business which is what has been sustaining demand is largely infrastructure, a little bit into agriculture, a little bit into that space. We have seen agriculture grow. We have seen tourism grow. We have seen transport grow. We have seen government infrastructure grow. So we think that even into next year because those have been the drivers of the economy into next year those sectors will create demand. We have got a pipeline of what those transactions are, some of them committed lines, some of them proposals that are undergoing processing. Again we think there will be a sustainable demand out of that particular space.

Yes, we have been conservative in terms of saying 15% as opposed to an average of about 22% from that traditional space of retail, business and corporate demand. We are a little bit conservative in the 2017 numbers, but part of it is backed by a pipeline on the corporate end. Part of it is hopefully return to normal patterns in terms of consumer lending. And part of it from the short-term demand that we have seen in the business. So we are reasonably comfortable with the 15% estimate.

Godfrey Mwanza
From corporate there is some latent demand that hasn't necessarily ramped up even in these few months since the rate cap decision. But on personal loans in particular would have expected that to have moved up the quickest and most of that latent demand to have been used already. What makes you so sure that there is more demand to come? The truth is before the rate cap the natural or normal growth was negative, or at least very low. So you are saying a return to normal, let's say just for personal – ignore SMEs and corporates – the overall was certainly lacklustre. So what do you mean by return to normal? Do you mean return to normal for that or before that?

Anthony Mburu
What I mean by return to normal is based on our historical numbers in terms of the patterns every time there are increments in the various industries in terms of salaries if you look at the government which is the biggest employer every time they increment the salaries for teachers, for people in the civil service in the police or defence or central government, salaries in the county governments, every time there is an increase in salaries there is an increase in demand. This year what we have seen is despite the normal patterns of increase in salaries, increase in employment by government, we did not see as huge an increase in demand on the retail space. But let me say it was not negative.

We at least as a bank saw an increase in loans across the retail space, but not at the same rate as we had been seeing in previous years. so what we are hoping is with interest rates having come down and the normal patterns in terms of people getting increments – the government is still talking of increasing employment in the space around teachers and those services where the demand is still there in terms of they are still required to employ more people – that should then see an increase in demand over and above the replacement of existing loans and the other things that go on. That is what I mean by a return to normal patterns. 2016 in the beginning of the year was not normal patterns because the impact of three years of rate increases. There were rate increases in 2015 and rate increases in 2016. We hope with that having been turned by the interest rate caps we may see a return to demand.

Patrick Nyaga
I think just to sort of reiterate what Anthony is saying to probably see the [unclear] properly for 2016 one would have to go back to sometime in September 2015, actually August 2015 where the rates in

this country moved from if you look at the deposit side fixed deposits at about 12% to at one point 24% or 25%. As at the time of closing 2015 we were actually on these rates. So by the time we went into 2016 as banks the most important thing was to try and make sure you shed the deposits because those rates were very high. Of course customers were also not comfortable borrowing with those kinds of high rates. And we saw quite a bit of that until around April 2016.

So from our analysis if you look at that cycle we are now going into 2017. Despite that it is an election year we are closing 2016 with rates that are low. And as Muli has said and Anthony there is still a lot of activity going on in the country, so there is demand for various things to be done. The infrastructure for example. There are a lot of people supplying the infrastructure and therefore there is demand now at the right rates. I think that is why we are a bit confident that achieving a 15% growth as opposed to the 20% that would have been the normal is possible. But again these are just group projections. As we go into next year we will probably be re-looking at how the year comes about. And if needs be then we will have to revise. Thank you very much.

Operator
Thank you. The next question is from Ola Ogunsanya of Rencap. Please go ahead.

Ola Ogunsanya
Good afternoon. Thank you for taking this call. I just have two questions. Firstly if you could just comment on the performance of the tier two and tier three banks. Are you noticing any signs of stress? And secondly what are you expectations…

Patrick Nyaga
Sorry we didn’t hear the first question.

Ola Ogunsanya
If you could just comment in terms of the performance of the smaller banks, tier two and tier three banks. Are there any evident signs of stress yet, or are these still early days post the interest rate cap? And my second question was on your expectations for the MPC meeting next week.

Patrick Nyaga
Thank you very much again for that question. Obviously as Co-op Bank we may not comment directly on the others, but I think what we have seen is for the segments that were lending at relatively high rates, for example at 25% or 26% on loans, even up to 30%, with the interest rate cap obviously then that becomes a bit of a problem because you can only lend at a maximum of 14%. So if you are a bank that is not able to take deposits at relatively low rates then your margins are completely squashed and therefore you may have difficulties. That is probably what I can say about the small banks. Maybe Anthony can add and then our economist can also give us a bit on the MPC.

Anthony Mburu
Thank you very much for the two questions. Regarding tier two and three banks obviously we are watching the results as they come out closely. The only anecdotal information we have is regarding some of them have talked of retrenchment to manage their costs. I’m sure this is information that you

already have. In terms of the interbank we have not seen any stress on the interbank. The liquidity seems to be still strong across the banking industry. Yes, it is sometimes skewed towards the bigger banks, but the distribution into the smaller banks has remained relatively okay and they have been able to meet their requirements without any issue. I know that is anecdotal but I guess that's the first place we look in terms of issues, interbank and liquidity.

In terms of the financials we are watching them as they come out. We have done some stress test scenarios but I'm sure you have done the same. We are waiting for the actualisation. But they have been able to weather part of the storm. The second leg is to see what they do in terms of their cost management because the margins will be squeezed. But there are various ways to look at it. You can try to reduce your cost of funds. You can try to reduce your operational cost. They have much more ability to deal with their operational costs because of their sizes or much speedier in dealing with their operational costs because of their sizes. So let's wait and see how that plays out. On the issue of the MPC I would request Muli, our economist, to maybe make a comment.

Anthony Muli
Thanks for your question. This is Anthony Muli. Our expectation for the MPC meeting later this month is that they will be guided by two main issues which we are not privy to the information. One is there is also an MPC survey they did in the month of November. The other issue is they will be guided by the growth rate of the private sector credit especially for October and for the first 20 days of November, of which most of the banks submitted either on Friday or today. So those are the two issues that will guide them. We currently are not privy to the rate of private sector credit growth for October and also the first 20 days of November which will be key issues for their discussion. Thank you.

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

Ronak Gadhia
Hi. Thanks again for taking my questions. Firstly can you just talk a bit more about your fee and commission income evolution going into next year, how you are increasing fees on any of your products if at all? And also within that we have seen a pretty strong increase in transaction volumes across your alternative channels. Is it possible to quantify the amount of revenues you are making from the alternative channels for the first nine months of this year and last year? And then the second one is really a follow-up. Anthony mentioned that a big driver for loan growth is increased demand from the retail and corporate sector because they can now afford more loans. Is there a concern by the bank that maybe the borrowers are over-leveraging themselves with the misguided expectation that interest rates will continue to remain low? And if there is an interest rate shock, which is highly likely given global monetary policy is getting tighter, does that mean that your asset quality could come under severe pressure?

Patrick Nyaga
Thank you Ronak. Very good questions. Let me start with the fee and commission income evolution now and into the next year. Yes, you are right in the sense that we have made a lot of effort to try and move our transactions to alternative channels. They are cheaper and you can also do more volumes

into those channels as opposed to the branch. Obviously the benefit here is that the more you move customers from the branch the less the operation cost we incur. And that is really turning out well as we go by. Where do we see ourselves making more money into the future? I think we are projecting to grow all our channel income, mainly the agent banking because when you look at the whole of this year our agency banking commissions have been growing significantly including the transactions. We are also expecting to see a lot of revenues coming from the mobile banking platform, MCo-op Cash. Even when you look at current September 2016 figures the highest growth in commissions has actually been mobile lines.

We see ourselves going into 2017 with fewer commissions from the branches, over-the-counter fees. ATMs for example will continue being a source of revenue but it is not significantly growing. So basically the evolution is to move from the traditional commission lines into more electronic, more agency, alternative channels. Actually if you look at specific growth, for example agents, our commissions grew by 90%. ATMs about 9%. MCo-op Cash grew by about 68%. Internet banking grew by 87%. So you can clearly see we even had a drop in branch revenue by about 42%. But obviously I think we have been achieving to make sure that lost income in branches is replaced by much more revenue in alternative channels. And then we also do less operating cost in the branches. So it is twofold. We grow our revenues and at the same time reduce our costs. And that is working very well and that is why we continue in terms of moving to the alternative channels. Thank you very much.

Ronak Gadhia
Sorry, Patrick, what is the current status of the interbank switch that was supposed to be introduced 15 months ago and continues to get delayed?

Patrick Nyaga
Yes, Ronak. I think you correct put it as continuing to be delayed. But I think it is on [unclear] and that is actually a game-changer for banks because it will make us be more competitive with telcos and enable us to increase transactions though banks which have largely migrated to telcos. So I think it should be on the cards into next year. Thank you.

Anthony Mburu
Ronak, I think your question was about future shock on asset quality. Where we are right now is I think James Kaburu mentioned to you the numbers in terms of we had an interest rate regime as far as Co-op Bank is concerned where we had an average yield of 14.6% down to 13.7% now. Now the bigger issue is more the psychological impact which it has had on customers. Instead of rates of 18% or 20% that were being quoted as compared to what they actually end up paying when they walk in and are able to negotiate their rates down to the 14% has been more the psychological benefit of feeling that it is cheaper. Then demand comes in. Then there is also the element of [unclear] should be cheaper. Especially for the retail and the business customers it is obviously cheaper.

But for the rest of the business it is a pipeline. We already have these customers on a plan and a proposal and we expect that that is going to follow through. So we are not going out and taking on extreme additional risk or extreme change in our target market. The target market remains the same. The credit quality remains the same. Our criteria for lending remain the same. And what we think is that whereas before interest rates could move in a very short period of time, a month or so – it has moved by about 600 basis points as happens in 2015 – we think there will be much slower movement.

Given time adjustments in terms of repayment ability by customers what I would say is right now the central bank has a lot more grip and control over what happens as far as interest rates are concerned. Previously margins could change, rates could change. There was much less control by the monetary policy. Today the monetary policy of the central bank will determine where rates go, especially the lending rates. I know as much as shocks could be there they will be much more managed in terms of the speed of that movement. So let me say from an external point of view that is where our confidence of less shock comes from.

The second is that from a credit criteria point of view we always leave a buffer for interest rates. The typical analysis we do has to include ideally best and worst case scenarios. And obviously if we feel that the proposal is not going to meet those sorts of scenarios then our policy has not changed in creating that sort of buffer. For those proposals that we put on board should rates turn – and hopefully they don't turn by 100% but turn in that gradual manner – customers should be able to withstand the changes in time that will be available. So I hear you in terms of shock and we are cognisant of that. Our policy does take that into consideration as we go about doing the things that we are doing.

Ronak Gadhia
Okay. Thank you.

Operator
Thank you. Our last question is a follow-up from James Starke. Please go ahead.

James Starke
Thank you. Returning to the MPC what risk do you see in the MPC actually reading recent weak private sector credit growth as a signal to actually in fact lower the central bank rate further? And the second question, what is your outlook for the yield curve into next year? We are already seeing the government revising up its domestic borrowing targets. I would venture that it is probably going to put upward pressure on the yield curve. And in the event that the curve does shift up how likely do you think it is that the MPC will in fact move the central bank rate up to adjust for the higher level that ultimately affects your funding costs particularly in an election year? Thank you.

Anthony Muli
Okay, James. Thanks for that. I think what you need to take cognisance of is the MPC is likely different now in the sense that the yields on the government paper are no longer very key to their decisions in the sense that the benchmark is no longer linked to an average of CBR and the 91-day T-bill rate. Their decision might be more linked towards GDP growth which is the decision they based on in the last revision of rates just to spur growth. The other issue is the latest numbers for private sector credit growth guides their position it the sense that that's the only way they can spur growth, through increasing credit growth.

Looking at the issue of the yield curve in essence what we are seeing if the numbers for October and the 20 days for November are very weak then it means that there is a likelihood of them revising down the CBR further to probably spur growth. Moving on to the issue of the yield curve what we have seen is that in the latest budget revision paper that the national treasury released they have revised the appetite for international credit. So they indicated that they will look at it more. What they have done is they have increased their projection for domestic borrowing by a further close to Kshs 60 billion. And given the history they are likely to revise that upwards come February and come May next year. So given that increased appetite for local credit then we are looking at the yield curve moving up. Thank you.

James Starke
If I could just return, you are sitting with a situation where potentially because of the cap credit growth is likely to be weak. That signal is likely to be read as no, we need to lower rates further to stimulate credit extension, which may or may not be an appropriate conclusion, and you are faced with a potential upward shift in the yield curve next year as a result of domestic borrowing. Are you not sitting on a potential massive margin squeeze here?

Anthony Muli
There is that risk. And also if you look at the two key deficits they also amplify that issue. If you look at the fiscal deficit, the percentage to GDP at about 9.3% its direction is upwards. It has been increasing. If you look at the current account deficit it will be shrinking now about 5.5%. So that is a potential risk as you put it.

James Starke
Thank you.

Operator
Thank you very much. Gentlemen, we have no further questions in the queue. Would you like to make some closing comments?

Patrick Nyaga
Thank you, Chris. Thank you everybody for listening to the call and thank you for the very enlightening questions. I hope we have satisfied you. As we always say we are available on email and telephone and any further questions can be taken care of. So thank you very much.

Operator
Thank you very much, sir. Ladies and gentlemen, that concludes this conference. You may now disconnect your lines.

END OF TRANSCRIPT