Status of Rate Cap Review in Finance Bill, 2018, & Cytonn Weekly #32/2018

Fixed Income

T-bills were oversubscribed during the week, with the overall subscription rate coming in at 120.4%, up from 102.2% recorded the previous week, due to improved liquidity in the money market. Yields on the 91-day and 364-day papers declined by 10 bps each to 7.6% and 9.9% from 7.7% and 10.0% in the previous week, respectively, while the yield on the 182-day paper remained unchanged at 9.0%. The acceptance rate for T-bills declined to 79.3% from 95.8% the previous week with the government accepting Kshs 22.9 bn of the Kshs 28.9 bn worth of bids received. The subscription rate for the 182-day and 364-day papers improved to 94.1% and 175.4% from 72.8% and 110.9%, the previous week, respectively while the subscription rate for the 91-day paper declined to 48.4% from 153.9% the previous week, with investors' participation remaining skewed towards the longer dated paper attributed to the scarcity of newer short-term bonds in the primary market.

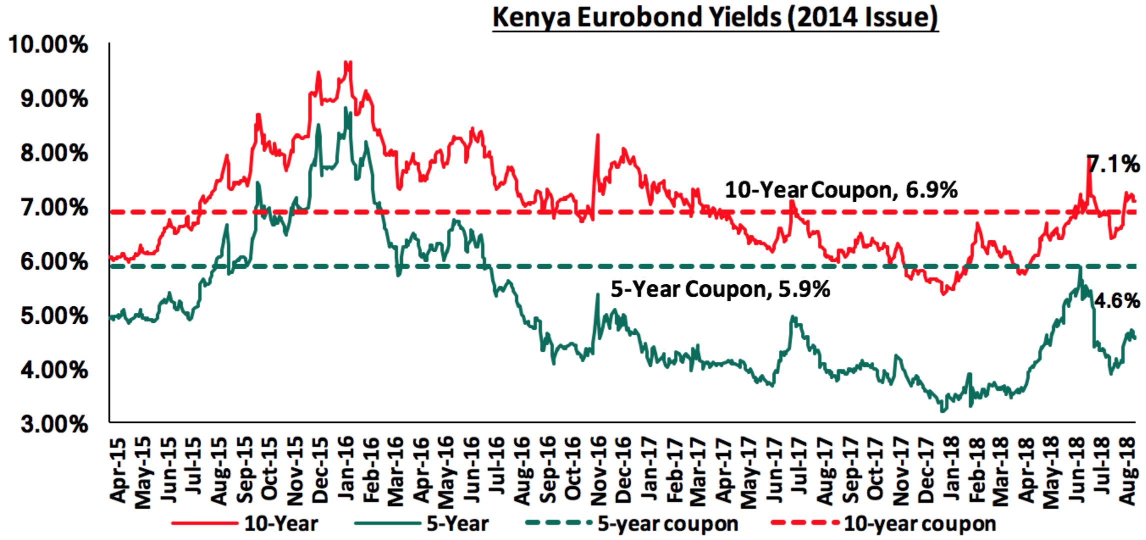
The Kenyan Government issued a new 10-year Treasury bond (FXD 1/2018/10) with a market determined coupon rate in a bid to raise Kshs 40.0 bn for budgetary support. The issue was under-subscribed, with the overall subscription rate coming in at 74.6%, while the weighted average rate of accepted bids came in at 12.7%, in line with our expectations of 12.7% - 13.0%. We attribute the continued undersubscription of government bonds to investors being cautious in lengthening their bond portfolio duration due to uncertainties in the interest rate environment as a result of the ongoing debate on the repeal of interest rate cap, which if passed, might result into an upward pressure on interest rates. The government accepted Kshs 19.4 bn out of the Kshs 29.8 bn worth of bids received, translating to an acceptance rate of 64.9%.

Liquidity:

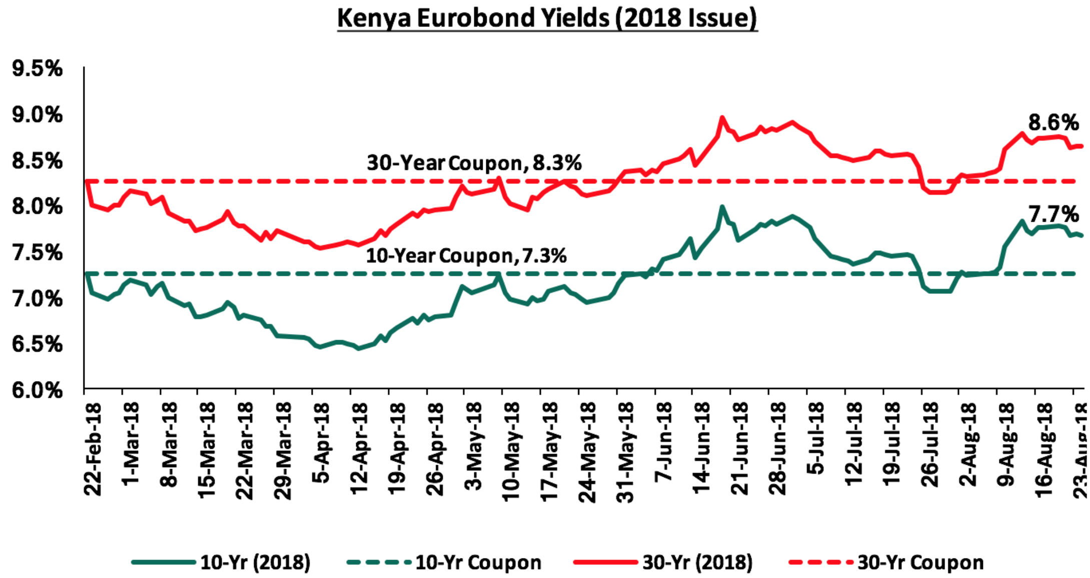
The average interbank rate declined to 6.1%, from 7.0% the previous week, while the average volumes traded in the interbank market increased by 97.1% to Kshs 17.9 bn, from Kshs 9.1 bn the previous week, with the increased activity in the interbank market being attributed to a pickup in demand for funds to facilitate VAT remittances by corporates. The decline in the average interbank rate points to improved liquidity, which the Central Bank of Kenya partly attributed to banks trading currency in the interbank markets at lower interest rates during the week.

Kenya Eurobonds:

According to Bloomberg, the yield on the 5-Year Eurobond issued in 2014 increased by 0.1% points to 4.6% from 4.5% the previous week, while yield on the 10-year Eurobond declined by 0.1% points to 7.1% from 7.2% the previous week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.2% points and 2.5% points for the 5-year and 10-year Eurobonds, respectively, an indication of the relatively stable macroeconomic conditions in the country. Key to note is that these bonds have 0.8 years and 5.8-years to maturity for the 5-year and 10-year, respectively.



For the February 2018 Eurobond issue, during the week, the yields on both the 10-year and 30-year Eurobonds both declined by 0.1% points to 7.7% and 8.6% from 7.8% and 8.7% the previous week, respectively. Since the issue date, the yields on the 10-year and 30-year Eurobonds have increased by 0.4% points and 0.3% points, respectively.



Key to note is the yields on the 2018 Eurobond issues as well as the 10-year 2014 issue which were on a decline this week, which the CBK attributed to improved investors' risk perception in the global markets.

The Kenya Shilling:

During the week, the Kenya Shilling appreciated marginally by 0.1% against the US dollar to close at Kshs 100.7 from Kshs 100.8 the previous week, driven by the relatively balanced demand and supply of the US dollar in the interbank market. The Kenyan shilling has appreciated by 2.4% year to date and in our view the shilling should remain relatively stable against the dollar in the short term, supported by:

i. The narrowing of the current account deficit to 5.8% in the 12-months to June 2018, from 6.3% in March 2018, attributed to improved agriculture exports, and lower capital goods imports following the completion of Phase I of the Standard Gauge Railway (SGR) project,
ii. Stronger inflows from principal exports, which include coffee, tea, and horticulture, which increased by 10.8% during the month of May to Kshs 24.3 bn from Kshs 21.9 bn in April, with the exports from coffee, tea and horticulture improving by 11.0%, 19.1% and 2.0% m/m, respectively,
iii. Improving diaspora remittances, which increased by 71.9% y/y to USD 266.2 mn from USD 154.9 mn in June 2017 and 4.9% m/m, from USD 253.7 mn in May 2018, with the largest contributor

being North America at USD 130.1 mn attributed to; (a) recovery of the global economy, (b) increased uptake of financial products by the diaspora due to financial services firms, particularly banks, targeting the diaspora, and (c) new partnerships between international money remittance providers and local commercial banks making the process more convenient, and,

iv. High forex reserves, currently at USD 8.7 bn (equivalent to 5.8 months of import cover) and the USD 1.5 bn stand-by credit and precautionary facility by the IMF, still available until September 2018.

Highlights of the Week:

During the week, the committee on Finance and planning tabled their proposals in the National Assembly during the second reading of the Finance Bill, 2018. The proposals were based on the comments received during public awareness and stake-holder participation conducted between 1st – 3rd August 2018, following the first reading of the Finance Bill, 2018 on 3rd July 2018 which proposed the repeal of section 33B of the Banking Act, which would result in the elimination of the Central Bank's powers to enforce an interest rate cap in banks and other financial institutions. Based on the deliberations, the committee was of the view that there is no justification for the repeal the interest rate cap, as there was no effort by banks to address the issue of high credit risk pricing. The committee also proposed that the Central Bank Rate (CBR) ought to be maintained as the benchmark rate as opposed to the Kenya Bank reference rate (KBRR) since the latter was not yet operational. The committee also proposed the removal of the 70.0% minimum limit on deposits, pegged on the Central Bank Rate (CBR) and instead, leave the decision of the interest rate to be given on deposits at the discretion of the banks and customers.

The committee also proposed the following exemptions to the Robin Hood Tax, with the proposed amendments set to be introduced during the third reading of the Finance Bill, 2018;

i. Exemption on transfers between accounts belonging to the same person within the same bank/financial institution,
ii. Exemption on the transfer of funds by or to the national government, county governments or the Central Bank of Kenya,
iii. Exemption on the transfer of taxes remitted to Kenya Revenue Authority (KRA) as well as refunds from KRA,
iv. Exemptions on the transaction of funds from the KRA collection accounts at the central bank,
v. Exemption on transfer of funds related to the purchase and sale of shares and securities at the Nairobi Securities Exchange (NSE),
vi. Exemption on the transfer of funds to and from registered retirement benefit schemes, and
vii. Exemption on Inter-bank transfers between bank and non-bank financial institutions or between non-bank financial institutions.

We have expounded more on the issues surrounding the interest rate cap on this week's focus note, and we maintain our view that a repeal or at least a significant review of the Banking (Amendment) Act, 2015, is essential given that the current regulatory framework has hampered credit growth, evidenced by the low private sector credit growth, which stood at 4.3% as at June 2018, below the 5-year average of 13.1%. We also commend the proposed exemptions on the robin hood tax. The exemption on inter-bank transfers has addressed the concerns on the negative effect on liquidity as banks would resort in holding cash to avoid extra charges from interbank transfers. There were also concerns on erosion on investment returns from transactions related to purchase and sale of shares which has also been addressed.

We are projecting the inflation rate for the month of August to range between 4.0% - 4.4%. The month on month inflation is expected to rise mainly due to:

i. An increase in petrol prices by 1.3% to Kshs 113.7 from Kshs 112.2 per litre previously, despite diesel prices having declined by 0.5% to Kshs 102.7 per litre, for the period of 15th August – 14th September 2018, this will directly affect transport costs and indirectly affect food prices in August,

ii. An increase in electricity prices, despite the scrapping of the Kshs 150.0 standing charge. This is because of higher rates charged to households due to a reduction in the subsidized rate to low income households, which was previously capped at 50 units per month under the old tariff regime but has now been reduced to 15 units of power per month, and
iii. An increase in some food prices outweighing a decline in others as well as the pass through effect from transport costs.

We expect inflation in H2'2018 to experience upward pressure, partly due to the expected rise in fuel and transport prices with the introduction of 16.0% VAT on petroleum products as from September 2018, which was first introduced in the VAT Act in 2013 with a grace period of 3 years that would have seen its enforcement in September 2016 but was further deferred by 2 years to September 2018. We however still expect inflation to remain within the government's set target of 2.5%-7.5% during the year.

Rates in the fixed income market have been on a declining trend, as the government continues to reject expensive bids as it is currently 46.6% ahead of its pro-rated borrowing target for the current financial year, having borrowed Kshs 69.0 bn against a prorated target of Kshs 46.6 bn. The 2018/19 budget gives a domestic borrowing target of Kshs 271.9 bn, 8.6% lower than the 2017/2018 fiscal year's target of Kshs 297.6 bn, which may result in reduced pressure on domestic borrowing. However, the National Treasury has proposed to repeal the interest rate cap, which if repealed can result in an upward pressure on interest rates, as banks would resume pricing of loans to the private sector based on their risk profiles. With the cap still in place, and the national assembly not keen on repealing it, citing that there have been no concerted efforts by banks to address high credit risk pricing, we maintain our expectation of stability in the interest rate environment. With the expectation of a relatively stable interest rate environment, our view is that investors should be biased towards medium-term fixed-income instruments.