Banking, Finance & Projects

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Kenya's rising bad loans: A closer look

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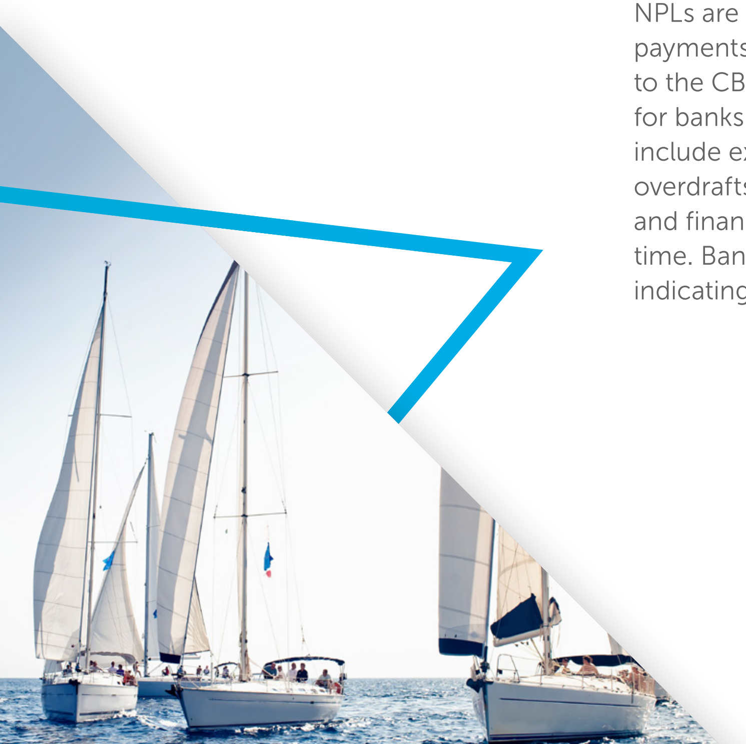
Kenya's rising bad loans: A closer look

The Kenyan banking sector is currently facing a significant challenge due to a sharp increase in non-performing loans (NPLs). In simple terms, a loan becomes non-performing when a borrower fails to make scheduled loan payments, either of principal or interest, for 90 days or more. This trend is worrying because, according to the Central Bank of Kenya (CBK), by December 2024, these bad loans accounted for 16,4% of all loans issued by banks – the highest level recorded in the past decade. The agricultural sector has been hardest hit, with 20% of loans turning bad, followed closely by the real estate sector at 18%.

What exactly are NPLs?

NPLs are loans where borrowers have stopped making payments for an extended period (over 90 days). According to the CBK Prudential Guidelines (rules set by the CBK for banks operating under the Banking Act), these loans include expired credit lines that haven't been paid back, overdrafts that exceed their limit for more than 90 days, and financial guarantees that have not been honoured on time. Banks typically categorise these loans as "*bad debts,*" indicating a low likelihood that they will be fully recovered.



Why are bad loans increasing in Kenya?

Several factors are driving this increase in NPLs. One significant reason is the broader economic environment. Kenya is still recovering from the effects of the COVID-19 pandemic, which severely impacted the economy. In 2024, the economy grew at about 4,7%, down from 5,7% the previous year. The country faced additional challenges such as severe drought conditions affecting agriculture, inflation, fluctuations in currency value and a decrease in consumer spending – all of which have put financial strain on borrowers and increased loan defaults.

Bank-specific issues have also contributed to the growing number of bad loans. These include high interest rates, weak internal lending policies and inadequate assessment of borrowers' ability to repay loans. In December 2024, commercial banks were charging an average lending rate of around 16,89%, which significantly increased repayment difficulties for individuals and businesses.

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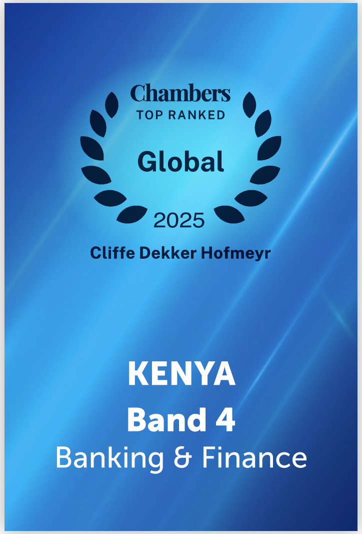

How do rising bad loans affect the public?

The increase in NPLs has direct consequences for both businesses and individuals. When banks face losses due to unpaid loans, they often respond by raising interest rates and making loan requirements stricter. As a result, borrowing becomes more expensive and less accessible, especially for small businesses and individuals. This reduction in available credit negatively impacts overall economic growth and investment opportunities across the country.

How are banks managing these risks?

To manage the risk associated with NPLs, banks adopt several measures recommended by the CBK Prudential Guidelines. One key measure is provisioning, which means banks set aside money specifically to cover potential losses from defaulted loans. While this protects banks against financial shocks, it also reduces their overall profitability and limits the funds available for new lending.

According to the CBK, loans are classified into five categories, each requiring different provisioning levels:

1. Normal loans (performing well) require only 1% provisioning.
2. Watch loans (30–90 days overdue) require 3% provisioning.
3. Substandard loans (90–180 days overdue) require 20% provisioning.
4. Doubtful loans (180–360 days overdue) require 50% provisioning.
5. Loss loans (over 360 days overdue) require 100% provisioning.

Additionally, banks may restructure loans by modifying repayment terms or extending repayment periods, seize collateral to recover unpaid amounts, or write off loans they deem uncollectible. Banks also rely on credit reference bureaus to share information about borrowers and identify those who may be at higher risk of default.

Furthermore, CBK regulations restrict insider lending to prevent banks from providing excessive loans to their own officers, directors, employees or major shareholders. According to the CBK Prudential Guidelines, insider lending cannot exceed 20% of the bank's core capital, and total insider lending must remain within 100% of core capital.

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Learning from Nigeria's approach

Recently, Nigeria's central bank took decisive action to address similar challenges by requiring bank directors with unpaid insider loans to resign. This proactive step significantly improved corporate governance and helped stabilise Nigeria's banking sector. While Kenya has similar regulations restricting insider lending, enforcement has historically been weaker. Stronger regulatory action in this area could be beneficial for Kenya.

The way forward for Kenya

Given the critical role banks play in Kenya's economy, it's essential to address both economic and bank-specific factors contributing to the rise in bad loans. Strengthening enforcement of existing CBK guidelines, particularly around credit assessment practices, is necessary to mitigate these risks. It will be interesting to see the CBK's response to the surging level of non-performing loans in the country.

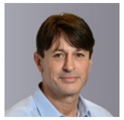
Brian Muchiri and Nicole Gacheche

OUR TEAM

For more information about our Banking, Finance & Projects practice and services in South Africa, Kenya, and Namibia, please contact:

Mashudu Mphafudi
Practice Head & Director:
Banking, Finance & Projects
T +27 (0)11 562 1093
E mashudu.mphafudi@cdhlegal.com

Sammy Ndolo
Managing Partner | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E sammy.ndolo@cdhlegal.com



Johan de Lange
Deputy Practice Head:
Banking, Finance & Projects
Director: Projects & Infrastructure
T +27 (0)21 481 6468
E johan.delange@cdhlegal.com

Dr Adnaan Kariem
Director:
Banking, Finance & Projects
T +27 (0)21 405 6102
E adnaan.kariem@cdhlegal.com

Mbali Khumalo
Director:
Banking, Finance & Projects
T +27 (0)11 562 1765
E mbali.khumalo@cdhlegal.com

Mohammed Azad Saib
Director:
Banking, Finance & Projects
T +27 (0)11 562 1567
E mohammed.saib@cdhlegal.com

Stella Situma
Partner | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E stella.situma@cdhlegal.com

Andrew van Niekerk
Director:
Banking, Finance & Projects
T +27 (0)21 481 6491
E andrew.vanniekerk@cdhlegal.com

Deon Wilken
Director:
Banking, Finance & Projects
T +27 (0)11 562 1096
E deon.wilken@cdhlegal.com

Kuda Chimedza
Senior Associate:
Banking, Finance & Projects
T +27 (0)11 562 1737
E kuda.chimedza@cdhlegal.com

Tsele Moloi
Senior Associate:
Banking, Finance & Projects
T +27 (0)11 562 1399
E tsele.moloi@cdhlegal.com

Brian Muchiri
Senior Associate | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E brian.muchiri@cdhlegal.com

Thato Sentle
Senior Associate:
Banking, Finance & Projects
T +27 (0)11 562 1844
E thato.sentle@cdhlegal.com

Stephanie Goncalves
Professional Support Lawyer:
Banking, Finance & Projects
T +27 (0)11 562 1448
E stephanie.goncalves@cdhlegal.com

Michael Bailey
Associate:
Banking, Finance & Projects
T +27 (0)11 562 1378
E michael.bailey@cdhlegal.com

Deepesh Desai
Associate:
Banking, Finance & Projects
T +27 (0)21 481 6327
E deepesh.desai@cdhlegal.com

Damaris Muia
Associate | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E damaris.muia@cdhlegal.com

Jamie Oliver
Associate:
Banking, Finance & Projects
T +27 (0)21 481 6328
E jamie.oliver@cdhlegal.com

Lutfiyya Ramiah
Associate:
Banking, Finance & Projects
T +27 (0)11 562 1711
E lutfiyya.ramiah@cdhlegal.com

Lloyd Smith
Associate:
Banking, Finance & Projects
T +27 (0)11 562 1426
E lloyd.smith@cdhlegal.com

Zipho Tile
Associate:
Banking, Finance & Projects
T +27 (0)11 562 1464
E zipho.tile@cdhlegal.com

Kaoma Vokwana
Associate:
Banking, Finance & Projects
T +27 (0)11 562 1687
E kaoma.vokwana@cdhlegal.com

Sidumisile Zikhali
Associate:
Banking, Finance & Projects
T +27 (0)11 562 1465
E sidumisile.zikhali@cdhlegal.com

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JOHANNESBURG
1 Protea Place, Sandton, Johannesburg, 2196. Private Bag X40, Benmore, 2010, South Africa.
Dx 154 Randburg and Dx 42 Johannesburg.
T +27 (0)11 562 1000 F +27 (0)11 562 1111 E jhb@cdhlegal.com

CAPE TOWN
11 Buitengracht Street, Cape Town, 8001. PO Box 695, Cape Town, 8000, South Africa. Dx 5 Cape Town.
T +27 (0)21 481 6300 F +27 (0)21 481 6388 E ctn@cdhlegal.com

NAIROBI
Merchant Square, 3rd floor, Block D, Riverside Drive, Nairobi, Kenya. P.O. Box 22602-00505, Nairobi, Kenya.
T +254 731 086 649 | +254 204 409 918 | +254 710 560 114
E cdhkenya@cdhlegal.com

NAMIBIA
1st Floor Maerua Office Tower, Cnr Robert Mugabe Avenue and Jan Jonker Street, Windhoek 10005, Namibia
PO Box 97115, Maerua Mall, Windhoek, Namibia, 10020
T +264 833 730 100 E cdhnamibia@cdhlegal.com

STELLENBOSCH
14 Louw Street, Stellenbosch Central, Stellenbosch, 7600.
T +27 (0)21 481 6400 E cdhstellenbosch@cdhlegal.com