

Title: STRESS TESTING: A CASE OF THE KENYAN BANKING SYSTEM

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ABSTRACT

Over the years, stress testing has become an indispensable aspect of risk management for banks given that banks are a central institution in the financial system. Stress testing has been used to figure out whether capital held by banks is enough to withstand exogenous circumstances that may not be within the bank's control. This study sought to carry out a common stress test for the Kenyan banks so as to investigate how much stress the banking system can withstand as well as which specific banks can withstand the shocks. A common stress test was carried out to ensure that all banks were subjected to similar scenarios and the impact of the shocks was measured by checking the changes in capital and the capital adequacy ratio. Six banks were initially picked to represent the Kenyan banking system but in the end, only two banks- Equity Bank and KCB were used due to data constraints. When subjected to the shocks, both banks were resilient through most of the shocks and had capital adequacy ratios that were acceptable as per Central Bank of Kenya regulations. However, KCB was more susceptible to the shocks due to inadequate loan loss provisioning. As a result of this, it was concluded that adequate loss loan provisioning is important so that banks do not erode their capital base which leads to lower lending levels and may even lead to a financial crisis. In addition to this, Central Bank of Kenya must also enforce the rules it sets when monitoring banks to ensure the stability of the banking system.