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GCR Commentary: African Banking Sectors and the Covid-19 crisis: First in, First out?

The African continent is still hoping to avoid catching up with other regions, in regard to confirmed COVID-19 cases. Regardless, the direct and indirect impact of the pandemic, alongside the oil price crash and rising global trade and political tensions have already cast a long shadow on Africa's 2020 outlook.

Below, GCR takes three African banking hubs, from the South, East and West of the continent and provides an opinion on how the banking sectors will cope with this potential 'annus horribilis'.

- We expect the Kenyan economy to outperform South Africa and Nigeria in 2020 and 2021, however, the banking sector has significant asset quality issues and could face significant stress in the lower tiers of the sector.
- The South African Banking system is the most stable, benefiting from lower credit losses and FX risks versus continental peers, but the economy is expected to be weak for some time.
- The Nigerian banking sector performance and economic recovery will be weak as they are both largely linked to the oil price and stability of the Naira.

We believe that the three economies and their respective banking sectors broadly entered the crisis at the same time, however from vastly different points.

South Africa was already in a technical recession when COVID-19 hit the shores. Comparatively, stricter lockdown rules have had a significantly negative impact on South Africa's consumption led economy. As a result, South Africa's economy could likely face the most significant contraction in 2020 relative to Kenya and Nigeria. Furthermore, due to structural impediments facing the economy (detailed below), it will also likely recover at the slowest rate. Nevertheless, the banking system is solid, especially amongst the oligopolistic top tier. Having said that, credit losses are expected increase markedly to over 2% in 2020 (from an average of just over 1% in 2019) and profitability is expected to come down to levels akin to the global financial crisis.

Kenya had the advantage of higher growth going into the crisis and, as a result, will probably recover more strongly than Nigeria and South Africa. However, the Kenyan banking sector was already encumbered with significant non-performing loans and now faces the additional challenge of potential exchange rate vulnerabilities and significantly reduced government fiscal space.

The Nigerian banking sector prospects appear inextricably linked to oil prices, which look like they may stabilize at relatively low levels for some time. We think asset quality will come under pressure again and profitability will decrease. However, we do not currently expect the declines to reach the troughs of 2015 or 2009.

Across all banking sectors, we expect the second and third tier banks to face considerable challenges, especially those with less stable funding profiles.

Economic Expectations: Kenya expected to outperform, South Africa sluggish and Nigeria inextricably linked to oil

In early 2020, South Africa was already struggling with low growth, weak state-owned enterprises, high unemployment, reduced competitiveness, low business confidence and intermittent load shedding. Once Covid-19 reached the shores, the government enforced one of the hardest and fastest lockdowns globally, hoping to flatten the curve and protect the population, which was sensible given the weak public sector healthcare and vulnerable population. However, the lockdown has had a significantly negative impact on South Africa's consumption led economy. As a result, we expect the economy to shrink by around 7% in 2020, the most significant contraction in a century. Furthermore, after some initial success, the contagion has accelerated, especially in the Western Cape. South Africa, at the date of publication has around 70,000 confirmed cases.

Currently, we are not expecting a dramatic rebound in domestic growth, but South Africa will likely return to positive territory (1%-1.5%) in 2021 due to improved household consumption, presuming the lockdown stops and the contagion is slowed. Longer-term growth is expected to be modest, partially because government led growth will have to slow if the government wants to rein in large fiscal deficits, especially given the reduction in revenues. Furthermore, in the absence of a global economic rebound, which improves commodity export prospects, there are few catalysts for a return to historically strong growth for South Africa, especially given the long-term structural constraints.

Kenya came into the crisis on the back of stronger, albeit slowing, growth. Nevertheless, 2020 is going to be a very challenging year for the economy on a number of fronts. Firstly, the decisive action by the authorities on the pandemic has caused a shock to the economy, reducing domestic consumption and significantly raised fiscal risks. Secondly, agriculture was materially hit by locust invasions. Thirdly, external risks have been rising significantly, due to the disruption in global supply chains, reduced exports and imports, lower tourism receipts and reduced remittances. We expect economic growth to be around 1% in 2020, with risks tilted towards the downside. We expect the hardest hit sectors to be services (transport, trade, tourism), industry (manufacturing and real estate), and agriculture. On the fiscal side, we see any consolidation of government as unlikely for a few years, with the fiscal deficit running close to 7.5-8% in 2020 and improving by 50bps/year after that. This is expected to bring government debt closer to 70-75% of GDP within that period. Furthermore, the current good FX reserves, low imports and modest oil prices are mitigating the pressure on the Shilling, but, we do not think this will continue forever. Eventually, the reduction in USD receipts from exports, tourism and remittances is likely to have a negative impact, especially as a majority of the latter factors will be affected by the significant economic declines in the U.K and U.S.

The World Bank expects a quick rebound in growth in 2021, to around 5.6% for Kenya. However, GCR is less optimistic because the government fiscal led growth cannot continue at the same rate going forward and the global demand may not recover in the short-term.

Nigeria was progressing on its recovery from the 2016 recession before the crisis, with economic growth at around 2%. However, the oil price crash and impact of the pandemic (both directly and indirectly) are likely to bring domestic growth down to negative territory in 2020 (around -3%) before a slow recovery back to the 2% range in the subsequent years. Our expectations reflect the slow improvement in oil prices from this point forward, balancing the announced cut in production by Organisation of the Petroleum Exporting Countries (OPEC) and currently high global inventories.

Positively, this should mitigate external risks which, although rising and structurally high due to the import dependent economy and exports reliance on oil receipts, are somewhat mitigated by sound FX reserves. Nevertheless, we do expect continued pressure on the Naira going forward. Fiscally, despite moderate public (and private sector) debt as a percentage of GDP, the government is increasingly restrained due to revenue dependence on oil receipts.

Longer-term growth will require substantial structural reforms, greater economic diversification and a general improvement in the investment climate, particularly due to the security issues in the north of the country.

The South African Banking System remains the most resilient, but credit losses and profitability are expected to deteriorate

The South African banking sector has remained resilient amidst ever increasing economic challenges over the past few years. Relative to other regional markets, the SA banking sector's credit loss ratio was favourable, hovering at around 1% over the past two years, although experiencing some upward pressure going into the crisis. Furthermore, over the past 10 years, the South African banks have had an average of 15-20% return on equity (ROE) and 1-2% return of assets, better than the average of emerging markets. We also consider that the sector benefits from its oligopolistic structure, good regulation, limited foreign currency risks and adequate capital levels. The sector does have structural funding shortfalls, but liquidity is considered appropriate for the risks.

Going forward, we expect two major impacts on the South African banking system; on asset quality and profitability. Given the early indicators from the banks, we expect credit losses will increase to between 1.5%-1.7% for the top tier banks, rising to over 2% for the sector has a whole; largely because the 2nd and 3rd tier unsecured and SME lenders will have a disproportionate impact on sector wide credit losses in comparison to their size.

South African households appear to be in a relatively good space to service debt, due to the reduction in household leverage over the past 10 years and the positive impact on affordability from lower interest rates. However, the reduction in employment and disposable income will bring up credit losses materially across most of the banks. Given the dynamics of the population, and the flat real estate industry over the past 5 years, we expect unsecured and semi-secured lending (over half of total household liabilities) to be the major source of credit losses. SME lending will also face a great deal of pressure, with credit losses climbing significantly. However, this book represents only about 7.5% of total banking sector loans. More positively, the overall corporate sector is expected to just about navigate through these challenging times, albeit with pockets of vulnerability, due to the modest levels of leverage. Going forward, GCR views the hospitality, tourism and discretionary retail sectors as the most at risk, due to enforced restrictions on population movement and social gatherings by the South African government caused by the COVID-19 pandemic. We estimate that these vulnerable sectors represent around 10% of the total loan books for the banking sector.

The return on equity and return on assets of the South African banking system moderated to 13.5% and 1.06% in March 2020 from 15.68% and 1.27% in March 2019 respectively, and we expect profitability to deteriorate further by the year end. This opinion reflects the lower interest rate environment, lower business transactions and higher cost of risk. Positively, the coverage of operating costs by relatively risk-free non-interest income underlines some stability for banks. With regard to capitalisation, we expect the tier one ratio to range between the 12.75% and 13.25% range by year end 2020 (13.6% as of year-end 2019.

The Kenyan Banking System asset quality is already taking strain, lower tier banks are especially vulnerable

The asset quality of the Kenyan banks was already relatively weak going into the downturn. The non-performing loan ratio increased to approximately 13% across the sector as at the end of April '20, from 4.4% at Dec'11.

Going forward, we expect further pressure on asset quality in 2020. Although the exact deterioration will depend on the public health and economic dynamics, we are estimating a rise in banking sector credit losses (new loan loss provisions against total loans) to around 3% - 3.5% in 2020. This is approximately a 100bps increase from the through the cycle average. We also expect losses to remain elevated in 2021, as the banks smooth out the reserving requirements from the crisis. Of particular concern are trade (12% of total banking sector loans), real estate (we believe there was a bubble in prices before the pandemic hit; 10% of total loans), tourism and manufacturing.

According to the latest numbers from the Central Bank of Kenya, the total value of restructured loans as at the end of April was KES 273 Billion (about 9.6% of the overall loan book). The sectors that have recorded the highest restructuring of loans in value terms are the same four industries – Trade at 26.3%, Real Estate at 18.6% and Tourism and Manufacturing each at 13.6%.

GCR also views the risk of foreign currency lending to be higher for the sector in 2020, due to the anticipated devaluation of the KES versus the USD and lower FCY receipts. We believe FX lending accounts for around 25% of Kenyan banking sector advances (on and off-balance sheet), but some banks carry much higher exposures. In regard to the foreign currency, we also believe that liquidity risks on the dollar book could rise materially in 2020.

The Kenyan banking sector remains adequately profitable on the whole, versus international peers. GCR expects a reduction in profitability over 2020, as a result of lower business activity (hitting fees and commissions), suppressed margins (balancing the impact of lower interest rates and the endowment affect with the removal of interest rate caps) and the increased cost of risk. Overall, we think ROE will reduce markedly the sector in 2020.

We consider banks operating in the lower 2nd and 3rd tier of the Kenya banking sector to be particularly exposed as they were already at significantly higher risk than the top tier going into the crisis, including relatively higher cost of funds, as well as the less stable and highly concentrated deposit books, weaker franchises and smaller capital bases. Overall, these banks have comparatively weaker asset quality, especially through the cycle and are structurally less profitable. It remains to be seen if the challenges brought about by the COVID-19 will provide added and decisive impetus to consolidation activity in the Kenyan banking system.

The Nigerian Banking System: Déjà vu? Asset quality deterioration and currency risk to test the system…again

Due to the pressures of the domestic economy and in particular the oil industry, we expect asset quality for the Nigerian banks to deteriorate materially in 2020. NPLs are expected to range between 9%-12% in 2020, depending on the classification, excluding restructurings. Stage 2 and stage 3 loans were already over 20% of gross loans at year end 2019. Of particular note, we believe foreign currency lending is exposed to the weakening of the Naira, and it accounts for about one-third of total lending. Many of these loans are backed by receivables in the same currency, mostly from the hydrocarbon industry. However, low oil prices and production heighten risks in upstream oil and gas sector. The banks restructured these loans in 2015/ 2016, after the oil prices fell sharply using an average break-even point of $45 per barrel. We also see high volumes of large single-name and industry concentrations in the loan book. The top 20 loans average approximately 30%-40% of gross lending, with most of the large banks serving a limited number of corporate borrowers.

We believe that credit losses will range between 3% and 3.5% average across the Nigerian banking sector for the next couple of years, despite the regulatory forbearance measures that will ease the classification of COVID-19 affected sectors.

Like Kenya, the Nigerian banking sector demonstrates three clear tiers, with significant advantages to the top tier of the market. The majority of Tier 1 banks (circa 65% of system-wide assets) have demonstrated profitability that is resilient to the credit cycle. On the other hand, Tier 2 (25%) and Tier 3 (10%) banks are more vulnerable, due to higher cost of funds and weaker asset quality, however they generally remain profitable. Overall, we expect the Nigerian banking sector profitability to reduce in 2020, due to lower business activity and high cost of risk.

Positively, the banks generally have strong local currency liquidity going into the crisis. On the other hand, foreign currency shortages can exacerbate liquidity risks in hard currency.

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