GCR Financial Institutions Sector Risk Scores
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Related criteria and research

Criteria for the GCR Ratings Framework, May 2019
Criteria for Rating Financial Institutions, May 2019
GCR Ratings Scales, Symbols & Definitions, May 2019
GCR Country Risk Scores, February 2021

The GCR Financial Institutions Sector Risk Assessment

The Financial Institutions sector risk score (ranging from 0 to 15) is a key factor in the operating environment component score. The core of the GCR Ratings Framework is based on GCR's opinion that an entity's operating environment largely frames its creditworthiness. As a result, the operating environment analysis anchors the underlying risk score for the GCR rating methodology. GCR combines elements of the country risk and sectoral risk analysis, blended across countries for entities operating across multiple jurisdictions, to anchor an issuer to its current operating conditions. For more details on any of the above, please read the related criteria and research listed below.

GCR will periodically publish updated "Financial Institutions Sector Risk Scores", which will supersede previous publications. This publication available at https://gcrratings.com/risk-scores/ supersedes the article published on 17 August 2020.

Financial Institutions Sector Risk Scores

Republic of Botswana, Sector Risk Score 5.5. Country Risk Score 9.0, Mapping Table 9.0 to 9.5*

Botswana's financial institutions sector risk score of '5.5' reflects the strong sovereign risk, small and concentrated economy, generally modest levels of non-performing loans and low foreign currency lending. We also factor in adequate levels of regulation and a relatively concentrated, profitable and well capitalised banking sector. Lastly, we balance the largely deposit-led funding base with underdeveloped local capital markets.

Cote D'Ivoire, Sector Risk Score 3.5. Country Risk Score 4.5, Mapping Table 4.5 to 5.0*

The financial institutions sector risk score of '3.5' for Cote D'Ivoire balances the strong economic growth and sound government fiscal position with moderately high non-performing loans and aggressive competition in the sector, as demonstrated by generally low levels of capital adequacy and profitability. Lastly, we balance the largely deposit-led funding base with underdeveloped capital markets.

Republic of Ghana, Sector Risk Score 2.5. Country Risk Score 3.5, Mapping Table 3.5 to 4.0*

The Ghanaian financial institutions sector risk score of '2.5' is restrained by the unquantified ramifications of the on-going COVID-19 pandemic and lower commodity prices, which pose major risks to the banking industry's operations and performance. Ghanaian banks face asset quality deterioration linked to high exposure to oil and gas sectors as a result of low but increasing oil prices. Despite the sound performance of the banking sector, initial assessments of the potential impact of the COVID-19 pandemic indicate that banks' operations may face challenges with credit extension, loan repayment, and correspondent banking relationships. The policy measures taken by the Bank of Ghana may help minimise the associated downside risks, including reducing the minimum regulatory capital adequacy ratio (CAR) to 11.5% and liquidity reserve requirement to 8%. Furthermore, the score takes in account the modest fiscal position of the government and state-owned enterprises, the improving albeit high stock of sector wide Non-performing loans of 14.5% at March 2020 and moderately high foreign currency lending (30% of total loans). We also consider the banking sector to be somewhat fragmented and regulated in line with regional norms. The banking sector is also considered to be adequately capitalized, with CAR averaging 21.2% at March 2020 broadly attributed to the 2018 regulatory reforms and recapitalization measures. Profitability is sound and improving, with an average return on equity of 21.2% at March 2020, but the operating efficiency remains low and the reduction in interest rates to 14.5% at April 2020 will affect net interest income and overall profitability going forward. Furthermore, yields are under threat from rising inflation to 10.6% at April 2020, consequently we expect interest rates will be restored to historic levels in the medium term. Local deposits are the primary funding source, with limited wholesale or external funding. Liquidity is sound, with cash and balances due from banks accounting for 36% of total assets at March 2020. However, there is a notable reduction in foreign currency deposits which may result in high liability mismatch on the dollar balance book. Fixed income capital markets are underdeveloped versus global peers.

Republic of Kenya, Sector Risk Score 3.5. Country Risk Score 4.0, Mapping Table 4.0 to 4.5*

The Kenyan financial institutions sector risk score of '3.5' balances the good economic growth and diversification with an increasingly strained government fiscal position and weak sector-wide asset quality, with non-performing loans of around 12% at December 31st, 2018. Positively, the foreign currency exposures (around 20%-25%) are moderate for the region, however we increasingly believe the Kenyan Shilling to be vulnerable to a reversal in remittances or USD flight out of the continent. We also consider the sector to be somewhat overbanked and strongly competitive, with tier one and international banks generally more profitable and having stronger asset quality. We believe that consolidation will be a recurrent theme across the sector going forward. Regulation is broadly in line with the regional average, although we see some weaknesses in the regulation of FX risks, the protracted resolution of failed banks and protection of the credit hierarchy during bank failures. We consider the funding for the top end of the market to be stable, dominated by retail and corporate deposits. However, institutional investor concentrations and Central Bank funding can permeate the funding of second and third tiers of the sector.

We have placed a positive trend on the sector risk score, to reflect the removal of the interest rate caps. We expect to wait until mid-2020 before we improve the sector risk score. This will allow for early signs of improvement by the banks, and also additional time to judge whether the fiscal position of the Kenyan government, the risks posed by FX lending and FX liquidity management, and asset quality, act as counter-weights to these improvements.

Republic of Malawi, Sector Risk Score 2.0. Country Risk Score 1.5, Mapping Table 1.0 to 2.0*

The Malawian financial institutions sector risk score of '2.0' reflects the modest economic growth of the country, alongside the restrained government fiscal position, weak but improving levels of non-performing loans and moderately high industry concentrations (trade, agriculture and manufacturing) in the loan and non-performing loan book. We consider regulation to be broadly in line with the region and complexity of the system. The banking sector is somewhat concentrated. Two out of the total nine banks dominate the sector with a combined market share of just over 45%. Positively, profitability and capitalisation remain at fairly good levels. Short-term deposits dominate the funding structure of the system. There are moderately high levels of foreign currency funding and lending (approximately 25%) and underdeveloped capital markets.

Republic of Mozambique, Sector Risk Score 2.0. Country Risk Score 1.0, Mapping Table 1.0 to 2.0*

The Mozambican financial institutions sector risk score of '2.0' is restrained by the current fiscal position of the government and some state-owned enterprises. Furthermore, non-performing loans are high but improving. Foreign currency lending is at moderately high levels, at approximately 25%. We view regulation as broadly in line with the region. The funding base of the sector is predominantly made up of retail and corporate deposits. Capital markets remain underdeveloped.

Republic of Namibia, Sector Risk Score 6.0. Country Risk Score 5.5, Mapping Table 5.5 to 6.0*

The reduction in the Namibian Financial Institutions sector risk score to '6.0', from '6.5', comes on the back of a significant weakening in the operating environment, which is expected to result in deteriorating asset quality, although overall sector stability is likely to be supported by sound capitalisation and oligopolistic sector structure. The strong capitalisation and oligopolistic characteristics of the Namibian banking sector is expected to enable them to cope with rising asset risk, at least over the short to medium term. We currently expect non-performing loans to increase to

5.5%-6.0% by FY2020. However, there is a real risk that economic conditions will remain depressed much longer than expected and asset quality will deteriorate even further. This may lead to a dilution in capital adequacy through moderated earnings, but still adequate to support sufficient internal capital generation. This, together with liquid and stable balance sheets, is likely to offer a medium-term safety net for the sector as a whole, which has shown resilience through three years of weak economic activity in the lead up to the pandemic.

Federal Republic of Nigeria, Sector Risk Score 3.5. Country Risk Score 3.75, Mapping Table 3.5 to 4.0*

The Nigerian Financial Institutions Risk Score of 3.5 is supported by strong local currency liquidity within the sector and stability in the funding (which is largely deposit based). Also, the banking sector appears well capitalized on average. In addition, consideration was given to regulatory compliance, which is considered adequate and in line with the regional average. However, concentration of the loan book by sector (oil and gas) heightens credit risk, though with modest levels of non-performing loans. We note that the Nigerian banking sector is highly fragmented, with the top tier of the sector controlled by a few players and increasing competition amongst players within the sector. The relatively low private sector debt is expected to continually increase going forward given the regulatory backed position of increased lending to the private sector, which would enable diversification. The standard negative one (-1) adjustment for NBFI was applied. However, there could be further negative adjustments up to negative two (-2) for any rated entity in sectors without strong regulatory oversight.

Republic of Rwanda, Sector Risk Score 4.0. Country Risk Score 3.75, Mapping Table 3.5 to 4.0*

The Rwandan financial institutions sector risk score of '4.0' balances the low wealth, the moderate size and diversification of the economy with modest levels of non-performing and foreign currency loans versus regional peers and regulation which is deemed to appropriate from its current levels of development and complexity. We consider the sector to be somewhat overbanked given the size of the economy, we note that the top tier of the sector is controlled by a few players but that regional banks are increasingly competitive in the country. Positively the banking sector appears well capitalised on average, but profitability can be modest. Funding is largely deposit based, with limited wholesale and external funding. The local capital markets are underdeveloped.

Republic of South Africa, Sector Risk Score 7.5. Country Risk Score 7.0, Mapping Table 7.0 to 7.5*

GCR has lowered the South African Financial Institution sector risk score to 7.5 from 8. The onset of the COVID-19 pandemic has compounded an already strained operating environment, with the South African Reserve Bank (SARB) projecting a 7% GDP contraction in 2020. 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 regards to capitalisation, we expect the tier one ratio to range between the 12.75% and 13.25% by year end 2020 (13.6% as of year-end 2019).

On a positive note, the sector risk score compares favourably to regional peers, due to the sound risk management of the top tier banks (which account for just over 90% of total industry assets) which will continue to underpin the sectors stability. The strong regulatory framework (through early adoption of international risk management practices) has also allowed for a build-up of good capital and liquidity buffers over the years, and while profitability will weaken, capital preservation will be aided by dividend suspensions and possibly lower credit growth that will keep leverage under control. The absence of any build-up in foreign currency mismatches due to regulatory exchange controls has meant that the depreciation and volatility of the South African rand during this period has not had a material impact on the sector. Furthermore, the reserve bank has stepped in to inject liquidity into the system and relax regulatory guidelines in order to provide some stability to the system and ensure banks can continue to fulfil their primary objectives of providing credit to the economy. This has stabilised liquidity in the system, at least in the short term, but medium term risks remain given the uncertain course of the pandemic and implications thereof.

United Republic of Tanzania, Sector Risk Score 2.5. Country Risk Score 3.75, Mapping Table 3.5 to 4.0*

The relatively low financial institutions sector risk score of Tanzania of '2.5' reflects the long-term weak asset quality of the sector, which has caused low levels of provisioning. Furthermore, there are relatively high (approximately 30%) levels of foreign currency lending and funding. The banking sector is moderately fragmented, with the top five and ten banks contributing 54% and 71% of total assets, and modestly profitable. We also note some shortfalls in the supervision and prudential regulation of the banking sector. The systemwide funding is largely retail and corporate deposit based, however, there have been historically large concentrations from institutional investors especially from those banks in the second and third tier.

United Kingdom of Great Britain & Northern Ireland, Sector Risk Score 11.0. Country Risk Score 14, No Mapping Table*

The UK Financial Institutions Sector Risk Score of '11.0' is supported by the wealthy and diverse economy, its position as a global hub for financial services, low through-the-cycle credit losses, a good regulatory regime and generally strong risk management, alongside diverse funding structures and deep, liquid capital markets. Conversely, the score is somewhat restrained by the moderate profitability of the sector, high interest rate sensitivity of households and domestic real estate, modest economic growth and the potential instability caused by the ongoing 'Brexit' process.

Republic of Uganda, Sector Risk Score 3.5. Country Risk Score 3.25, Mapping Table 3.0 to 3.5*

The Ugandan financial institutions sector risk score of '3.5' balances the low levels of private sector leverage (approximately 15% of GDP) and currently modest levels of non-performing loans, with high amounts of foreign currency lending (35% of total loans) and high concentration risks. The system is dominated by the largest commercial banks, which largely have well managed foreign owners. Positively, profitability and capital adequacy of the system currently appear to be robust. Banking supervision and regulation are sound. Deposits dominate the funding base of the system. Capital markets are underdeveloped.

Republic of Zambia, Sector Risk Score 2.0. Country Risk Score 1.75, Mapping Table 1.0 to 2.0*

The Zambian financial institutions sector risk score of '2.0' is restrained by the currently high fiscal strain facing the Zambian government and public sector more generally, but also high levels of foreign currency lending (over 35%) and high lending concentrations. We consider the regulation to be broadly behind the regional average, but the structure of the sector benefits somewhat from the dominance of foreign owned banks, which control 83% of the banking sector assets. We believe corporate and retail deposits make up the majority of the funding base, although we also anticipate a high amount of foreign lines. Capital markets remain underdeveloped.

Republic of Zimbabwe, Sector Risk Score 1.0. Country Risk Score 0, Mapping Table 0.0 to 1.0*

Zimbabwe's financial institution sector risk of '1' is restrained by rising hyperinflation and the unquantified ramifications of the on-going COVID-19 pandemic posing major risks to the banking industry's operations and performance. Furthermore, severe local currency devaluation, volatile monetary policy, and a long-term weak fiscal position are a material risk to business stability and the already weak banking sector consumer confidence. In the majority of Zimbabwean banks, monetary assets make the bulk of net assets. As a result, in a hyperinflationary environment, monetary losses will erode performance gains and nominal capital. Furthermore, yields are under threat from rising YoY inflation to 785.55% at May 2020.

The traditional banking model is already at risk, the next 12 months will further catalyst the holding of illiquid fixed assets over loans or liquid assets. Due to the significant local currency devaluation, some banks may not be able to attain the regulatory minimum Tier 1 capital equivalent of USD30m by December 2020. The new capital requirements are considered a step in the right direction to ensure stability and soundness of the banking sector provided the central bank takes a firm stance on non-compliant institutions. However, there is higher likelihood of policy revision opposed to license revocation. We expect the hyperinflationary environment will persist driven by high local money supply growth in the wake of the COVID-19 pandemic.

Despite the sound loan book performance of the banking sector, initial assessments indicate that banks' operations may face additional challenges with credit extension and loan repayment. Local currency liquidity is sound, however, GCR expects foreign currency ("FX") liquidity challenges to persist and high probability of default on FX debt. GCR also believes that promoting exchange rate stability, will remain extremely taxing given continued foreign exchange shortages and persistent monetary instability in 2020. Regulation is viewed relatively weaker than the regional average, improvement efforts are constrained by political interference resulting in an unstable operating environment. Failure by regulatory and monetary authorities to arrest regulation, governance & policy certainty may result in the sector score being negatively impacted. The score also takes into account the somewhat fragmented sector, which has created stiff competition, but the banks in the top tier are generally profitable and adequately capitalized. Funding is largely deposit based, spread between corporate and retail deposits. However, we expect large concentrations in the funding base due to erosion of household incomes and moderate probability corporate closures.

*Country Risk scores as at date of publication.

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