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South African Banks' Credit Risks Are Rising As The Economy Slows

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South African Banks' Credit Risks Are Rising As The Economy Slows

South African banks are facing growing credit risks as the economy worsens. The outlook on all banks we rate in the country turned negative at the end of 2015, reflecting the negative outlook on the sovereign, the prospect of slower economic growth, rising interest rates, and inflationary pressures on the banking system's asset quality. We expect top-tier banks will face credit losses on their lending activities ranging between 0.9% and 1.2% in 2016, worsening by another 20 basis points (bps) in 2017.

Elements of market dislocation are also entering the banking system, with one bank up for sale, another likely to be divested, the re-entry of one bank from resolution, and a fourth bank shaking up mass market retail banking in the country. South African banks' expansion into other parts of the continent also appears less attractive in 2016 than over the past few years, which is likely to limit appetite for growth and raise credit costs. Consequently, banks' strategic focus is likely to turn defensive rather than expansionary.

Overview

- South African banks face profitability pressures over the next two years amid a weakening economy and rising credit risks.
- Market changes in the banking system, and a less attractive outlook for their operations in other parts of Africa could add profit pressures.
- Funding pressures have eased, but banks face regulatory pressure and rising risk costs.

Nevertheless, funding pressures on banks have eased a little due to the proposed regulatory discretion on the requirements on banks of the net stable funding ratio (NSFR; the proportion of long-term assets which are funded by long-term, stable funding. However, we still expect the restructuring of funding will continue, albeit at a slower pace. We consider short-term concentrated wholesale funds to be a common idiosyncratic risk for most of the banks in the sector. Yet, systemic risks are lower than in other emerging markets because of the closed rand system and minimal reliance on external and hard currency funding.

We expect that changing funding profiles, regulatory changes, and rising credit costs will place pressure on the industry's profitability in 2016 and 2017, despite the endowment effect from increasing interest rates.

Table 1

Rated South African Banks

	Issuer credit ratings	National scale ratings	Asset base (bil. ZAR)*	Market capitalization (bil. ZAR)
Investec Bank Ltd.§	BBB-/Negative/A-3	zaAA-/zaA-1	473.63	100.05
Standard Bank of South Africa Ltd.**	BBB-/Negative/A-3 (Unsolicited)	N.R	1,979.35	215.23
FirstRand Bank Ltd. §§	BBB-/Negative/A-3	zaAA-/zaA-1	1,139.51	270.49
Capitec Bank Ltd. ***	BB+/Negative/B	zaA/zaA-2	62.95	71.11

Table 1

Rated South African Banks (cont.)				
	Issuer credit ratings	**National scale ratings**	**Asset base (bil. ZAR)***	**Market capitalization (bil. ZAR)**
Nedbank Ltd.§	BBB-/Negative/A-3	zaAA-/zaA-1	925.73	93.37
Absa Bank Ltd.§	N.R	zaAA-/zaA-1	1,144.60	124.71
African Bank Ltd.§	B+/Negative/B	zaBB-/zaB	50.68	N.A.

*Asset base of the group entities. §Year ended March 31. **Year ended Dec. 31. §§Year ended June 30. ***Year ended Feb. 28. N.A.--Not available. Source: S&P Ratings Direct. Ratings and market capitalization are as of April 28, 2016.

Table 2

South African Banks Key Metrics						
(%)	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Growth in assets	4.63	4.15	8.35	9.57	9.09	9.96
Growth in net loans	1.57	4.42	9.06	8.71	10.35	10.04
Growth in revenues	5.78	4.96	18.00	9.34	11.26	8.91
Growth in net income	11.40	44.03	(2.52)	11.02	15.53	18.37
Nonperforming loans to gross loans	6.38	5.22	4.46	3.74	3.25	3.21
Loan loss reserves to nonperforming loans	38.69	42.27	52.25	61.24	64.07	66.16
Credit losses to average assets	0.73	0.59	0.75	0.69	0.60	0.57
Cash, money market and securities to total assets	24.56	26.60	27.41	19.45	19.84	27.32
Return on average assets	0.99	1.37	1.25	1.28	1.35	1.46

Source: Rated banks' financial statements.

Economic Growth Revised Down, External Risk Revised Up

We expect the South African economy will grow by 0.8% in 2016 and 1.8% in 2017, slowing from 1.3% in 2015. The reasons for the weakening macroeconomic outlook are manifold. However, we think they can broadly be bracketed into two groups: long-term domestic structural challenges, such as low wealth, poor labor market relations, and infrastructure bottlenecks; and short-term domestic structural challenges, such as low business confidence, the prolonged drought, constrained electricity supply, and somewhat restrained household spending. Some external pressures are also dragging on growth. For example, commodity prices are down, largely due to weaker demand from China, South Africa's biggest export destination. Meanwhile, the weak growth, political mismanagement, and generally negative sentiment against emerging markets, including South Africa, has weakened interest from foreign as well as domestic investors. The resulting portfolio outflows have caused significant currency deterioration, which has accelerated inflation and raised interest rates.

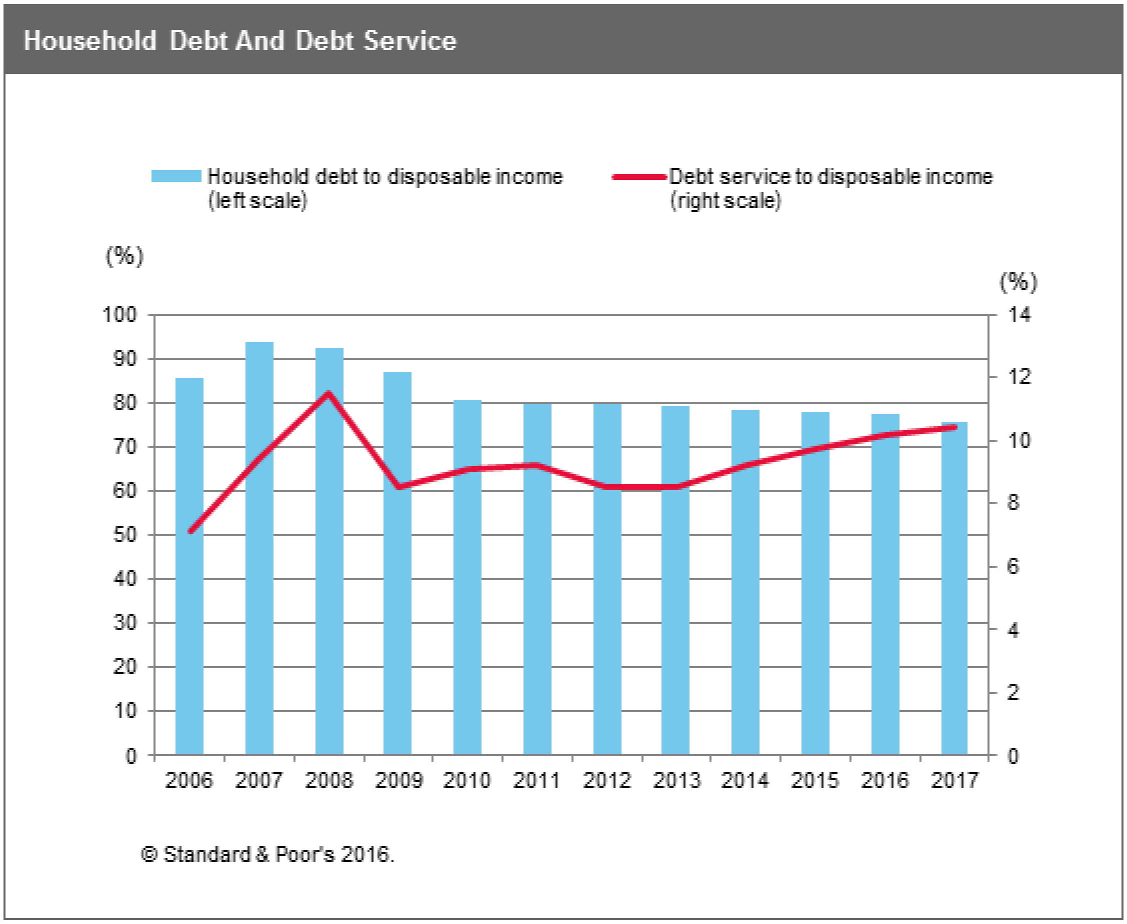
Credit Costs Are Likely To Rise Toward The End Of 2016

We expect that the myriad of external and domestic economic factors will put pressure on the credit costs of South African banks into late 2016 and early 2017. Banks have been diversifying their loan books since 2008. Mortgage lending has shrunk from 33% of total loans in 2008 to 28% in 2015, while alternative forms of retail credit have increased from 12% to 16% over the same period. As a result, the overall contribution of households to banks' loan books has lessened somewhat over the past seven years. Lending to corporates has taken up some of the slack in growth over that time, rising at a relatively faster rate than households. This now contributes 40% of total loans, from 35% in 2008.

The growth of the corporate loan book has outperformed our expectations, which had been guided by the very low business confidence levels recorded in the domestic economy over the past few years. We believe this faster growth can be explained by the quick growth of the domestic infrastructure space (particularly renewables), growth into Africa, and some inflationary domestic capex. We nevertheless think corporate lending will struggle to reach the average 10% growth rates accomplished over the past five years, given our expectations of lower government and infrastructure spending, less attractive continental expansion, reduced economic activity from key export partners, as well as generally sluggish growth and the weak rand. We also see some room for deterioration in the quality of the corporate book as a result of these adverse trends, especially for small businesses, and due to the high leveraging of recent years. Standard & Poor's data shows that South African corporates' EBITDA has reduced slightly over the past five years, particularly the past two. This excludes the mining sector, which, if included, would materially drag down the performance of the entire corporate sector. Positively, the banks are not overly exposed to mining, which accounts for less than 3% of total loans, and they have very little foreign currency lending across the entire corporate book, which protects the quality against the weak rand. We therefore expect the corporate loan book will continue to outperform loans to households in 2016, although a concentration of large loans to single names is a weakness.

We continue to believe that domestic households pose the most significant source of risk for the banks because of their relatively high leverage and low wealth levels compared with other emerging markets. On a positive note, household leverage (defined as household debt to disposable income) has been gradually decreasing over the past few years, to 77.6% at year-end 2015 from 79% in 2013 (see chart 1). Less positive, however, is that the nature of this leverage has changed from the secured residential mortgages and more unsecured lending and installment credit. We believe this reflects two trends: first, the relatively quicker deleveraging of the wealthy versus the middle and lower income markets; and, second, a tightening of credit policies restricting access to long-term secured credit in favor of shorter-term higher-margin loans. As a result of this, as well as pressure on disposable income from slower real-wage growth versus inflation, we believe that, despite the decline in household leverage, general household affordability has been decreasing.

Chart 1



Declining affordability among South African households can best be illustrated by the debt service-to-disposable income ratio, which increased to 9.7% in 2015 from 8.5% in 2013. Over the past few years, modest interest rates have been the primary driver for household affordability. Yet, while the recent interest rate rises have had a significant impact on debt service, we also expect inflation to have an equally big impact by eroding disposable incomes going forward. Against our anticipation of interest rate rises of between 75-125 basis points (bps) over the next 12-18 months and inflation of between 7%-8% in 2016, we expect debt service-to-disposable income to rise to around 10.2%-10.4% in 2016, the highest levels since 2008. In tow of this, we believe household asset quality will start deteriorating once again in 2016, albeit not to lows of 2008 unless there was an unexpectedly rapid growth in inflation and interest rates or an unanticipated house price correction. The improved mix of bank loan books, lower loan-to-value of residential mortgages, and the absence of bubbles in the credit or real estate boom should mitigate against this. On the other hand, there seems very little likelihood of any reprieve for households, so that long-term pressure on asset quality seems here to stay. We expect credit losses for the top-tier banks to range between 0.9% and 1.2% in 2016 and to worsen by another 20 bps into 2017.

Table 3

Rated South African Banks Key Asset Quality Metrics						
	2010	**2011**	**2012**	**2013**	**2014**	**2015**
Nonperforming loans (bil. ZAR)	138,128	117,561	109,601	100,062	95,708	104,071
Loan-loss reserves (bil. ZAR)	53,440	49,689	57,268	61,274	61,318	68,855
Nonperforming loans to gross loans (%)	6.4	5.2	4.5	3.7	3.3	3.2
Loan-loss reserves to nonperforming loans (%)	38.7	42.3	52.3	61.2	64.1	66.2
Credit losses to average assets (%)	0.7	0.6	0.8	0.7	0.6	0.6
Credit losses to operating revenues (%)	13.4	10.8	12.5	11.3	9.7	9.3
Risk-weighted assets/total assets (%)	51.61	53.53	54.64	54.64	55.13	54.71

Source: Rated banks' financial statements.

Relative Industry (In)Stability

South African banking has been operating as a strong oligopoly for nearly 20 years. This industry structure maintains stability, raises barriers to entry, and maintains the profitability of the sector. Up until three years ago, the banking sector was seen as ripe for acquisition from large global financial institutions. This led to the near takeover of Nedbank Group Ltd. by HSBC Bank PLC in 2011, the 20% stake in Standard Bank Group that the Industrial and Commercial bank of China (ICBC) purchased in 2007, and the increased stake taken by Barclays Plc in Absa in 2013.

Yet, this trend now seems to be in reverse. Barclays PLC and Old Mutual PLC have both stated their intention to divest their banking operations in South Africa, driven essentially by regulatory changes and investor pressure. In March 2016, we lowered the ratings on nonoperating holding company (NOHC) Barclays Africa Group Ltd. to reflect our opinion that the lowering group support no longer mitigates the NOHC's additional risk of structural subordination from the largest operating bank (see "Barclays Africa Group Downgraded To 'zaA/zaA-2'; Subsidiary Absa Bank 'zaAA-/zaA-1' Ratings Affirmed," published March 9, 2016, on RatingsDirect). As we do not factor in any support to the ratings on Nedbank Ltd., we do not expect any changes in the ratings upon divestment.

Another key change for the banking sector over the past few years has been its growth into Africa. This trend was driven by a perceived need to diversify out of the South Africa and follow the domestic corporates into the continent. In 2015, banks' reported revenue contribution from Africa differed significantly between individual banks. The rest of Africa contributed approximately 25% of headline earnings in 2015 for Standard Bank Group but only 6% of headline earnings in 2015 for Nedbank Group. We do not expect the banking sector's African exposure will be a material differentiator of bank ratings in 2016, but it could be a source of additional credit impairments, add some potential capital drain, and provide a lower contributor to revenues given the pressures faced on the continent.

A further alteration in the banking sector landscape is that Capitec Bank Ltd. has in recent years become a serious challenger in the South African mass and middle market retail banking space. As of Feb. 29, 2016, the bank reported 7.3 million active retail clients (approximately 17.5% of the total market), up from 1.5 million in 2009. We expect the bank's rate of customer acquisition will slow down, but we still believe it could become the country's third-largest bank in terms of customer numbers by end-2017. The way in which banks offer products and services to South Africa's retail sector is likely to become increasingly competitive, especially in the transactional space, over the next few years.

Regulation In 2016

We expect regulation of the South African banking system to remain a supportive factor for the ratings on domestic banks, but we also believe it will be an increasing strain on profitability and management time in 2016.

Plans to introduce a twin regulatory structure--aimed at separating prudential regulation and market conduct of financial services--under the South African Reserve Bank and the Financial Services Board, respectively, have been delayed into 2016. With the exception of some additional managerial oversight and management time, and potentially some fee and commission changes, we don't anticipate any material changes for the banks under the new framework.

African Bank came out of resolution on April 4,2016, providing a useful test for the upcoming resolution regime (see "African Bank Ltd. Assigned 'B+/B' And 'zaBB-/zaB' Ratings After Restructuring; Outlook Negative," published April 5, 2016. We changed our classification of the South African government to unsupportive from supportive in December 2015 due the bail-in of African Bank creditors and the ongoing work on adopting a resolution regime.

We expect the principles of South African banking legislation will follow the "Key Attributes for Effective Resolution Regimes," proposed by the Financial Stability Board, developed together with the IMF and the G-20. In essence, we continue expect the framework will:

- Allow for market-led solutions, when appropriate;
- Allocate full loss absorbency to shareholders and hybrid capital instruments, including subordinated note holders, and then possibly haircut senior note holders, while protecting retail depositors;
- Offer a retail deposit insurance scheme;
- Adopt a resolution strategy for banks on an individual basis, depending on the prevailing market conditions and the size, scale, and complexity of the institution in question; and
- Provide more guidance regarding the concept of total loss-absorbing capital (TLAC) and/or a minimum requirement for own funds and eligible liabilities (MREL).

What is the Story On The Introduction Of Covered Bonds In South Africa?

For a long time, the South African regulators ruled out allowing banks to issue covered bonds because of concerns about their seniority versus depositors. However, in 2014/2015, owing to the discussion regarding resolution regimes, and specifically the anticipated introduction of retail depositor guarantees, these regulatory concerns seemed to have somewhat alleviated. Meanwhile, potential domestic issuers reacted with relative enthusiasm to the introduction of covered bonds, largely due to the idiosyncratic challenge of meeting the Basel 3 net stable funding ratio (NSFR). As a result, the South Africa Reserve Bank and the National Treasury set up a working group to change the legal framework and insolvency regulations, among other things, to facilitate a resolution regime that would have made space for covered bonds. However, in late 2015 some national discretion was allowed regarding the NSFR, and domestic investors, who provide a considerable amount of domestic bank funding, are reluctant due to the potential impact on pricing and loss-given default of senior unsecured debt ratings and spread widening. As a result, we expect any covered bond market development is at least three years away.

Funding Pressures Are Idiosyncratic, Not Systemic

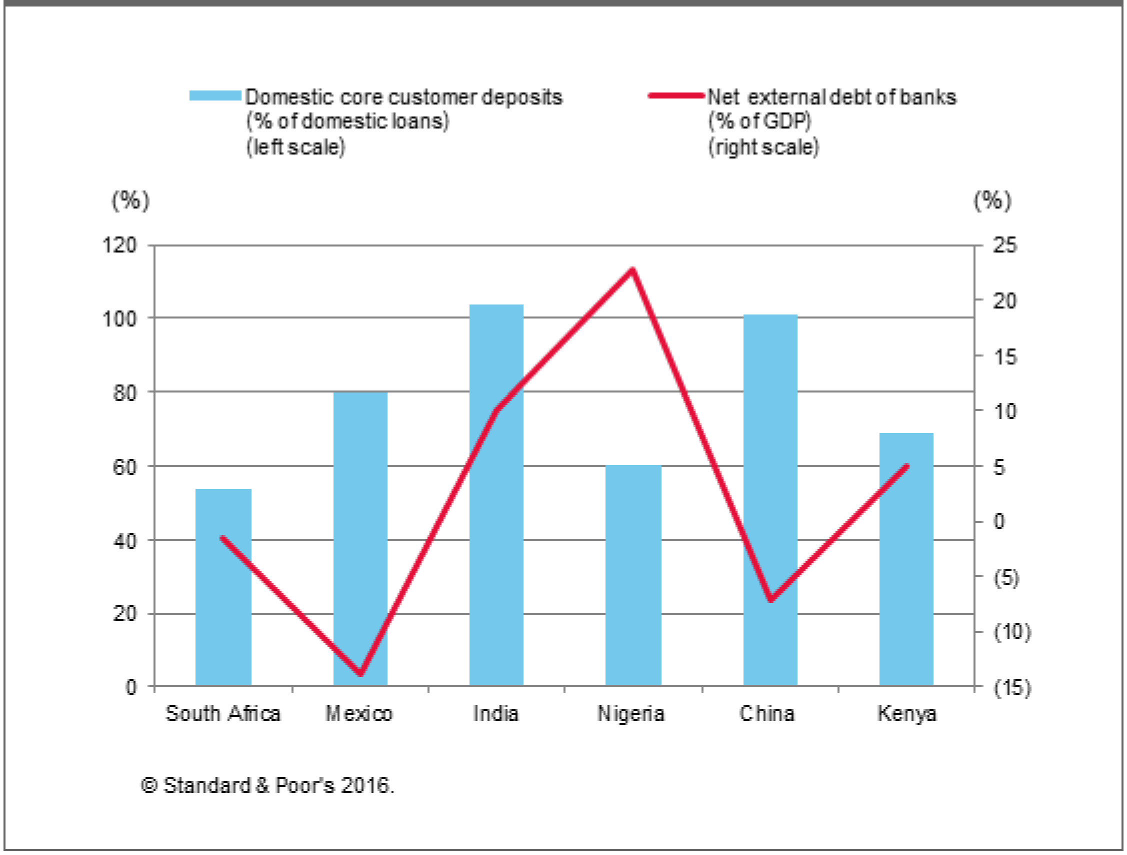
Funding has been a significant area of focus for the banks, largely due to regulatory pressures. The recent proposal for national discretion on the net stable funding ratio (NSFR) was positive news for the banks. It will allow a lower weighting for less-than-six-month funds from institutional investors. Using this discretion, the banks will meet the NSFR and have already met (with or without the use of the committed liquidity facility) the liquidity coverage ratio. Nevertheless, we expect the banks will continue some of their efforts to reposition their funding over the next few years. Undoubtedly, long-term issuance offshore is unlikely given the expense and the decline in global liquidity. Efforts to push institutional investors to term at all costs will probably lesson. However, we still expect competition for retail, SME, and operational corporate deposits to be fierce and use of securitization (in-house for committed liquidity facility purposes and for funding relief) and high quality liquid asset preference to continue.

We believe this is important because banks in South Africa face the idiosyncratic funding risk that concentrated wholesale funds could leave a bank if there is a capital or credit event. We believe the trapped liquidity caused by the closed rand system would guard against systemic shock in such an event. However, banks would need emergency central bank liquidity support to survive, which wouldn't necessarily guard against late payment or haircuts on senior or subordinated obligations of a bank placed into resolution.

With regard to systemic shock, we see the closed rand system and lack of external and hard currency funding as a significant boon for the South African banks, especially compared to other emerging markets, which is important given reduced global liquidity and anti-emerging market investor sentiment.

Chart 3

South Africa And Peers External Funding And Domestic Core Deposits



Related Criteria And Research

- African Bank Ltd. Assigned 'B+/B' And 'zaBB-/zaB' Ratings After Restructuring; Outlook Negative, April 5, 2016
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