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South Africa Banking Outlook 2018: An Oasis Of Stability In A Weak Operating Environment

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South Africa Banking Outlook 2018: An Oasis Of Stability In A Weak Operating Environment

Weeks into 2018, South Africa's banking sector is still stable, although the domestic economy continues to struggle with low growth.

The outlooks on all rated South African banks are stable for the first time since 2013. Thanks to their fairly robust financial performance, these banks have found a balance between weak economic growth and low investor and household confidence in South Africa.

Overview

- Our outlooks on the long-term issuer credit ratings of the banks' we rate in South Africa are stable, and the majority of issuers have stand-alone credit profiles (SACPs) that are higher than our ratings on the sovereign.
- The weak pace of economic growth, an unstable fiscal position, the government's rising contingent liabilities, and persisting political uncertainty dull recovery prospects.
- We expect South African banks will continue to enjoy resilient financial performance in 2018, although we believe profitability has likely peaked.

South African banks have rung in the new year with the same challenges as the previous years': Weak economic growth, ongoing political noise (but with positive signs of change), and state-owned enterprises with significant liquidity and governance problems that continue to restrain business, investor, and retail confidence. Alongside the government's constrained fiscal position, these factors are delaying any recovery.

However, South African banks are likely to withstand these challenges thanks to their strong credit standings compared with that of the sovereign.

South African banks have been extending credit slowly and with increasing conservatism, while simultaneously building capital and loan loss provisions, thanks to the sector's longstanding robust profitability. Even the funding and liquidity fundamentals appear more solid for the domestic banks than they did five years ago, with early compliance with the Basel III ratios seemingly no longer an issue. Furthermore, and more importantly in our opinion, South African banks are less exposed to external factors than their emerging market peers.

Table 1

South African Banks Rated By S&P Global Ratings

Bank name	Absa Bank Ltd.	African Bank Ltd.	Capitec Bank Ltd.	FirstRand Bank Ltd.	Investec Bank Ltd.	Nedbank Ltd.
Anchor	bbb-	bbb-	bbb-	bbb-	bbb-	bbb-
Business position	Strong (+1)	Weak (-3)	Moderate (-1)	Strong (+1)	Adequate (0)	Strong (+1)
Capital and earnings	Moderate (-1)	Very strong (+2)	Strong (+1)	Moderate (-1)	Adequate (0)	Moderate (-1)
Risk position	Adequate (0)	Weak (-2)	Moderate (-1)	Adequate (0)	Adequate (0)	Adequate (0)

Table 1

South African Banks Rated By S&P Global Ratings (cont.)

Bank name	Absa Bank Ltd.	African Bank Ltd.	Capitec Bank Ltd.	FirstRand Bank Ltd.	Investec Bank Ltd.	Nedbank Ltd.
Funding and liquidity	Average & Adequate (0)	Below average & Adequate (-1)	Average & Strong (0)	Average & Adequate (0)	Average & Adequate (0)	Average & Adequate (0)
SACP	bbb-	b+	bb+	bbb-	bbb-	bbb-
ALAC support	0	0	0	0	0	0
Sovereign support	0	0	0	0	0	0
Group support	0	0	0	0	0	0
GRE support	0	0	0	0	0	0
Additional factors	(2)	0	(1)	(2)	(2)	(2)
ICR	Not applicable	B+/Stable/B	BB/Stable/B	BB/Stable/B	BB/Stable/B	BB/Stable/B
National scale rating	zaAA-/--/zaA-1+	zaBBB/--/zaA-2	zaAA-/--/zaA-1+	zaAA-/--/zaA-1+	zaAA-/--/zaA-1+	zaAA-/--/zaA-1+

Note: All data as of Feb. 1, 2018. SACP--Stand-alone credit rating. ICR--Issuer credit rating.

Political Turmoil, Weak Economic Growth, And Struggling State-Owned Enterprises Have Increased Headwinds

We continue to expect weak economic growth for South Africa, although we project an improvement in real GDP growth to a still modest 1% in 2018 from 0.7% in 2017. Excluding agriculture and mining, South Africa's services-dominated economy barely grew last year. The private sector is investing less than the depreciation of the capital stock. On a per capita basis, consumption is declining. Despite close to 40% depreciation in the nominal effective exchange rate since September 2007, exports of manufacturing and other non-commodity sectors have been sluggish. This is the case even though the global economy is improving.

Discouragingly, since 2015, South Africa's economy has not been creating jobs on a net basis. With the population increasing at an annual pace of around 1.6% per year, South Africa's rate of unemployment has increased to an estimated 28% as of the second quarter of 2017 from 25% three years ago. South Africa's real per capita GDP growth rate has continued to decline, averaging -0.7% over 2015-2018. (See "South Africa Ratings Lowered On Weakening Economic And Fiscal Trajectory; Outlook Stable," published Nov. 24, 2017, on RatingsDirect.)

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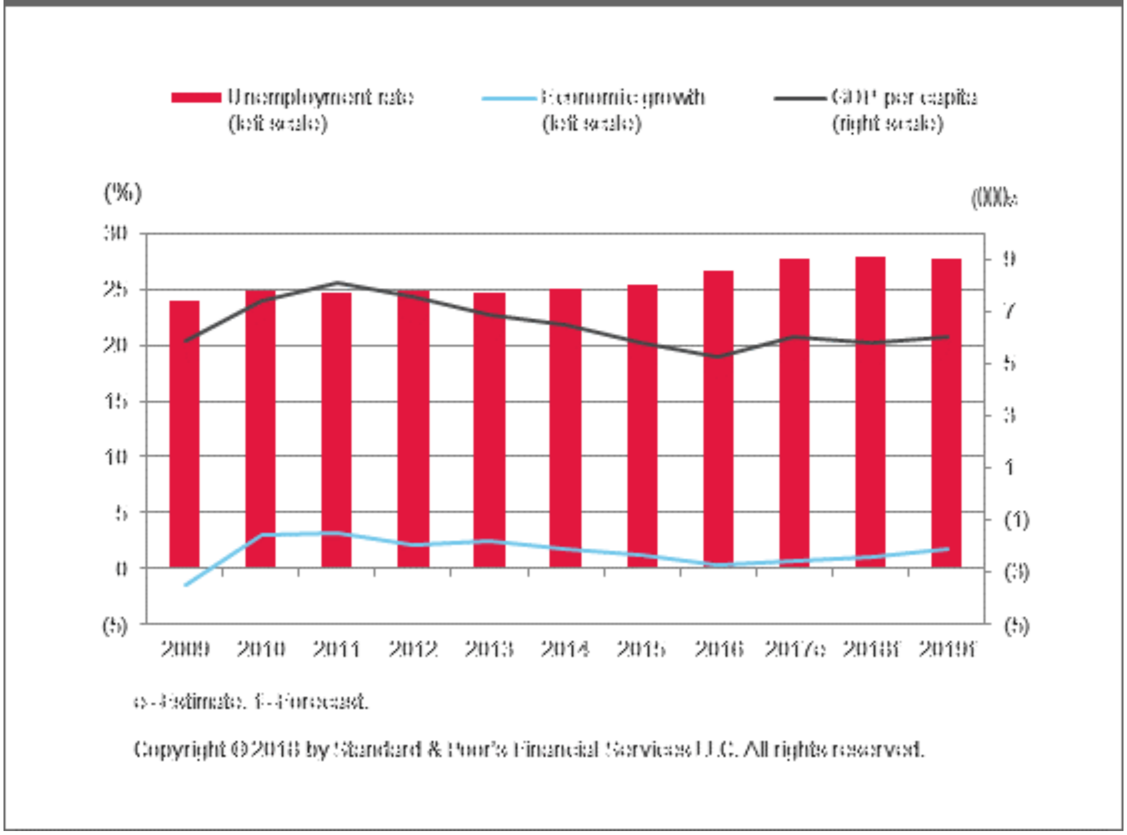
Chart 1

South Africa -- Economic Growth, Unemployment, And GDP Per Capita (2009-2019)



Still, we note that South Africa started 2018 with renewed optimism after the December 2017 victory of Mr. Cyril Ramaphosa, who was elected president of the African National Congress, South Africa's ruling party. The rand has reacted favorably to Mr. Ramaphosa, a seasoned politician and known businessman. However, we believe that improved private sector business sentiment will not translate to private sector investment in the short term. This is because private sector optimism is somewhat based on hope that Mr. Ramaphosa will push forward the state capture inquiry, tackling the taint of corruption and mismanagement at the senior executive level of government and its state-owned enterprises, and bring about some policy certainty alongside fiscal disciple. In our opinion, these are significant hurdles to jump, especially in the context of the 2019 general elections, and beyond, the challenges of addressing persisting socio-economic inequalities.

Positively, the political turmoil has not materially hurt the banking sector, despite last summer's attempt to undermine the independence on the South African Reserve Bank (SARB), which we believe has been rebuffed. The SARB is in a small minority of global central banks that has a few minor private sector shareholders. The debate regarding its nationalization is just a wrinkle in the political dialogue, in our opinion, but its independence from political interference is essential.

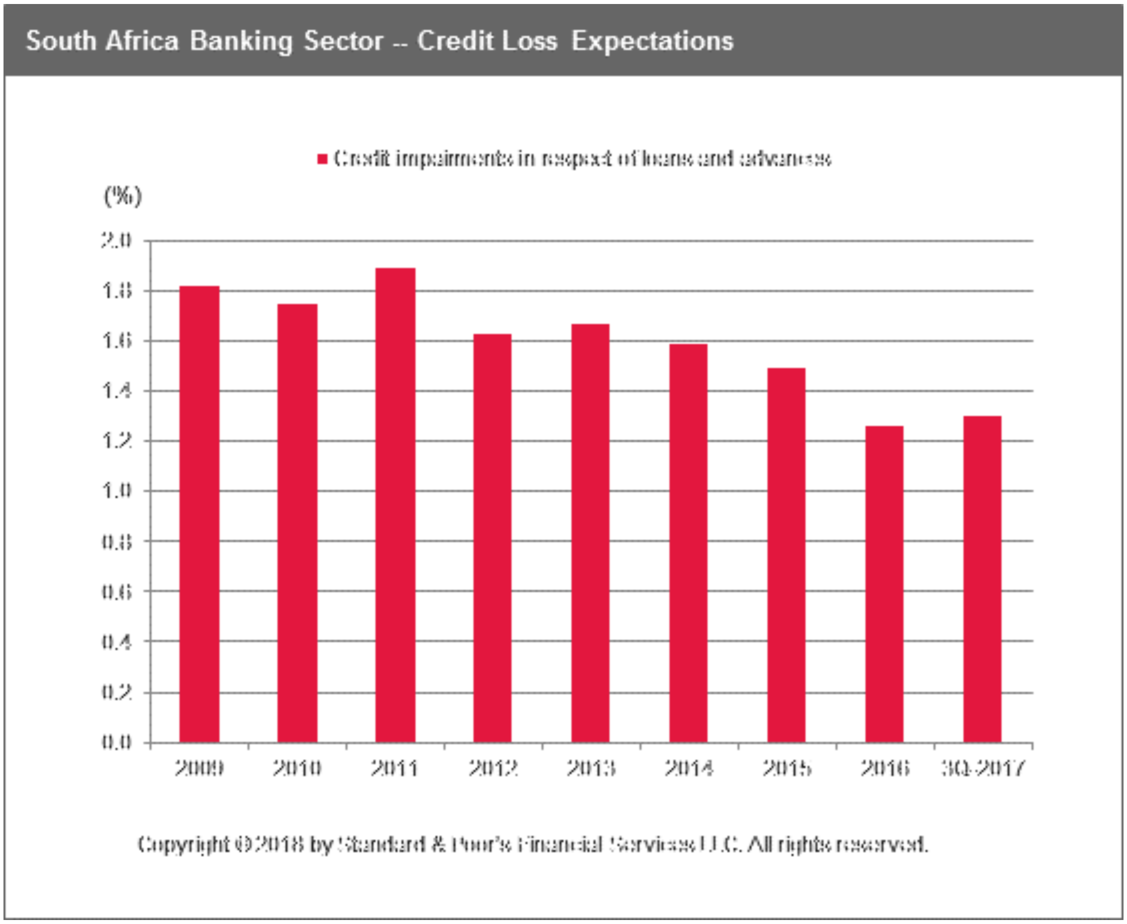
Reviving the performance of state-owned enterprises is another imminent challenge for the government. Public power company Eskom, in particular, faced meaningful liquidity shortfalls in January 2018, and its bonds were threatened with suspension from the Johannesburg Stock Exchange due to a delay in releasing its results. Positively, the loan books of most rated banks have minimal exposure to state-owned enterprises, including Eskom. Nevertheless, we believe they have started lending now that the governance issues are being tackled and there are open derivative positions that could trigger some direct losses to financial institutions in the event of a default. The indirect risk of the major failure of a large state-owned enterprise could be significant for the wider financial system since the asset management industry bears heavy exposures to these entities.

Asset Quality Will Remain Strong Despite Low Growth

Total private sector credit (defined as total household debt, plus corporate credit from banks and capital markets) has increased by less than 1% of GDP over the past three and a half years. Household lending has shrunk in real terms over the same period. We continue to expect sub-inflation growth in retail lending in 2018, because low economic growth, rising unemployment, and political uncertainties still confine consumer confidence. Corporate lending, which had been the engine for growth for the banking sector since 2013, also appears to have dropped in line with inflation.

Overall, we expect credit losses for the top-tier banks to range between 0.7% and 1.0% in 2018, and the lower-tier banks, especially the unsecured consumer lenders, will continue to drive to somewhat larger sector-wide losses (see chart 2).

Chart 2



We still believe that domestic households pose the greatest source of risk for South African banks, because of their relatively high leverage and low wealth levels compared with other emerging markets. Positively, we have seen an improvement in the fundamental health of domestic households in South Africa. Firstly, household debt to disposable income of households is on an eight-year improvement streak. By end-2018, we expect it to be around 72.5%, down a full 13% since its peak in 2009. Furthermore, we anticipate that debt serviceability to disposable income will improve to 9.4% in 2018 versus 9.6% in 2016. As such, despite a decreasing amount of mortgage lending to total lending (chart 4), the interest burden for households is improving for the first time in five years. This is in part due to the small interest rate cut in 2017. Moving further into 2018, we expect a continued minor improvement in household spending power, reflecting broad stability in domestic rates, with a bias toward slow and low cuts, and controlled inflation.

Chart 3

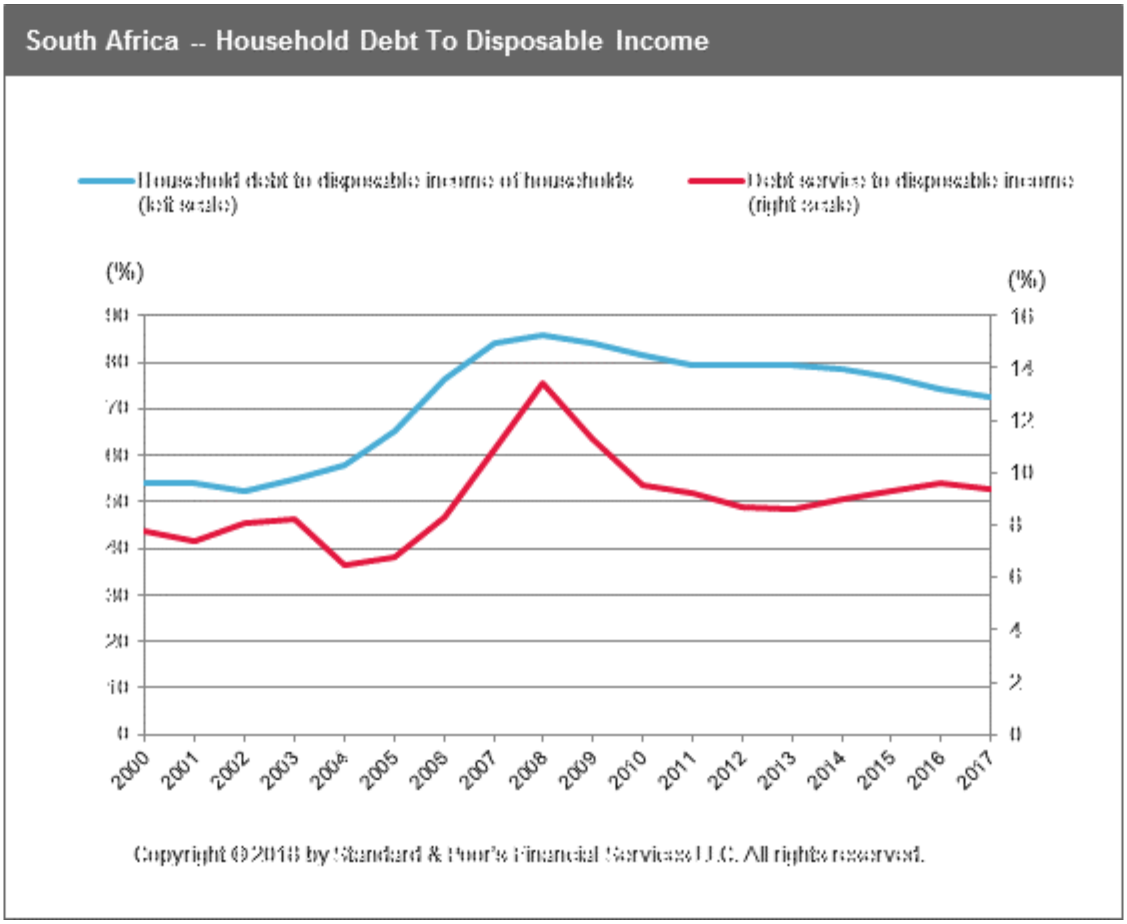

South Africa -- Household Debt To Disposable Income
Household debt to disposable income of households (left scale)
Debt service to disposable income (right scale)
(%)
(%)
90
80
70
60
50
40
30
20
10
0
16
14
12
10
8
6
4
2
0
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
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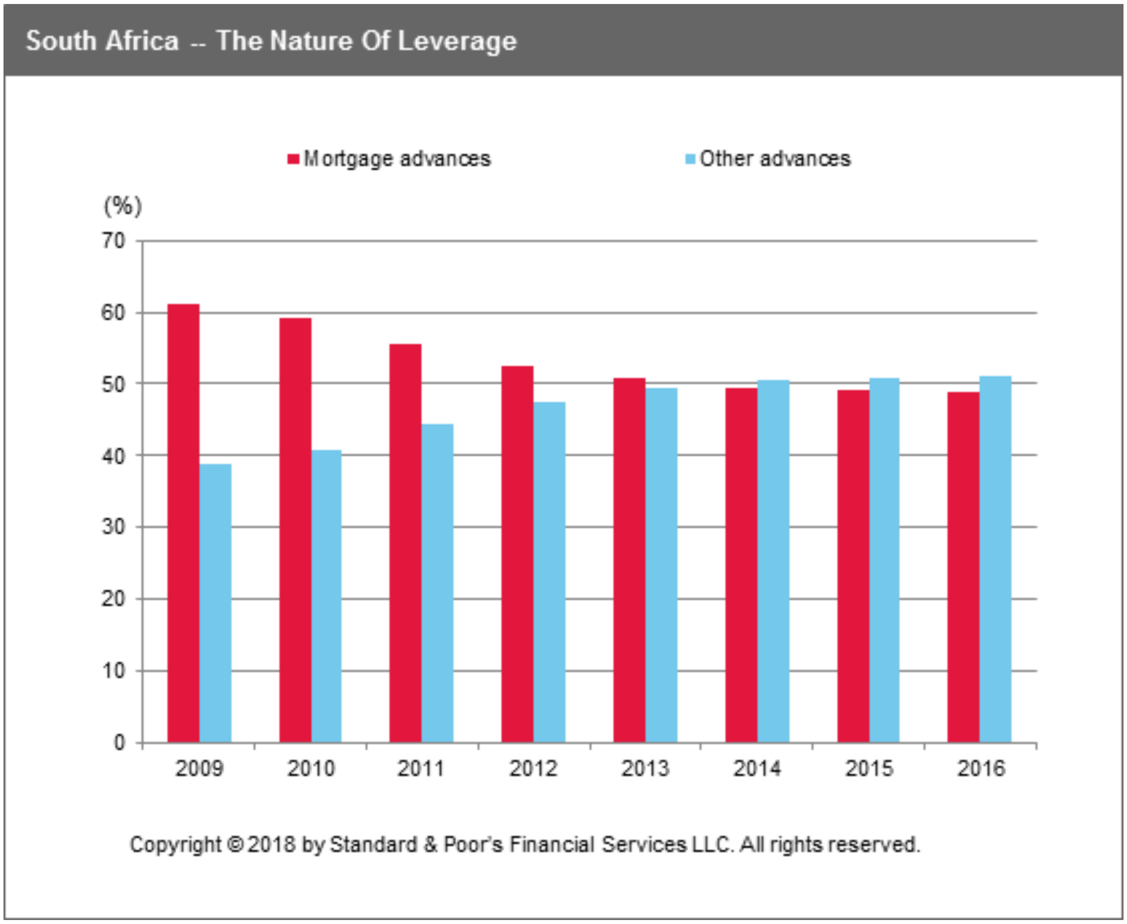
Chart 4



The South African housing market has largely been flat in real terms over the past seven years, balancing uncertainty and weak economic performance with historically modest interest rates and slow growth in housing supply. Overall, we anticipate the housing market will see marginal real growth in 2018. We note, however, a pronounced difference in the changing values of the different market segments. The middle classes appear to have the lowest appetite for home ownership, whereas the upper classes seem to have largely deleveraged. Perhaps most interesting, in our view, is the relatively rapid growth among lower income households, due to the combination of supply constraints and quicker population growth in this bracket.

Chart 5

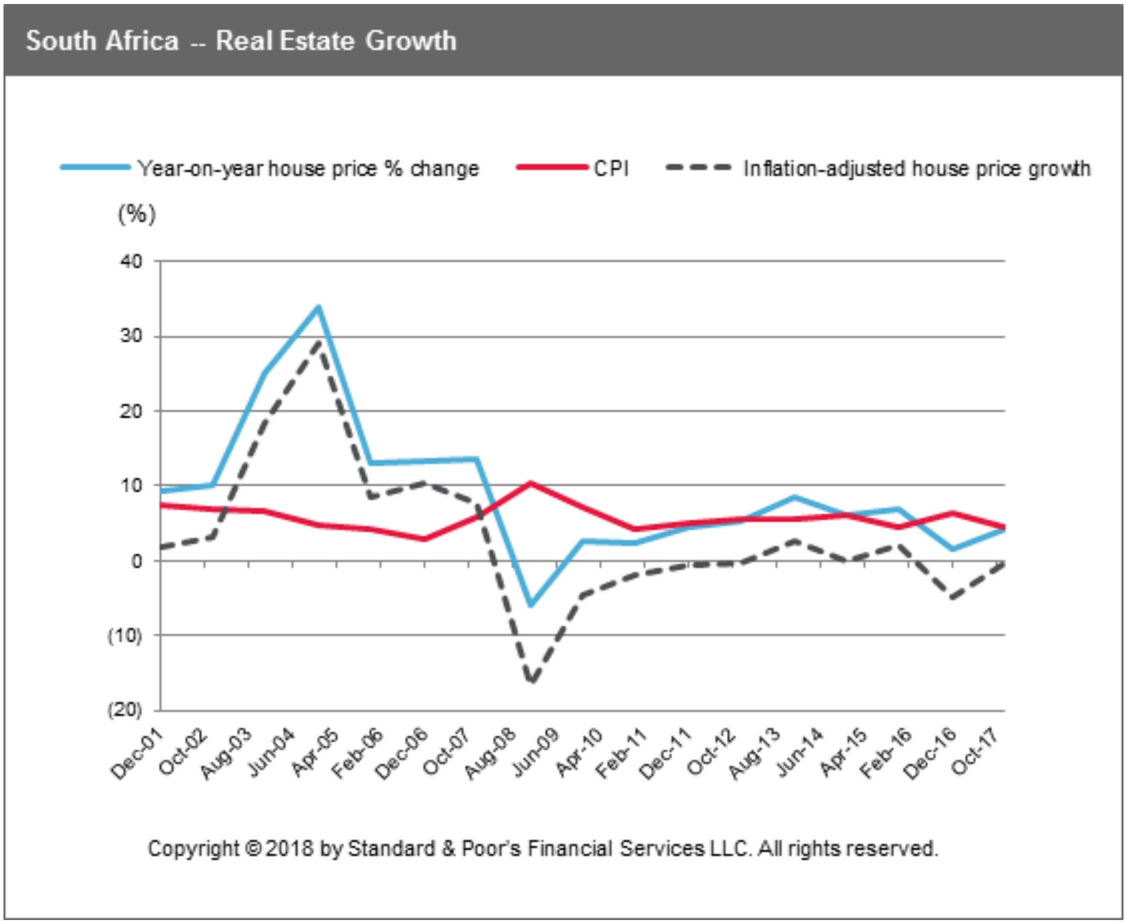

South Africa -- Real Estate Growth
Year-on-year house price % change
CPI
Inflation-adjusted house price growth
(%)
40
30
20
10
0
(10)
(20)
Dec-01
Oct-02
Aug-03
Jun-04
Apr-05
Feb-06
Dec-06
Oct-07
Aug-08
Jun-09
Apr-10
Feb-11
Dec-11
Oct-12
Aug-13
Jun-14
Apr-15
Feb-16
Dec-16
Oct-17
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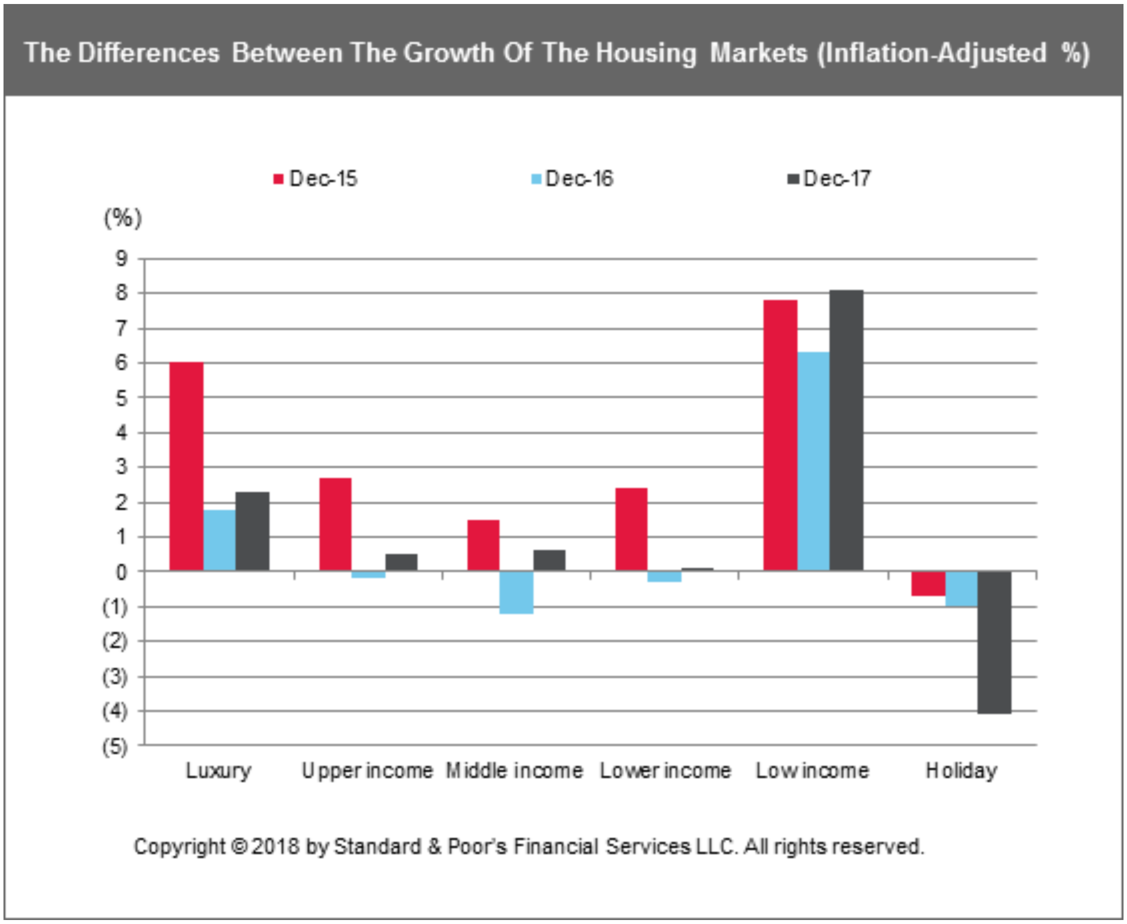
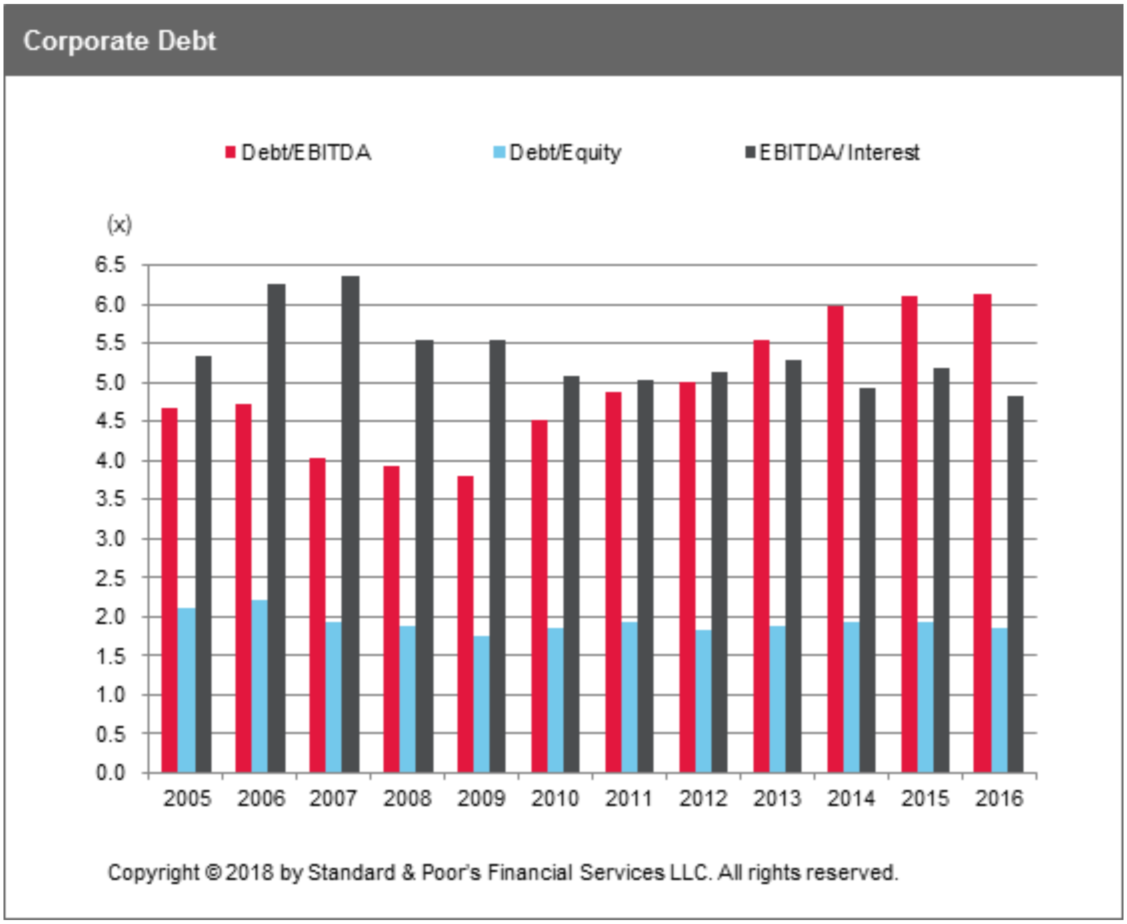
Chart 6



We see possible deterioration in the quality of the corporate loan books, due to leverage's upward creep over the past five to 10 years (averaging around 10% per year) and weaker profitability. S&P Global Ratings-adjusted debt to EBITDA for the domestic corporate sector exceeded 6x in 2017 from 5x in 2012. However, the interest coverage improved somewhat over the same period on the back of structurally lower interest rates. We continue to see material risks stemming from the construction sector.

The fall from grace of South African international retail holding company Steinhoff International (not rated) in late 2017, due to accounting irregularities, has yet to play out fully. However, we understand the domestic banks are exposed to the separately listed South African retail group, which appears to be less affected at this stage.

Chart 7



Performance Expected To Remain Solid

Against the context of low growth and stable credit losses, we expect South African banks to maintain robust profitability and sound capitalization in 2018. Although the banks have yet to release the impact of International Financial Reporting Standards rule 9 on both their capital adequacy and ongoing profitability, we do not expect a material change in our expectation.

Given the endowment effect of a negative interest rate cycle, reduction in fair value income (reflecting the downgrades and weak economy) and weak business flows, there is some pressure on revenue growth. Furthermore, while major banks have focused on cost management over the past few years, we do not factor in any additional efficiency gains going forward, reflecting the inflationary environment and high IT costs. The banking sectors amalgamated cost to income rose to 55.75% at end-September 2017 from 54.62% one year earlier, but our expectation of continued low credit losses is a silver lining.

Given the above, we project that in 2018 South African banks will be resilient against the discouraging economic situation domestically and show stable performance, but that profitability has most likely reached its peak.

Due to the continued weak credit extension and ongoing good internal capital generation, we think capital has slight upside potential, despite the banks reporting capitalization at the top end of the range. Total capital adequacy increased to 16.84% at Sept. 30, 2017 from 15.47% one year earlier.

South African banks funding and liquidity has improved over the past few years, increasing the amount of core deposits (non-financial corporate and households) to approximately 53% of total funds in 2017 from 45% in 2011. Also, there has been a slight lengthening of term by the financial corporates over that time. We still believe the concentrated nature of funds to financial corporates remains an idiosyncratic risk for most banks. However, we also believe a systemwide liquidity event is less likely than other emerging markets due to exchange controls, limited external funds (about 8% of total funds in 2017) and a net creditor position.

Related Criteria

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Sovereign Government Rating Methodology And Assumptions, June 30, 2011

Related Research

- South Africa Ratings Lowered On Weakening Economic And Fiscal Trajectory; Outlook Stable, Nov. 24, 2017
- Ratings On Eight South African Financial Institutions Lowered Following Similar Action On Sovereign, Nov. 29, 2017
- An Illustrative Rating Path For A Systemic Bank In A Bail-in Resolution, Oct. 4, 2017

Only a rating committee may determine a rating action and this report does not constitute a rating action.

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