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South African Bank Outlooks Remain Negative But The Pressure Is Easing

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South African Bank Outlooks Remain Negative But The Pressure Is Easing

The outlooks on all rated South African banks remain negative at the start of 2017, continuing to reflect the combined pressures of weak economic growth and the persistent credit risk of over-leveraged households.

We expect GDP growth in 2017 to improve to a still modest 1.4% from 0.5% in 2016. At the same time, the impetus for rapid interest rate rises is declining, reflecting low economic growth and inflation just outside the publicized range of the South African Reserve Bank (the central bank). As a result, we expect the downside risks will continue to lie dormant for the domestic banking sector and therefore credit losses for the top tier banks of between 0.8% and 1.0% in 2017.

Overview

- Low economic growth and high household leverage remain a persistent, albeit dormant, risk for bank credit quality.
- We believe better growth and lower inflationary and interest rate pressure should allow for only a mild deterioration in asset quality.
- Profitability should remain robust, although rest-of-Africa business may cause some volatility to the bottom lines.
- Funding pressures have eased but remain a dominant risk.

We expect the domestic banking sector's return on equity to stabilize at 15%-19% for the next couple of years as the positive effect of the gradual rise in interest rates is mitigated by increasing provisions and cost of funds.

We continue to believe the elements of industry dislocation that entered the system in 2015/2016 will have little or no impact on the profitability of the system. We do, however, believe the rest-of-Africa operations may represent an ongoing drain on some banking groups' profitability over the next 12 months.

Over the past few years, funding pressures have eased due to regulatory discretion. This, alongside the gains already made, is likely to stop South African banks actively adjusting their funding and liquidity profiles further. We continue to believe short-term concentrated funds represent an idiosyncratic risk to bank creditors, but the closed South African rand system and lack of external funding mitigates system-wide risk.

Table 1

Rated South African Banks -- Key Metrics

(%)	2011	2012	2013	2014	2015	2016*
Growth in assets	0.11	10.89	9.98	7.18	14.89	2.17
Growth in net loans	1.99	10.07	10.47	10.19	10.29	2.58
Growth in revenues	7.23	17.46	9.39	11.69	9.43	0.58
Growth in net income	53.63	(10.68)	15.95	17.62	13.10	(13.42)
Nonperforming loans to gross loans	5.30	4.45	3.61	3.07	2.93	3.40

Table 1

Rated South African Banks -- Key Metrics (cont.)						
(%)	**2011**	**2012**	**2013**	**2014**	**2015**	**2016***
Loan loss reserves to nonperforming loans	41.00	50.85	60.02	65.35	66.75	63.25
Credit losses to average assets	0.66	0.86	0.75	0.65	0.62	0.66
Cash, money market, and securities to total assets	23.32	23.25	23.07	22.59	23.55	22.81
Return on average assets	1.60	1.35	1.42	1.54	1.57	1.26

*2016 includes data for African Bank Ltd. Source: Rated banks' financial statements.

Economic Growth Still A Weakness

We have marginally revised down our real GDP growth assumptions for South Africa to 0.5% for 2016 and 1.4% for 2017 (last June we forecast 0.6% for 2016 and 1.5% for 2017). Our revised projections are contingent on global growth, and, in particular, South Africa's terms of trade. The economy remains directly and indirectly linked to demand for commodities, especially from China. Long-term domestic challenges remain a persistent drag on growth, and while the government has identified important reforms and supply bottlenecks, it will take a long time to address the longstanding skills shortage and infrastructure bottlenecks. Without signs of real improvement or at least policy certainty and continuity, private sector investment is likely to remain low. Household spending will likely remain restrained.

Real Credit Growth And Costs To Remain Flat

As a result of the factors described above, we expect the fairly benign credit growth of the past few years to continue into 2017. Corporate credit growth has continually outperformed our expectations, but we don't expect to the buoyant 9% growth seen in the first half of 2016. This is because the pockets of infrastructure development (particularly in the renewables space) and real estate deals are less attractive, and the "into Africa" story is less compelling.

We continue to expect a very modest return of residential mortgage lending, balancing the soft economic environment against a gradual easing in mortgage underwriting standards and some increasing appetite at the high end of the market. We anticipate that upper and middle income-bracket consumers will drive mortgage growth because they are less restrained by high debt and inflation than those on lower incomes. Furthermore, we believe the recent regulatory changes on the affordability guidelines and additional charges for unsecured lenders will soften overall unsecured credit growth, which is already quite low.

Despite the low growth, we believe that credit losses for the domestic banking sector face only slight deterioration in 2017. We now expect credit losses for the top tier banks to range between 0.8% and 1.0% in 2017.

We continue to believe that domestic households pose the most significant source of risk for banks because of their relatively high leverage and wider income disparities compared with other emerging markets. Positively, 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 85% in 2008. Less positive, however, is that the nature of this leverage has changed from

the secured residential mortgages to more unsecured lending and instalment credit. We believe this reflects two trends: first, the 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--amid pressure on disposable income from slower real-wage growth versus inflation, and despite the decline in household leverage--we believe that general household affordability has weakened.

Declining affordability for South African households can best be illustrated by the debt service-to-disposable income ratio, which increased to 9.3% in 2015 from 8.7% in 2012. Over the past few years, modest interest rates and inflation have been dually responsible for weaker household affordability.

We believe that the impetus for interest rate increases is declining, balancing the lower economic growth and inflation just outside the publicized range of the central bank. Exogenous shocks could change this, especially if the U.S. dollar interest rate normalization occurs quicker and harder than we currently expect. However, our base case now anticipates interest rate rises of 25-75 basis points over the next 12-18 months and inflation of 6%-7%, which will continue to pressurize household affordability but not materially weaken asset quality.

We also see for the possibility of deterioration in the quality of the corporate book as a result of these adverse trends, especially for small businesses, and due to the leveraging of recent years. Our data show that South African corporates' EBITDA margin 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, South African 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. This protects the quality of the loans against the weak rand. We therefore expect the corporate loan book will continue to outperform loans to households in 2017, although a concentration of large loans to single names is a weakness.

Chart 1

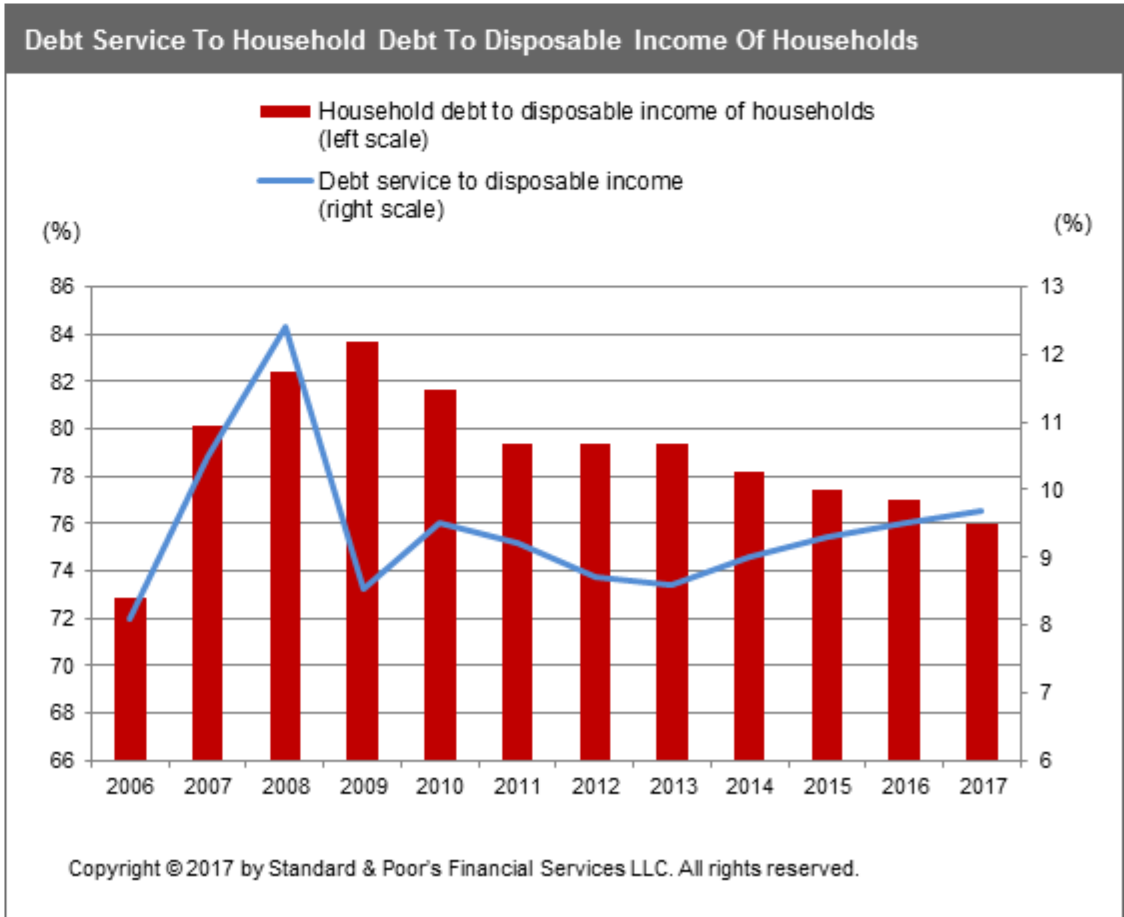
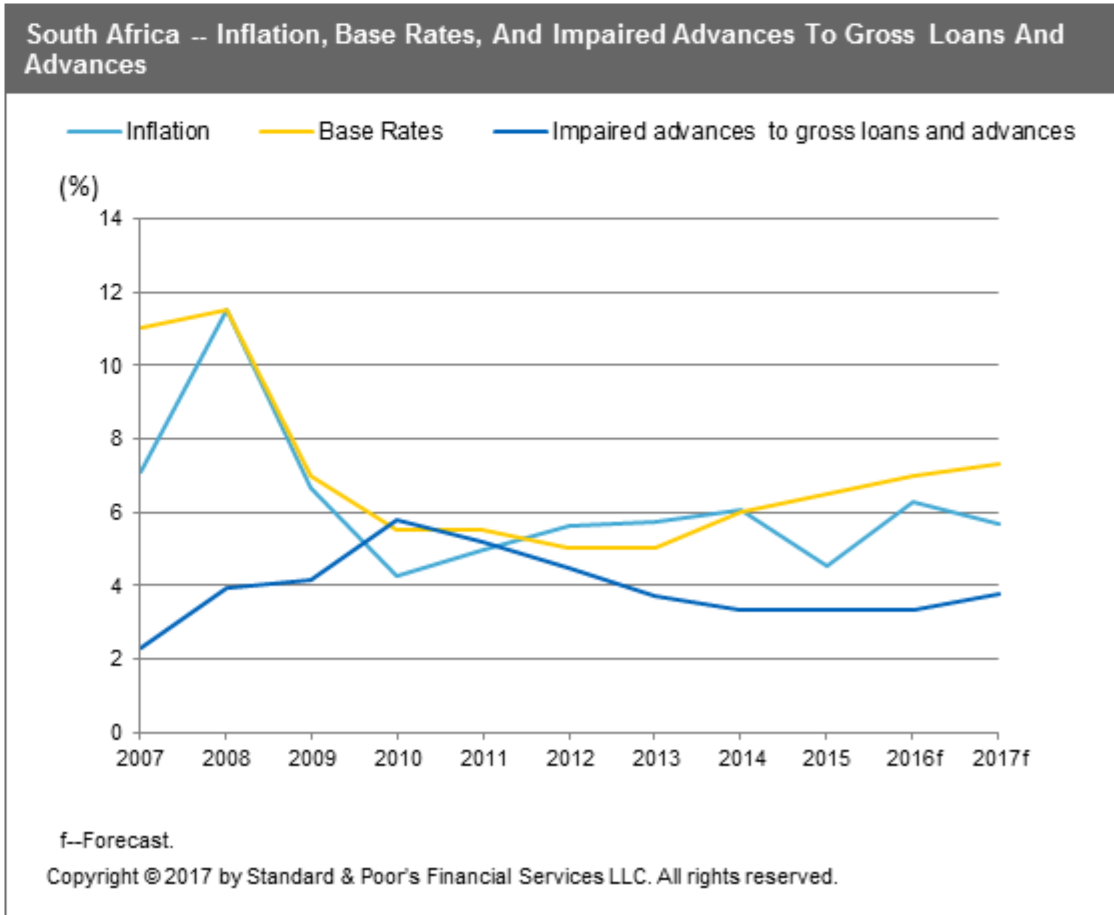


Chart 2



Restructuring Of Funding Profiles Expected To Halt

Before mid-2016, South African banks had been focusing on changing their funding profiles due to the regulatory challenge of meeting the Basel III liquidity coverage ratio (LCR) and net stable funding ratio (NSFR). They aimed to garner more retail and corporate deposits, lower long-term lending, and achieve greater structuring of credit in order to comply with the LCR phased-in targets, albeit still using the committed liquidity facility set up by the central bank. Banks have tried to achieve all of the above without significant disruption so far, in our opinion. Furthermore, regulatory discretion for the NSFR in late 2015 and early 2016 effectively led to a lower weighting for funds from institutional investors, which has made compliance with this ratio much easier going forward.

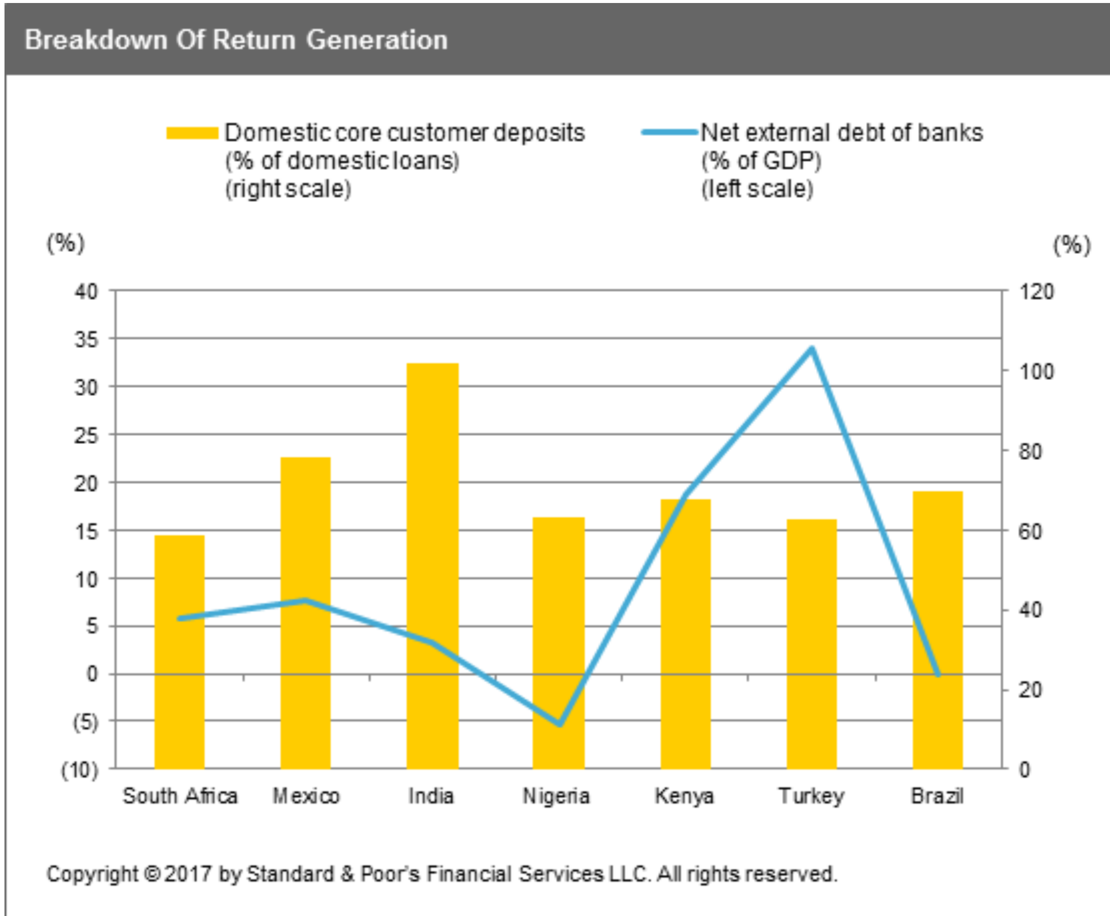
As a result of the regulatory discretion and gains already made in the restructuring of funds, plus the relatively expensive nature of long-term capital market issuance, we expect the ongoing drive to change the funding profile to slow or even stop, which, given the growth of negotiable certificates of deposit in 2016, is arguably already happening.

We continue to believe that the ongoing restructuring of funds is important because banks in South Africa face the funding risk that concentrated wholesale funds could expose the bank to if there is a capital or credit event. Some

banks could 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. From 2018/2019, we could see banks with more stable funding having

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 with other emerging markets, which is important given reduced global liquidity and anti-emerging market investor sentiment.

Chart 3



Industry Dynamics

We expect the domestic banking sector's return on equity to stabilize at 15%-19% for the next couple of years as the positive effect of the gradual rise in interest rates is mitigated by increasing provisions and cost of funds. Conversely, non-interest income growth looks set to come down, especially when the current deal flow of large one-off corporate merger & acquisition and restructuring activity moderates.

The various divestments and partial unbundling of South African banking groups are having no visible effect on their performance to date, and are not expected to in the next year. Conversely, the rest-of-Africa businesses are expected

to be a differentiator in banking group profitability in 2017, with some continued drag expected from Sub-Saharan subsidiaries and associates over the year.

The regulatory capital adequacy of the banking sector improved significantly in 2016, with common equity tier one increasing to 12.21% as of Sept. 30, 2016 from 10.98% one year earlier (despite the continued payment of strong dividends). As a number of banks are at the top end of their published targeted ranges we do not anticipate similar increases in the next 12 months, although with one eye on Basel III capital adequacy and resolution we do expect a slight improvement in banks' capital adequacy ratios.

Table 2

Rated South African Banks

	Issuer Credit Ratings	National Scale Ratings	Asset Base (Bil. $)*
FirstRand Bank Ltd. (1)	BBB-/Negative/A-3	zaAA-/zaA-1	78.0
Absa Bank Ltd. (2)	NR	zaAA-/zaA-1	77.5
Nedbank Ltd. (2)	BBB-/Negative/A-3	zaAA-/zaA-1	64.1
Investec Bank Ltd. (3)	BBB-/Negative/A-3	zaAA-/zaA-1	42.2
Capitec Bank Ltd. (4)	BB+/Negative/B	zaA/zaA-2	4.7
African Bank Ltd. (3)	B+/Negative/B	zaBB-/zaB	2.6

Source: S&P Ratings Direct. Ratings as of Jan. 13, 2017. *Asset base of the group entities. (1) Year-end as of end-June; (2) Year-end as of end-December; (3) Year-end as of end-March; (4) Year-end as of end-February. NR--Not rated.

Related Research

- African Bank Ltd. Assigned 'B+/B' And 'zaBB-/zaB' Ratings After Restructuring; Outlook Negative, April 5, 2016
- Barclays Africa Group Downgraded To 'zaA/zaA-2'; Subsidiary Absa Bank 'zaAA-/zaA-1' Ratings Affirmed, March 9, 2016
- Banking Industry Country Risk Assessment: South Africa, Dec. 13, 2016
- What The Rescue Of African Bank Ltd. Implies For Future Support Of Systemically Important Banks In South Africa, Sept. 8, 2014
- South Africa's Bank Recovery Regime Is Taking Shape, But Questions Remain, July 31, 2014

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