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South Africa 2020 Banking Outlook: A Weak Economy Overshadows The Sector's Resilient Performance

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Key Takeaways

- Resilient credit fundamentals, in conjunction with increased digitalization and greater efficiency, will likely support the performance of South African banks this year.
- They are unlikely to boost lending because of weak economic conditions and increased conservatism.
- A new pack of reforms, including the likely introduction of a resolution regime, will make for a full regulatory agenda.

South African banks are unlikely to boost lending in 2020 amid economic uncertainty. S&P Global Ratings believes the weak economy will continue to dictate banks' risk appetite. We expect real GDP growth to average 1.6% in 2020-2021. The slow pace of reform is leading investors to hold off on potential investments. As a result, banks extended credit slowly and with increasing conservatism in 2019.

At the same time, South African banks generally display strong and stable returns, resulting from recurring fee income, low credit costs, and good cost control. However, their cost base is comparatively higher than those of other emerging-market peers'. In our view, the banks' success in managing their transition to agile and leaner financial institutions by controlling operational and credit costs will be a key factor for their stand-alone creditworthiness, that is, excluding sovereign considerations.

Regulation will be center stage in 2020. We believe South Africa is the jurisdiction among major emerging markets most likely to make tangible progress in introducing a resolution regime in 2020. The 2018 adoption of Twin Peaks, the new regulatory regime for the financial sector, underpins the commitment of the South Africa Reserve Bank (SARB; the central bank) to a more integrated financial supervision model, a better fit for South African financial conglomerates.

We have assigned negative outlooks on the ratings for all top-tier banks in South Africa, which largely reflects the outlook on the sovereign (BB/Negative). Prolonged weak economic growth, exacerbated by a high fiscal deficit and the slow pace of reforms, could further undermine

households' resilience, given their high levels of debt, leading to a sharp increase in credit risk in the banking sector. That said, we acknowledge that, amid challenging macroeconomic conditions and changes to the industry, we expect sectorwide resilience, despite potentially weakening revenues, but broadly stable earnings as banks continue to streamline costs.

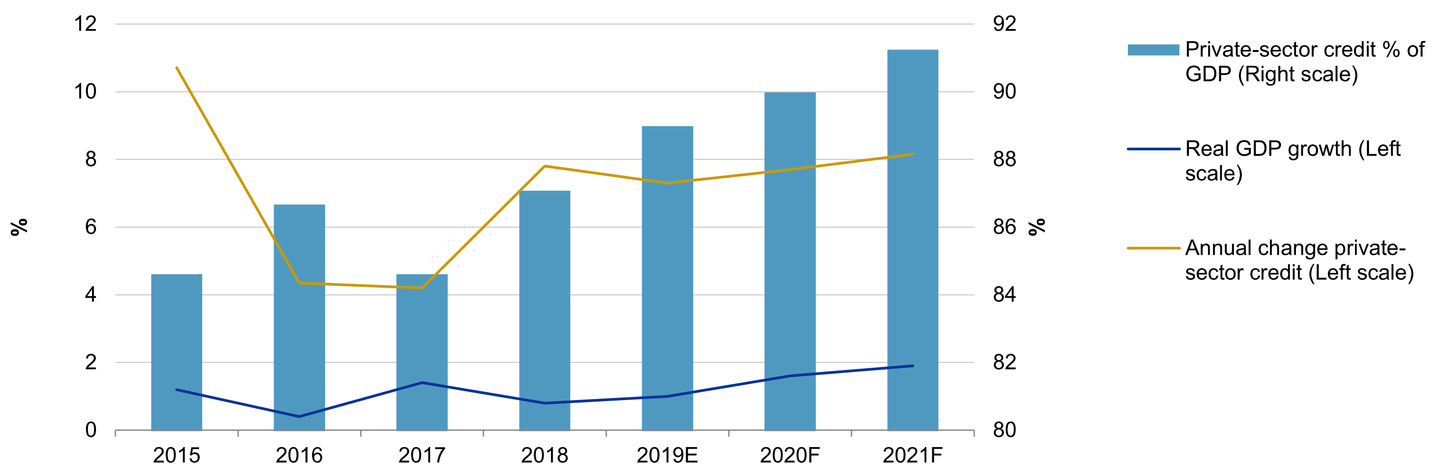
High indebtedness will persist because of weak GDP growth and business confidence

Total private-sector credit (defined as total household debt, corporate debt from the banks, and capital markets) will remain high but steady at 85% of GDP on average through 2021, on the back of a weak economy but stable inflation.

Following the 2019 presidential elections, authorities are pursuing key economic and social reforms amid considerable challenges. South Africa's economic growth is depressed by low investment, power shortages, dry weather, and slow reform momentum. We estimate growth for 2019 at 0.6%. Real GDP per capita has been shrinking since 2014, exacerbated by the depreciation of the South African rand. Unemployment is at a 16-year high of 29%. South Africa's recent poor macroeconomic performance has caused a material deterioration in the fiscal outlook and reduced the generation of tax revenue. The country now faces a two-pronged challenge: to reinstate its fiscal credibility while simultaneously restoring economic growth. We believe that overall reform efforts will likely be lackluster and not significant enough to spur strong GDP growth in the short term. The focus is on measures to promote private-sector investment by removing policy uncertainty, improving competitiveness in economic sectors, and announcing fiscal measures to stabilize public finances and restore state-owned enterprises' balance sheets to improve financial sustainability. The government has also expressed its willingness to correct historical imbalances through land reform, which has worried some investors.

Chart 1

South Africa's Private-Sector Credit Leverage Is High, Linked To Weak GDP Growth



F--Forecast. E--Estimate. Source: S&P Global Ratings.

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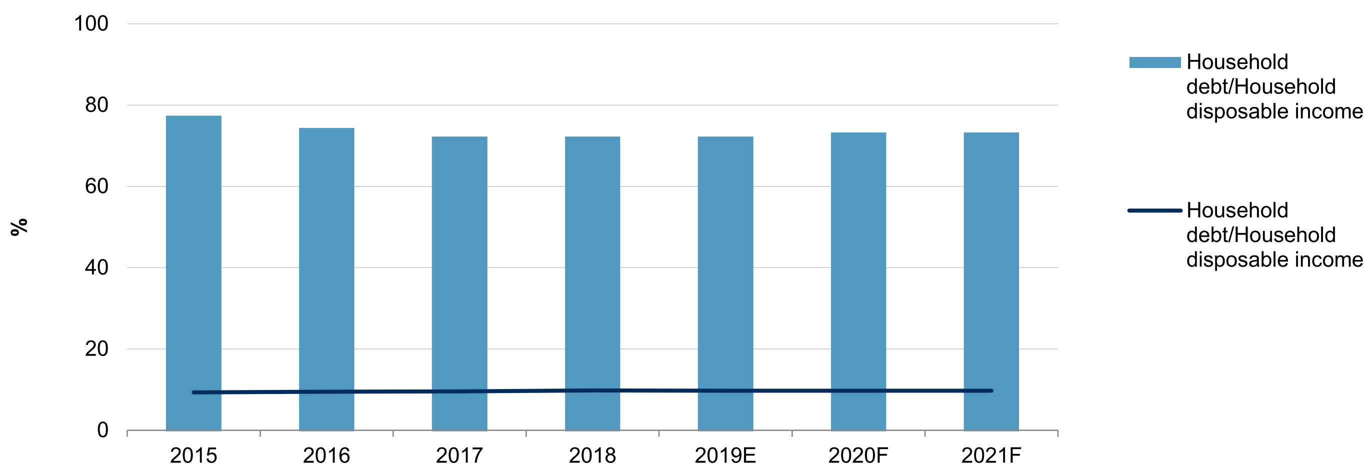
Asset quality will remain resilient, with banks extending credit prudently

While we forecast lending growth will range 7%-8% in 2020-2021, total private-sector credit (defined as total household debt, corporate debt from the banks, and capital markets) will increase by only 1% of GDP over the next two years (see chart 1). Credit leverage in the economy is high in South Africa relative to its low wealth levels and high household leverage (see chart 2).

Chart 2

South Africa's Household Leverage Metrics Will Remain High But Stable



F-S&P Global Ratings' forecast. E--S&P Global Ratings' estimate. HH--Household. Source: S&P Global Ratings.

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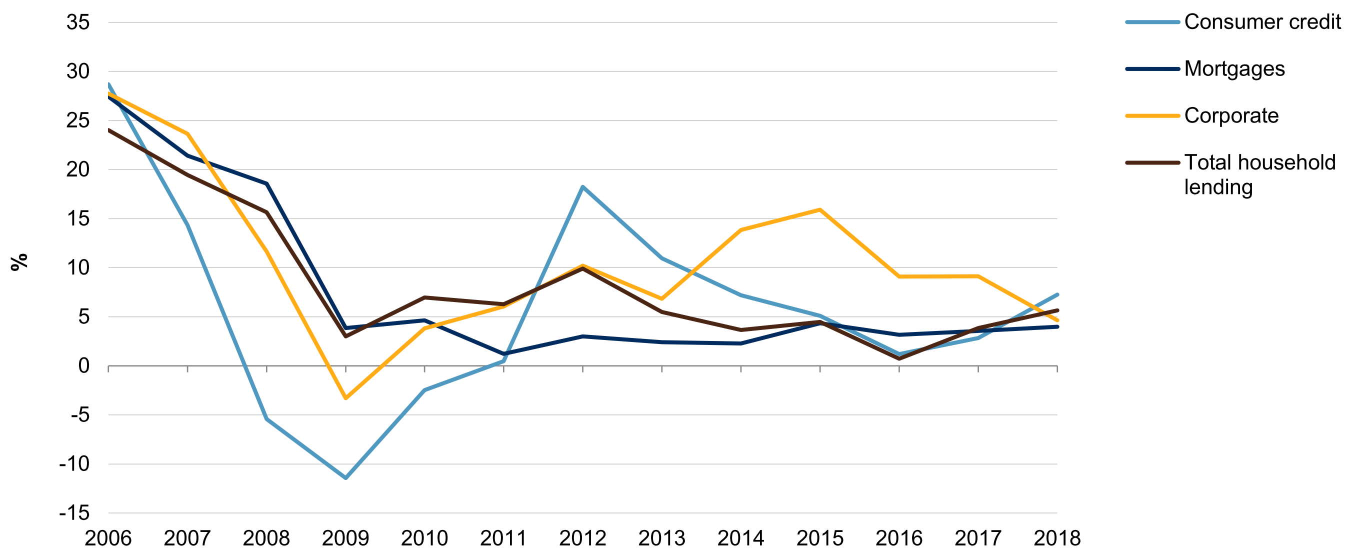
Consumer lending, which is generally more cyclical and susceptible to the weak macroeconomic environment, will likely benefit from the recent interest rate cut. The SARB's Monetary Policy Committee cut its benchmark rate by 25 basis points to 6.25% in January 2020. This will provide some relief to leveraged households as lower inflation boosts disposable income. As a result, we expect modest growth in retail lending over the next 12-18 months. A combination of credit cards and personal loans will likely support the trend in consumer credit, while mortgages and auto financing will remain muted. We view major banks' prudent appetite for credit as appropriate for the level of economic risks in the country. Less positive, however, is that the nature of household leverage has changed since 2009, with unsecured lending and installment credit increasing faster than secured residential mortgages (see chart 3).

Corporate lending growth, which has been the engine for banking sector growth in 2013-2015 (see chart 3), will likely be flat in 2020. We view the major banks' generally modest credit losses a sign of proactive risk management and low risk appetite, appropriate for the weak economic environment. We see some room for deterioration in the quality of the corporate loan book because of these adverse trends, especially for small businesses, and due to the high leveraging of recent years. Signs of stress materialized in 2019 on the fringes of the commercial real estate

market, where office vacancy rates have increased in recent years and construction sector growth has slowed significantly since the last wave of projects leading to the 2010 World Cup. Although banks are keen on financing infrastructure development, such as renewable energy projects, a sustained improvement in consumer demand and business confidence is needed to boost corporate demand for credit. Nevertheless, we expect the corporate loan book will continue outperforming household loans in 2020. Positively, public-sector lending (including to the embattled state-owned enterprises) accounts for less than 3% of direct lending from the banking sector.

Chart 3

Credit Growth By Asset Class In South Africa: Unsecured Lending Has Been Growing Faster Than Secured Lending



Note: Consumer credit includes credit cards, leasing finance, and overdrafts. Source: South Africa Reserve Bank.
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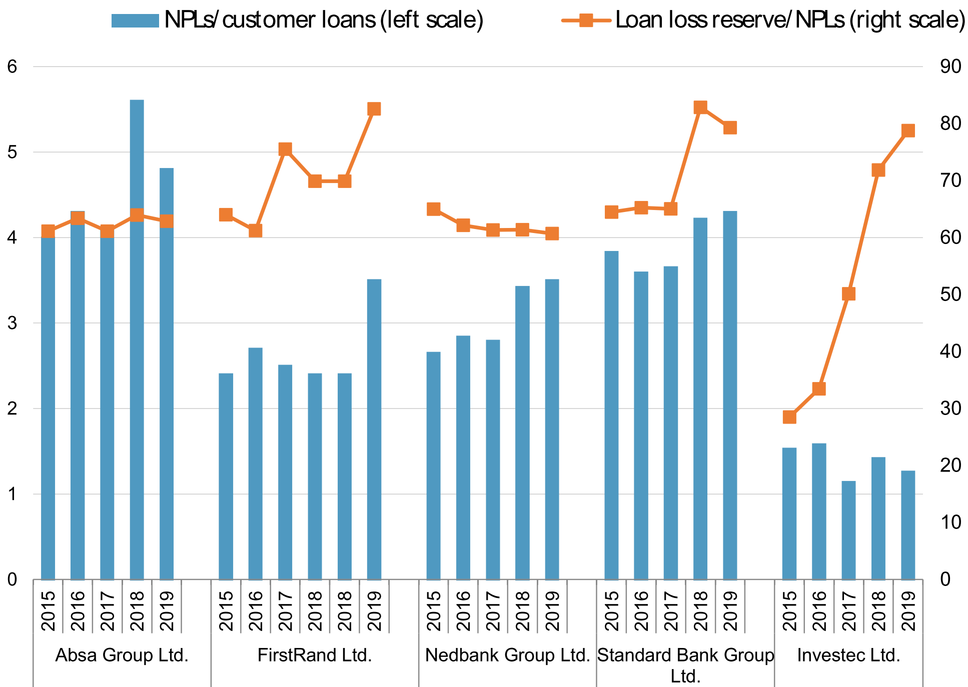
Overall, we expect credit losses for the sector to increase slightly to 1.2% in 2020, versus 1% in 2018. Positively, provisioning levels appear to have improved since 2017, partly due to the change in the mix of nonperforming retail loans to unsecured from secured lending and IFRS 9's new rules for impairment charges (see chart 4). South African banks have some of the lowest credit losses in their peer group (see chart 5). However, the historic provisioning levels of the major banks were too low for the economic risks and the high household leverage due to the real estate collateral held by South African banks. Positively, the South African residential market has recorded flat growth in real terms over the past four years, but has been supported by historically modest interest rates and slow growth in housing supply. We expect flat real estate prices in the next few years because the reform agenda will take time to produce significant economic growth improvements.

Chart 4

Top-Tier South African Bank's Asset Quality Metrics Remain Resilient Despite Challenging Economic Conditions



NPL--Nonpeforming loans. Source: S&P Global Ratings. Data as of June.30, 2019.

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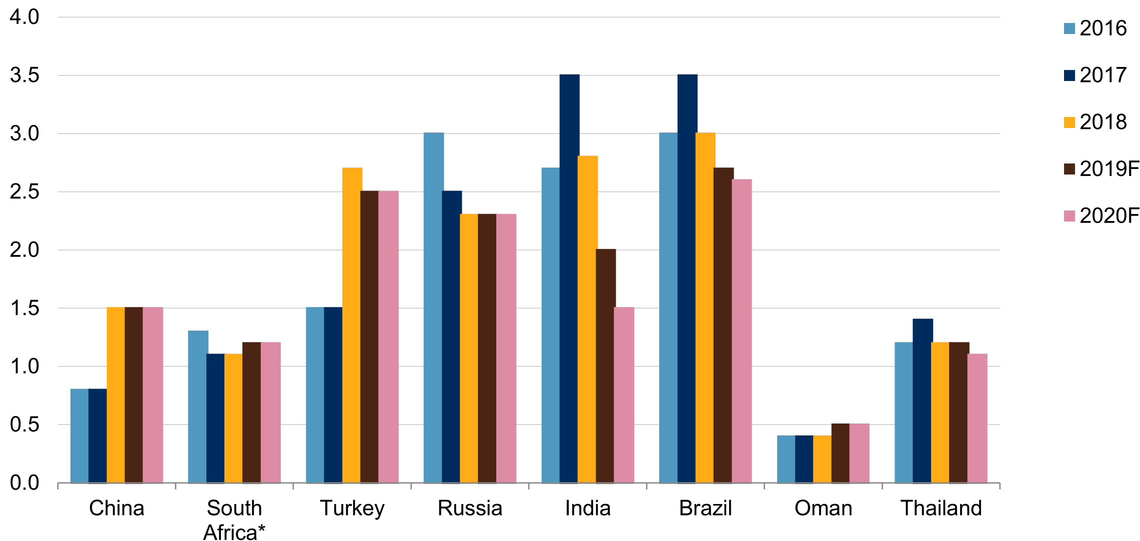
Chart 5

South Africa Banking-Sector Credit Losses Are among The Lowest Among Peers'



F--S&P Global Ratings' forecast. Source: S&P Global Ratings.

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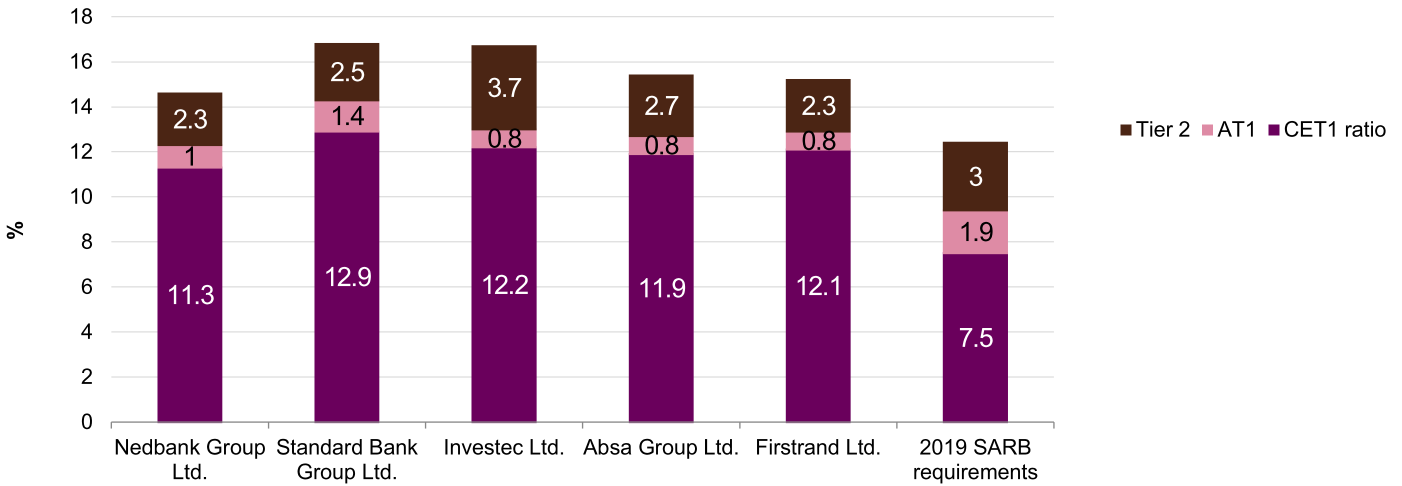
Stable returns, thanks to efficiency gains and innovation, and good capitalization will support the stability of the sector

We expect provisions will increase mildly due to the adoption of IFRS 9, which came into effect on Jan. 1, 2018, for banks with a fiscal year ending Dec. 31. Most banks have adopted the three-year transitional arrangement, thus reducing the effect on their common equity tier 1 (CET1). South African banks are well capitalized and their regulatory capital levels have been supported by the issuance of additional tier 1 capital in recent years to comply with Basel III requirements (see chart 6). In contrast, their capitalization is moderate according to our risk-adjusted capital model given the high economic risk that we reflect in our risk charges (see chart 7). However, return on equity (ROE) for rated banks averaged 18% on June 30, 2019, slightly down from 18.7% for fiscal-year 2018, on the back of subdued economic growth. We expect the banking sector's ROE to stabilize at current levels, balancing low growth and broadly stable asset quality metrics. Banks have developed significant resilience to downturns through the diversification of their business model, including recurring fee income, stemming from their core banking operations but also insurance and wealth management or international subsidiaries (see chart 8).

Chart 6

South Africa Top-Tier Banks Capitalization: Largely Comprised Of Equity



Source: Banks' June 2019 interim results.

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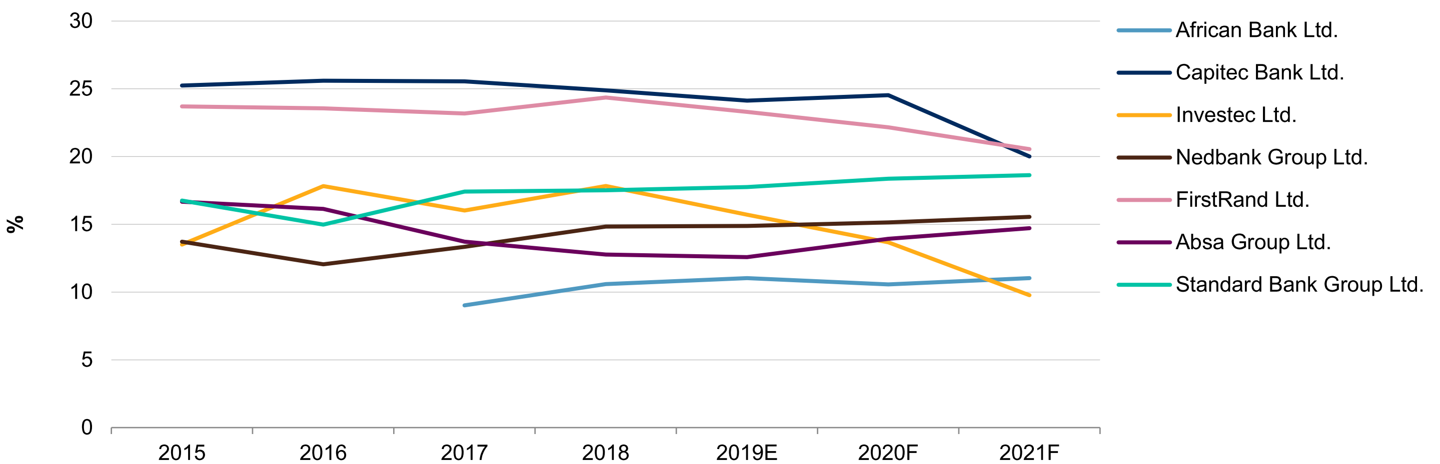
Chart 7

South African Banks' Return On Average Equity Has Been Resilient Through The Cycle



F--S&P Global Ratings' forecast. E--S&P Global Ratings' estimate. Source: S&P Global Ratings.

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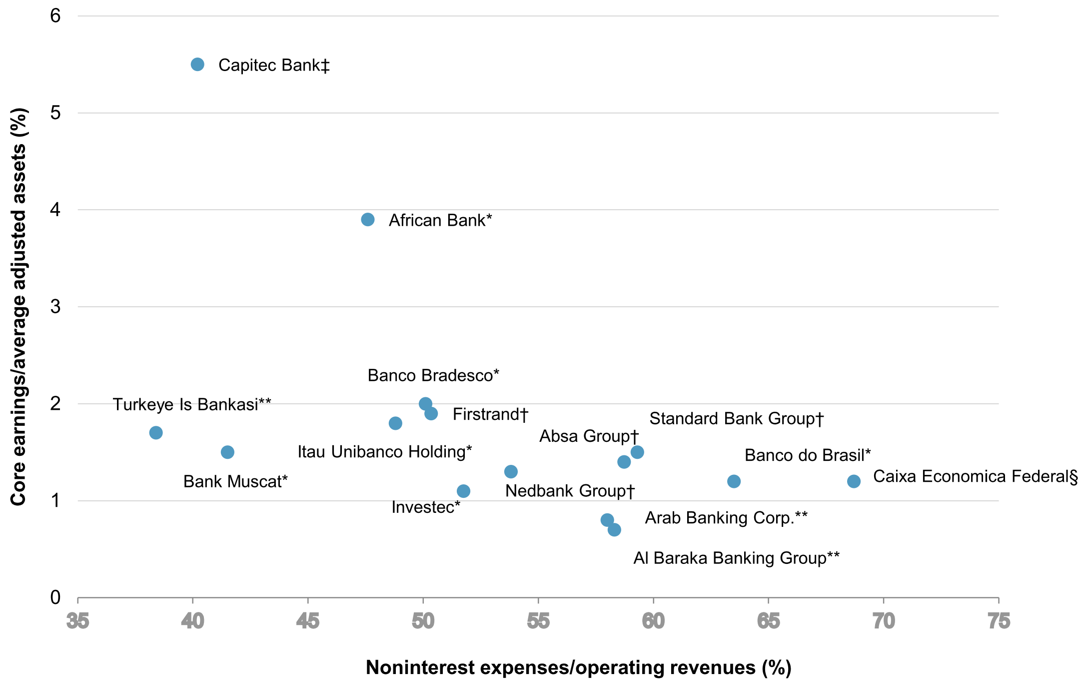
We do not believe the entrance of digital-led banking solutions will result in widespread disruption in the sector. Leading banks have embarked on technological transformations to improve

efficiency and meet changing customer needs on the back of increasing pressure on revenue. We expect banks will continue to invest in their digital platforms and capabilities and rigorously control costs given that their cost-to-income ratios compare less favorably than with those of some peers (see chart 9). In our view, banks' success in controlling operational and credit costs will be a key differentiator in their creditworthiness over the medium term.

Chart 8



*As at Sept. 30, 2019. §As at March 30, 2019. †June 30, 2019. ‡Aug. 31, 2019. **Dec. 31, 2018.
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The SARB's additional pack of reforms will make for a full regulatory agenda

The SARB's early adoption of global standards demonstrates a clear commitment to ensure that South African banks are viewed as well-managed and stable institutions among emerging-market banks. The adoption of Twin Peaks in 2018 not only illustrates the regulator's objective to be in line with international best practices but also adopt a more integrated financial supervision model that better caters to South African financial conglomerates. In that spirit, we expect the regulator to introduce a new pack of reforms gradually to meet Basel IV requirements. Furthermore, we expect the SARB will continue to support the sector as it introduces new reforms. Due to the structure of bank funding in South Africa (as banks compete with institutional money managers for contractual savings), the SARB introduced a degree of national discretion for banks to meet the Basel III net stable fund ratio and the committed liquidity facility (CLF) to support the top-tier banks' efforts to meet the liquidity coverage ratio (LCR). Nonetheless, we expect the CLF to fall

away by year-end 2022 since banks have fully complied with the liquidity coverage ratio ahead of schedule.

Among emerging markets, South Africa is the most likely to implement a resolution regime broadly in line with the Financial Stability Board's key attributes of effective resolution regimes for financial institutions, such as a resolution authority, legal framework, and a resolution tool kit. We continue to believe that a deposit insurance scheme and, ultimately, an effective resolution regime, will be introduced over the next 12 months. We expect more guidance about South African banks' regulatory capital adequacy ratios in a resolution-effective regime for domestic systemically important banks. We believe this could become more important as banks increasingly issue notes with mandatory convertible write-down features. At this stage, we do not apply extraordinary support in the form of additional loss-absorbing capacity to South African bank issuer credit ratings.

Our 2020 outlook is negative

We have negative outlooks on all the South African banks we rate (see table 1). This largely reflects our negative outlook on the sovereign rating. We do not rate financial institutions in South Africa above the foreign currency sovereign ratings, due to the direct and indirect impacts that a sovereign distress would have on banks' operations. The South African economy could suffer a sharp increase in credit risk. The lack of progress on policy reforms and an enfeebled economic environment could further weaken households' resilience, given their already-high levels of debt. Private-sector investments are unlikely to be significant as long as domestic constraints, including inadequate electricity supply and an overall weak business confidence, persist. That said, we believe that small pockets of lending exist in renewable energy, as well as in personal loans and mortgages in the midmarket. The SARB's independence is a key pillar to robust, transparent financial institutions. Any erosion of this independence would weaken our view of the South African banking sector.

Ultimately, only a stronger economy will prompt sustained lending activities. This will depend on a controlled fiscal trajectory and lower debt levels, which in turn can lead to stronger consumer and investor confidence.

Table 1

South African Banks: Ratings and Outlooks

	SACP	ICR	National scale rating	Outlook
Absa Bank Ltd.	bbb-	N/A	zaAA/--/zaA-1+	N/A
African Bank Ltd.	b+	B+/B	zaA-/--/zaA-2	Negative
Capitec Bank Ltd.	bb+	BB/B	zaAA/--/zaA-1+	Negative
Investec Bank Ltd.	bbb-	BB/B	zaAA/--/zaA-1+	Negative
FirstRand Bank Ltd.	bbb-	BB/B	zaAA/--/zaA-1+	Negative
Nedbank Ltd.	bbb-	BB/B	zaAA/--/zaA-1+	Negative

SACP--Stand-alone credit profile. ICR--Issuer credit rating. N/A--Not applicable. Data as of Jan xx, 2020.

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