Q3'2020 Banking Sector's Asset Quality

Following the release of the Q3'2020 Listed Banking Sector results, we decided to take an in-depth look at the sectors loan book which recorded a weighted average y/y growth of 15.0% in Q3'2020 and the asset quality which deteriorated during the period of review. In this note, we shall cover the following;

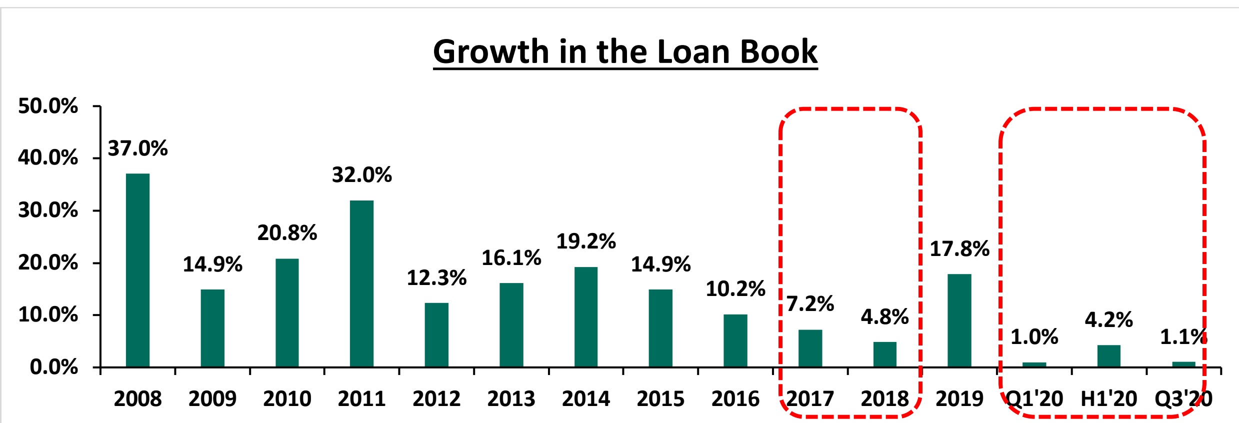
i. Performance of the Banking Sectors' Loan Book,
ii. Banking Sectors Asset Quality,
iii. Loan Restructuring, and,
iv. Conclusion

Section I: Performance of the Banking Sectors' Loan Book

Over the years, the banking sector has experienced distress and disruptions, with the major ones that adversely impacted the sector's profitability being:

i. The tough operating environment during the periods of the 2007-2008 Post-Election Violence,
ii. The implementation of the interest rate caps towards the end of 2016, and,
iii. Most recently, the Covid-19 Pandemic.

However, despite these disruptions, the sector has always remained resilient, with the loan book growth withstanding and maintaining a positive growth, across the periods we have reviewed. During periods of economic shocks the appetite for both borrowing and lending reduces, driven by borrowers increased credit risk and the lenders' heightened credit screening procedures. The graph below highlights the listed banks' loan book growth over the last 12 years;



Key take-outs from the graph include:

i. The shocks from the post-election violence, as a result of the disputed 2007 elections spilled over to Q1'2008 but were outweighed by an aggressive branch network expansion, where the total number of bank branches grew by 19.6% to 887 branches from 740 branches in 2007, which opened up more lending opportunities. The credit information sharing regulation passed in 2008 also aided banks in credit risk assessment making it faster to asses a borrower's credit worthiness and hence a 37.0% growth in the loan book in 2008. Consequently, as a spillover of the global financial crisis, where the banking industry being the most affected, led to a sharp decline of 22.1% points to 14.9% in 2009 from 37.0% in 2008,
ii. Increased demand for credit by the various economic sectors coupled with 9.2% increase in the branch coverage led to an 11.2% points increase in the loan growth to 32.0% in 2011. The high interest rates in the market starting in 2011 led to borrowers shying away from taking loans, and the effect was a sharp decline in the loan growth by 17.7% points to 12.3% in 2012. Though the high interest rates

persisted to 2013, coupled with the uncertainty surrounding the elections in March 2013 the loan growth increased increase by 3.8% points to 16.1% and further to 19.2% in 2014,

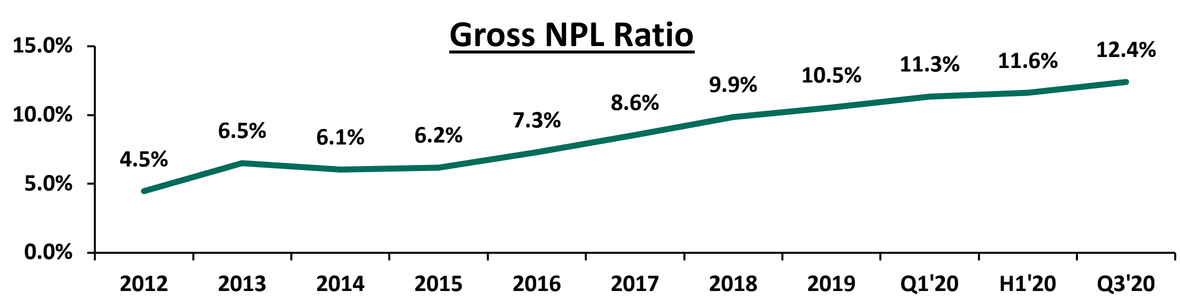
iii. During the interest rate cap legislation, which was passed in September 2016, the banking sectors loan book growth was severely affected, recording a 7.2% growth in 2017, 3.0% points lower than the 10.2% growth recorded in 2016. The growth continued to decline to 4.8% in 2018, as banks tried to adopt new risk assessment measures such as the enhanced use of credit reference bureaus (CRB). In a report by the Central Bank of Kenya (CBK) on the impact of the interest cap, the regulator highlights that following the capping of the interest rates, the number of loan accounts declined while the average loan size rose by 37.0%, reflecting lower access to small borrowers and larger loans to more established firms. Additionally, banks drifted away from lending to Micro, Small and Medium Enterprises (MSMEs),

iv. The removal of the interest rate cap in 2019 saw the loan book record an expansion as total loans in the listed banking sector grew at a rate of 8.0% y/y to Kshs 2.5 tn from Kshs 2.3 tn in 2018. The growth in loans was accelerated towards the tail end of FY'2019, following the repeal of interest rate cap in November 2019, and,

v. In the three quarters of 2020, the listed banks loan book has recorded the lowest growth of 1.1%, 4.2% and 1.0% on a q/q basis. The onset of the pandemic brought about heightened lending risk as both individuals and businesses were hugely affected by the containment measures put in place, and hence the Banks shied away from lending. 2020 is set to be a tough year for the sector as the COVID-19 pandemic continues to take a toll on the sectors loan book.

Section II: Asset Quality

The banking sector's asset quality has always been affected by periods of economic shocks. The onset of the pandemic has resulted in a tough operating environment for the banking industry, with the major sectors including: the personal/household, manufacturing and Real Estate sectors that take up 74.5% of the industry loan book, being severely affected by containment measures instituted by the government, hence increasing the risk of default. The listed banks' NPL ratio has deteriorated in 2020 to a high of 12.4% in Q3'2020 from 9.8% in Q3'2019.The chart below highlights the asset quality trend over the last 8 years:



Below are the key take outs from the chart above:

i. In 2013, a mix of high interest rates environment and subdued economic activities associated with uncertainty around the March 2013 general elections affected the banking sectors asset quality, with the NPL ratio increasing by 2.0% points to 6.5% from 4.5% recorded the previous year. Notably, the gross non-performing loans grew at a 3-year CAGR of 12.4% to Kshs 81.9 bn in 2013, from Kshs 57.6 bn in 2010,

ii. During the periods following the implementation of the interest rate cap in September 2016, the sector's NPL ration grew at an average of 1.2%, higher than the average growth rate of 0.8%,

iii. The NPL Ratio increased by 1.3% points to 9.9% in 2018, and continued increasing to 10.5% in 2019 before the onset of Covid-19 pandemic. The increase in recent years can partly been attributed to delays by the government in releasing payments to counties and the private sectors, which has left many suppliers unable to service their debt obligations.

iv. The listed banks asset quality deteriorated in Q3'2020, with the Gross NPL ratio rising by 2.6% points to 12.4% from 9.8% in Q3'2019. Key to note, the NPL Ratio recorded in Q3'2020 is the highest ever recorded over the last 8 years but lower than a historical high of 35.0% in 2003. The deterioration in asset quality was as a result of the coronavirus-induced downturn in the economy, which led to an uptick in the non-performing loans.

As we have seen above, the banks' asset quality has always been affected by exogenous factors including tense political environments and periods of economic shocks. Therefore, 2020 has not been an exemption with the Covid-19 pandemic providing a unique challenge that has negatively impacted on the sector asset quality. The table below highlights the bank's asset quality in Q3'2020 as compared to Q3'2019:

Bank	Q3'2019 NPL Ratio	Q3'2020 NPL Ratio	Q3'2019 NPL Coverage	Q3'2020 NPL Coverage
HF Group	28.2%	25.4%	44.4%	58.2%
KCB Group	8.3%	15.3%	56.5%	58.5%
NCBA Group	12.4%	14.1%	60.2%	58.3%
Standard Chartered Bank Kenya	14.9%	14.8%	77.0%	78.2%
Co-operative Bank of Kenya	10.5%	13.2%	55.5%	50.1%
Stanbic Bank	10.9%	12.3%	58.9%	61.8%
I&M Holdings	12.7%	11.2%	62.5%	66.8%
Equity Group	8.4%	10.8%	45.8%	52.0%
Diamond Trust Bank	8.9%	8.7%	48.0%	62.5%
ABSA Bank Kenya	6.8%	7.6%	78.6%	64.9%
Mkt Weighted Average	**9.8%****	**12.4%***	**57.8%****	**59.2%***
*Market cap weighted as at 01/12/2020 **Market cap weighted as at 29/11/2019				

Key take-outs from the table include;

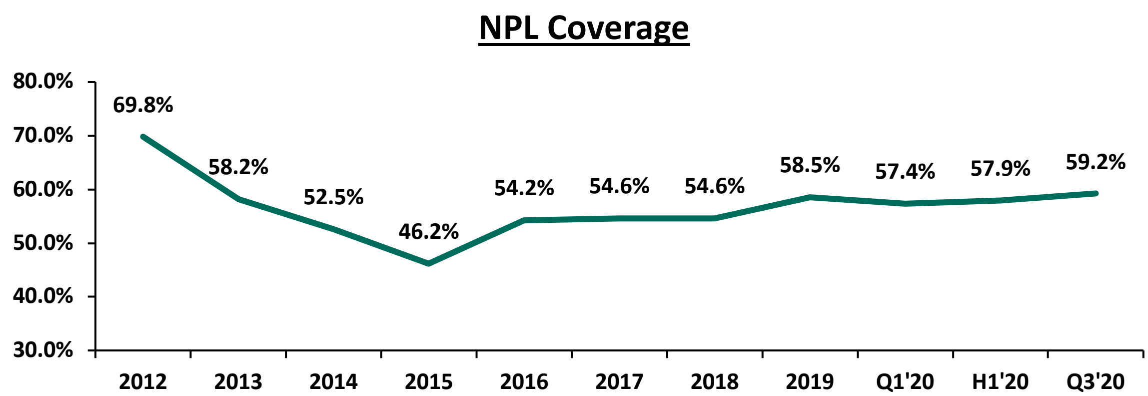
i. Asset quality deteriorated during the period of review, with the NPL ratio rising by 2.6% points to a market cap weighted average of 12.4% from 9.8% in Q3'2019. The deterioration in asset quality was as a result of the coronavirus-induced downturn in the economy which led to an uptick in the non-performing loans,

ii. NPL Coverage has risen to a market cap weighted average of 59.2% in Q3'2020 from 57.8% recorded in Q3'2019, as the banks increased their provisioning levels to proactively manage risks given the tough economic conditions. We expect higher provisional requirements to subdue profitability during the year across the banking sector on account of the tough business environment, and,

iii. ABSA, NCBA and COOP recorded a decline in their NPL Coverage despite their NPL ratios rising, which could suggest modest provisioning. Given the current economic environment and elevated risk of loans defaults, we expected high provisioning for the banks. Key to note, during the Co-operative Bank Q3'2020 briefing, management indicated that the decline in the NPL Coverage was attributable to the downgrade on some of the non-performing loan book. The management however indicated that the 123.4% Q/Q and 89.4% Y/Y growth in provisions was an adequate response to the disruption occasioned by the ongoing pandemic more so in the personal consumer sector, which once in a while might not be fully collateralized and as such the Bank had to have higher provisioning for them due to the risk.

The deterioration of the bank's asset quality is expected to continue in the medium term as banks continue to suffer credit losses in their loan portfolio. According to the data from the November 2020 MPC Meeting, high levels of NPLs were witnessed in sectors such as Tourism, Real Estate, Hospitality as well as Transport and Communication mainly due to the disruption of business and operations caused by the pandemic. Notably, recoveries and repayments in the trade, manufacturing and construction sectors offset the increase in the NPL levels.

NPL Coverage: During the periods of economic distress, banks have continued to provide cover for potential losses in their loan portfolio as evidenced by the rise in NPL Coverage ratio throughout the years. The graph below highlights the trend on the NPL Coverage:



Below are the key take outs from the chart above:

i. In 2013, the NPL coverage declined by 11.6% points to 58.2% in 2013 from 69.8% in 2012. This was attributable to the high interest regime witnessed in H1'2012 impacting negatively on the quality of loans. Consequently, the NPLs increased by 32.3% to Kshs 81.9 bn in 2013 from Kshs 61.9 bn in 2012, against a slower growth the general loss provisions. On the back of a political and economic regime change in 2013, the banks reduced their coverage further by 5.7% points to 52.5% in 2014 from 58.2% in 2013. This was mainly attributable to increased efforts in recoveries and improved credit appraisal monitoring standards through the passing of the credit information sharing regulation, which encouraged the banks to reduce their loan loss provisions and hence reducing the NPL Coverage ratio,
ii. In 2015, the coverage declined by 6.2% points to 46.2% from 52.5% in 2014, this was on account of a slowdown in private sector credit growth which reduced to an average of 20.5% in 2015 from an average of 23.5% in 2014. Particularly, there was a reduction in lending to areas perceived as risky and hence a lower loan loss provision against a stagnant NPL ratio which was at 6.1% for 2014 and 6.2% for 2015. The coverage remained relatively the same averaging at 54.4% between 2016 and 2018, mainly because of the general provisioning rising in tandem with the rising NPLs,
iii. The adoption of IFRS 9 in 2019 as we had discussed in an earlier Topical Research Note on IFRS, requires commercial banks to consider historic, current and forward-looking information in assessing expected credit loss impairment, the sectors NPL Coverage has risen by 4.6% points to 59.2% in Q3'2020 from 57.4% in Q1'2020. From the recently released CBK Bank Credit Survey Report for Q2'2020, Banks are facing challenges especially in generating stress testing modeling data, related to the global COVID-19 pandemic. IFRS 9 is expected to play a key part in accessing the Credit risk posed by reduced activities in some of the sectors including hospitality, real estate and manufacturing, in order to allocate the necessary NPL Coverage.

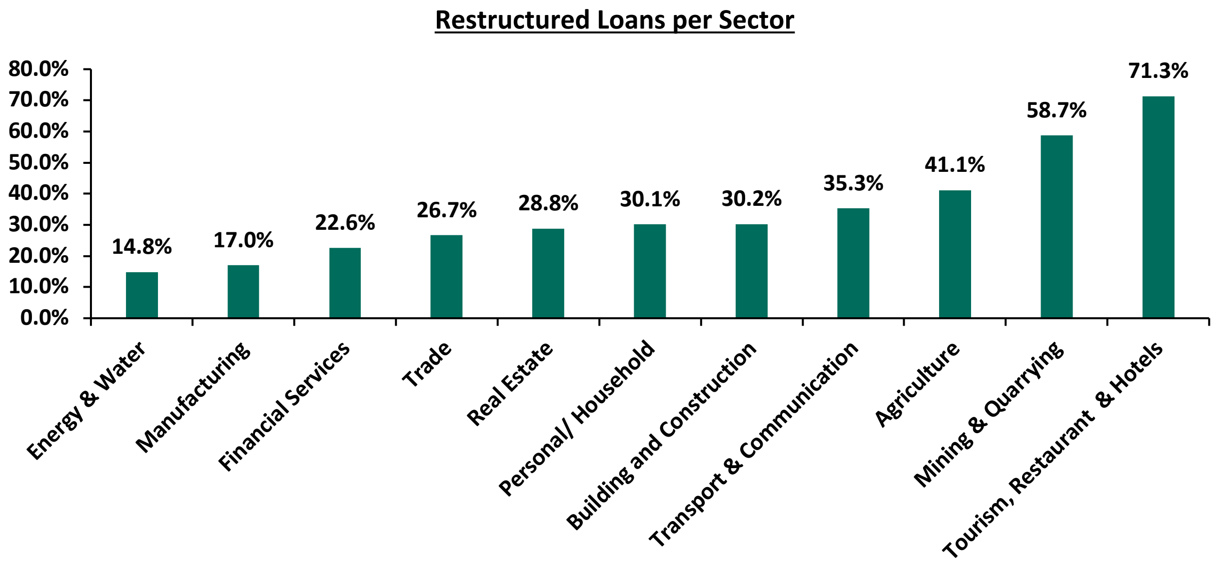
Key to note, in the Guidance note by the CBK on the implementation of IFRS 9, banks were given a five-year transition period beginning January 2018 to fully comply with the IFRS 9 computation of the regulatory capital.

Given the stringent application of IFRS 9, we expect increased provisioning in the sector in the medium term given the slow recovery process seen in most sectors. However, we believe that this will overwhelm the sector with significant loan provisioning levels and as such, put a strain to the sectors capital levels.

Section II: Loan restructuring

In March 2020, in response to the effects emanating from the pandemic such as the disruption business operations which has led to reduced revenues, the Central Bank of Kenya provided commercial banks and mortgage finance companies with guidelines on loan reclassification, and provisioning of extended and restructured loans as per the Banking Circular No 3 of 2020. In the press release on 18th March, the regulator indicated that banks would seek to provide relief to the borrowers and that the lenders would restructure the borrower's loan for a period of up-to one year. Following this guidance, the banking sector has seen a total of Kshs 1.4 tn, representing 46.5% of the total Kshs 3.0 tn banking sector loan book, being restructured as at October 2020.

The graph below highlights the restructured loans per sector as at June 2020:



Source: CBK – Financial Stability Report, October 2020

Key take-outs from the graph include;

i. In the period ending June 2020, the Tourism sector had the highest loans restructured at 71.3%, which can be attributed to the collapse of global travel and reduced revenues in the sector following the lockdown measures put in place by the government earlier to curb the spread of the virus, and,
ii. Similarly, reduced export earnings due to the lockdown measures put in place by Kenya's trade partners in the wake of the Coronavirus pandemic partners saw decreased demand for Kenya's exports and as such, sectors such as the Agricultural sector, Trade and Manufacturing sector saw 41.1%, 26.7% and 17.0%, respectively, of their loans restructured.

Notably, the COVID-19 pandemic has dampened economic activities and disrupted business operations with most businesses recording a reduction their revenue due to a slowdown in activities. Further, given this subdued environment and the reduced revenues for businesses, businesses continue to demand working capital to help them mitigate the tough operating environment resulting from the global pandemic, and as such, banks have had to increase their provisioning levels as they cover for downgraded facilities, with the expectations of an increase in defaults across sectors.

Conclusion

Given the uncertainty of the tenor of the pandemic, we expect the banking sectors provisioning levels to increase in the medium term, with the sector's asset quality deteriorating. Should the asset deterioration trend persist, we expect this to have a significant impact on the sector's bottom line due to associated impairment charges. However, we believe that the adoption of IFRS 9 will continue to enhance the sectors credit risk provisioning as well as its ability to withstand losses occasioned by loan defaults.

We expect the sectors loan book to record muted growth as the pandemic continues to affect the revenue performance of major sectors in the economy, as evidenced by the lagged recovery of some sectors. Depending on the specific banks' lending strategy and loan book concentration, we believe that the loan book will be impacted differently. Additionally, we believe that the muted growth in the sector's loan book will stem from the increase in allocation to government securities as banks shy away from lending, in a bid to reduce credit risk. Despite these shortfalls caused by the pandemic, we remain positive that the banking sector will show resilient performance amid these short-term and long-term shocks.