CBN's five-year plan: same direction; more dimensions

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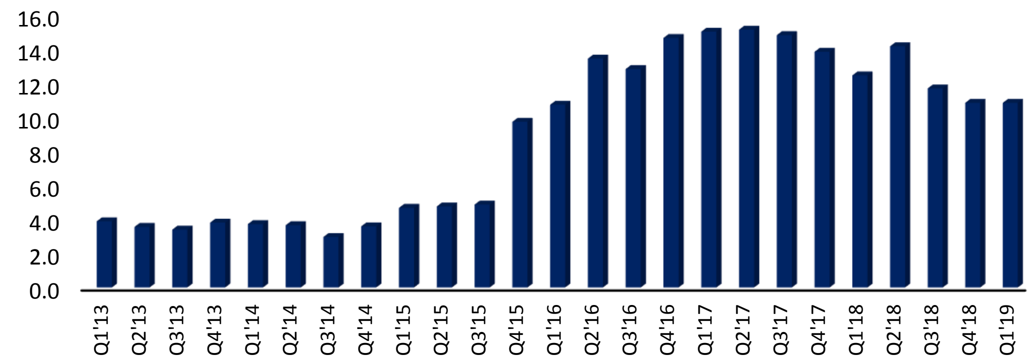
Although the nation still awaits ministerial appointments and more direction from the fiscal authorities, the Central Bank of Nigeria (CBN) had ensured that its policy targets for the next five years did not remain uncertain for long when it released its five-year plan in June 2019. In line with our expectation (click *here* to read our note on Emefiele's re-appointment and macro implications), the CBN's proposed policy thrust centered around exchange rate stability and targeted interventions in non-oil economic sectors. Precisely, the apex bank is aiming to 1) maintain macroeconomic and financial stability, 2) improve financial system stability 3) work with Deposit Money Banks (DMBs) to improve access to credit 4) diversify the economy through targeted intervention programs and 5) foster financial inclusion. Although the plan is largely a mirror image of CBN's first term strategy under Emefiele, the resolve to pursue the improvement of financial system stability appears to be stronger. In addition to this, the apex bank has wasted no time in rolling out new modalities and initiatives towards the attainment of the set objectives. In the sections below, we assess the core objectives for the next 5 years with a view to assessing the potential implications.

What is new?

CBN wants to improve financial system stability and may recapitalize banks to achieve the objective. A standout of CBN's 5-year plan is its focus on improving financial system stability, and central to that objective is the potential recapitalization of banks. This objective is likely driven by the need to ensure that Nigerian banks have enough buffers to withstand systemic shocks. Since the last recapitalization exercise in 2005, a 183.0% depreciation of the naira has led to a significant plunge in the minimum capital requirement of banks to $70.0 million in 2019 compared to $193.8 million in 2005. To our minds, CBN's concern about a possible inadequacy of the current minimum capital may have been motivated by higher non-performing loans in the balance sheet of banks, principally stoked by the collapse of global oil price in 2014. To this point, we note that the oil and gas sector accounted for c.30.4% of the total loan portfolio of banks in Q1'19 (vs. 24.0% in 2018). Other core exposures of the Nigerian banking sector from a loan portfolio standpoint include manufacturing (14.7%), government (9.0%), and finance, insurance & capital markets (7.4%). Clearly, the decline in oil price may have had a second order effect on the non-oil loan portfolio that drove further pressure on the sector loan book. In line with this, NPL ratio deteriorated from 3.5% prior to the oil price collapse in 2014 to 10.8% in 2019.

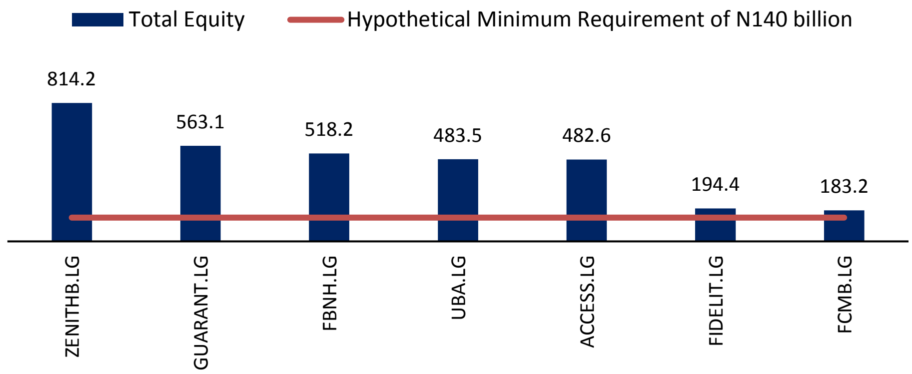
Figure 1: Historical NPL in Nigerian banking sector (%)



Source: CBN; CardinalStone Research

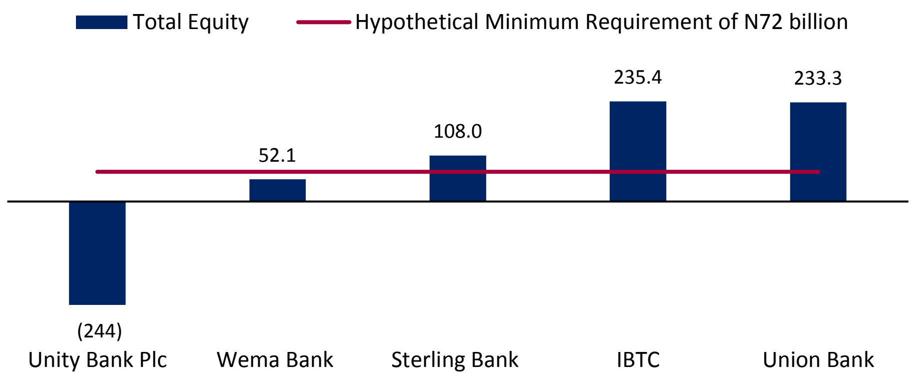
Thus, the renewed focus on shoring up the capital bases of banks in the coming years is understandable, especially in view of the recent stress test which indicated that banks with less than N1.0 trillion in assets would not survive in the event of a deterioration in their NPL's to 50.0%. For the CBN to restore capital buffers to 2005 levels in dollar terms, it will have to raise capital requirement for national banks to c.N72.0 billion ($200.0 million) and that of international banks to c.N144.0 billion ($400.0 million), assuming an exchange rate of N360/$. Our analysis suggests that while internationally licensed banks have no problem meeting our scenario threshold, some national banks may need to source extra capital or consolidate with peers to keep substantial buffers over our hypothetical higher minimum requirement. Notwithstanding, a robust financial system with the capacity to take on risk will be essential for the sustainable provision of credit to the real sector.

Figure 2: International Banks possess substantial capital buffers (N' billions)



Source: Company financials (Q1'19); CardinalStone Research

Figure 3: National Banks may need to raise additional capital (N' billions)

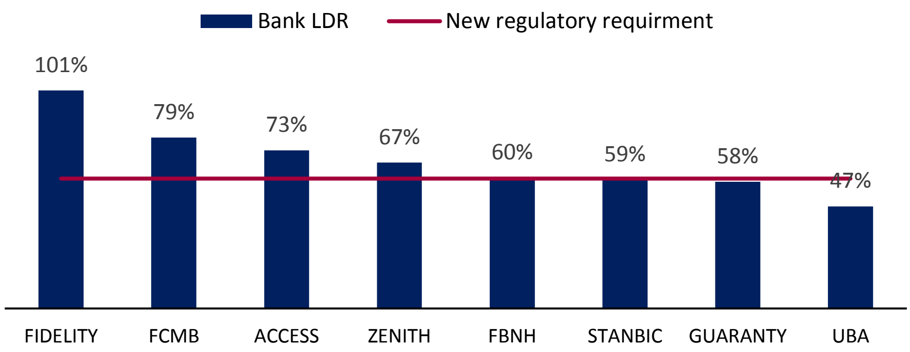


Source: Company financials (Q1'19); CardinalStone Research

CBN looks set to take more drastic steps to increase lending to real sector. The CBN embarked on several initiatives to improve real sector lending in the last 5 years with limited success, as private sector credit only recorded marginal growth of 1.0% between 2016-2018 after an initial surge of 15.4% YoY in 2016. Some of the initiatives of the last 5 years include the introduction of a national collateral registry, which, as at April 2019, had over N1.2 trillion registered on the platform; and the introduction of a more flexible cash reserve ratio for banks providing funding to green and brown field projects in manufacturing and agriculture sectors. In the next five years, the CBN is planning to expand the scope of its previous policies, with added objectives including: broadening the range of collateral MSMEs can provide to banks; increasing the enrollment of unique banking customers to 100.0 million on the BVN system; supporting the development of invoice financing; and introducing a consumer lending framework for large department stores, automobile companies and equipment leasing auctions. In line with these objectives of deepening access to credit, the CBN recently released a guideline instructing banks to maintain a minimum loan to deposit ratio (LDR) of 60.0% by September 2019 (compared to sector LDR of 58.5% as at May 2019 and regulatory maximum of 80.0%).

Although bank lending to the domestic economy rose by 8.2% YoY to N20.974 trillion (as at April 2019), the CBN's move highlights an increasing need to encourage greater allocation to strategic segments within the private sector. In addition, the apex bank may have been concerned about the recent decline in LDR to 58.5% in 2019 (from 67.4% as at May 2018) and the concentration of existing loans in the volatile oil and gas sector. Based on Q1'19 numbers on Nigerian operations, our analysis suggests that most banks under our coverage may not have to increase loans significantly to adhere to the new requirement, save for United Bank for Africa (UBA) Plc. While we highlight that the regulation could incentivize some DMBs to extend loans to targeted sectors due to the implied benefit in the computation of LDR, banks are likely to weigh this benefit against the risk of a possible increase in NPLs due to fresh exposure to fragile real sector segments.

Figure 4: Most of our coverage banks already meet CBN's LDR requirement



Source: Company financials; CardinalStone Research

Same old same old as CBN doubles down on its last term mandates

The CBN reaffirmed its core objectives of ensuring stable FX and reining in inflationary pressures in the next 5 years by leveraging monetary tools such as open market operations and reserve requirements. Notably, the CBN emphasized that exchange rate stability is likely to be crucial in achieving its single digit inflation target in the medium-to-long term. Although a target inflation band was not explicitly stated in the policy document, we believe the CBN will aim to anchor expectations around its previously stated target of between 6.0-9.0%. In our view, we see the CBN's target as optimistic given structural impediments such as the vulnerability of crop produce (which accounts for c.50% of the CPI) to weather and seasonality effects. With average growth in crop production falling below the population growth rate for the first time in a decade in 2018 (2.1% vs population growth rate of 2.7% in 2018), inflationary pressure from food prices is unlikely to abate in the near term. Furthermore, the possible devaluation of the naira, implementation of cost reflective energy tariffs and deregulation of the downstream oil sector all present upside risks to inflation in the near-to-medium term. While we note that CBN's sustained support for the agricultural sector has the potential to increase production in the medium term and thus cushion the volatile impact of weather conditions, the burden of risks remains largely tilted to the upside in our view. Our base case expectation is for inflation to average c.11.5% YoY in 2019 (vs. YTD average of 11.3% YoY).

FX stability has been largely achieved in the last 2 years, following several currency devaluations that caused shocks to the price environment, as oil prices tumbled from highs of $155/barrel in 2014 to an average of $44/barrel in 2016. The apex bank achieved relative stability through frequent interventions in the various exchange windows, which we expect to be sustained in the near term given prevailing global fundamentals (monetary easing in developed economies, steady oil price outlook owing to recently agreed extension of OPEC cuts and FX reserves well above CBN's comfort level of c.$30.0 billion). In Emefiele's second term, we expect I&E FX window to remain the primary exchange window, with a possibility of further convergence of all FX rates still likely. We also do not rule the possibility of a devaluation of the naira in the medium term as our expectation of sticky double-digit inflation could result in further overvaluation of the NGN and increased pressure on the apex bank.

Nigeria's monetary authority still seeks diversification through extension of intervention programmes. Intervention initiatives such as the Anchors Borrowers Programme, Presidential Fertilizer initiative, Nigerian Bulk Electricity Payment Assurance Facility and FX restriction on over 42 banned items were synonymous with the CBN in the last 5 years. The objective of diversification is closely tied with that of exchange rate stability as the long-term goal is to propel targeted sectors to help drive non-oil exports to US$13.0 billion (2018: $2.0 billion) and diversify FX earnings from crude oil exports. In the next 5 years, the lender of last resort plans to deepen some of the aforementioned reforms. Some other measures being pursued by the CBN include:

- Introducing a non-oil export dimension to the ABP with a focus on linking small holder farmers to international buyers
- The provision of improved seedlings as well as access to finance for rural farmers across certain identified commodities
- Strengthening of the capacity building arm of the ABP to support better farming practices and improved output.

Although the intensification of farmer-herder clashes makes it difficult to assess the success of the initiatives, the worry for the central bank remains the persistently low repayment rates associated with loans extended to businesses in these segments.

Figure 5: Loan extension and repayments of key intervention programmes

Development Initiatives	Inception	Loans since inception (N'billions)	Repayments (N'billions)
Commercial Agriculture Credit Scheme (CACS)	2009	603.29	328.31
Power and Airline Intervention Fund (PAIF)	2010	301.37	145.52
The Accelerated Agriculture Development Scheme (AADS)	2013	57.62	19.21
he Nigeria Electricity Market Stabilisation Facility (NEMSF)	2014	183.09	30.46
Anchor Borrowers' Programme (ABP)	2015	174.75	21.41
The Paddy Aggregation Scheme (PAS)	2017	14	-
The Nigeria Bulk Electricity Trading-Payment Assurance Facility (NBETPAF)	2017	704	534.14

Source: CBN Annual Report; CardinalStone Research

We expect the apex bank to aggressively pursue financial inclusion in the next 5 years. According to EFinA, Nigeria has made only marginal strides in financial inclusion since 2014, as the percentage of population that is financially served grew by only 2.8ppts to 63.2% between 2014 and 2018. To achieve its objective of 95.0% access to financial services, the apex bank plans to leverage technology. Fostering the implementation of initiatives such as the cashless economy, USSD, mobile banking, and agent networks is likely to be important for the accomplishment of this goal. We believe that the release of the guideline for the operation of payment service banks bodes well for CBN’s medium term outlook on this front. Payment service banks are likely to enhance access to financial services in rural areas, predominantly dominated by the relatively poor. We believe that telecommunication operators are well positioned to successfully execute mobile money services owing to their vast network coverage and expertise of their parent/holding companies. Furthermore, Nigeria’s relatively high dependency ratio (87.2%), sizable informal sector (c. 55.0% of GDP) and vast population living in rural areas (49.6%) provide the underlying bases for the success of payment service banks.

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