Sub-Saharan Africa banking review
A review of the 2014 calendar year
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Foreword

This is our first review of the major banking markets across Africa. We have chosen to do this exercise, given that financial services, and banking in particular, is becoming more and more critical to the economies of Sub-Saharan Africa. As these markets remain in a strong growth cycle, the need for formal financial services typically rises in tandem, and so does the ratio of bank assets to GDP. This is most visibly seen in the smallest and less mature markets. In Rwanda, for example, bank earnings outpaced GDP growth by a multiple of 20.1 times.

Our approach is based on an analysis of three of the largest African banking markets, namely South Africa, Nigeria and Kenya. However, given that economic integration in the East African Community (EAC) is far more advanced than other regional economic and political clusters across Sub-Saharan Africa, we also included Tanzania, Uganda and Rwanda, creating an east Africa perspective. Already the EAC's GDP is collectively valued at over US$100b, making it the fourth-largest economy on the continent, after Nigeria, South Africa and Angola. (We have excluded Angola from this study due to the difficulties of obtaining reliable and timely banking information. We are planning to include Angola as part of this study in future.)

Within the two largest economies, namely Nigeria and South Africa, our coverage was confined to the Tier 1 banks, which in both cases account for the major portion of total industry assets. In South Africa, these banks make up approximately 90% of the total. In the EAC, we included all but a handful of banks. Partly this is because the banking markets are less concentrated, meaning the Tier 1 banks are not as dominant, with the Tier 2 banks representing a sizable share of market although Tier 1 banks tend to outperform on earnings and profitability metrics.

We trust you will find this review insightful and thought-provoking, and we particularly highlight our special topic, mobile money, which we believe will become critical to driving financial inclusion and revenue growth in future.

Emilio Pera
Financial Services Leader
EY Africa
Executive summary

Although banks in Sub-Saharan Africa faced slowing economic growth in 2014, they nevertheless reported sound profits growth.

Weakening growth impacted South Africa and west Africa more than it did in east Africa, although impairment charges rapidly deteriorated in two of the four east African markets.

West Africa’s growth slowed late in the year and may only strain banking profits in 2015, while the region’s largest banking market, South Africa, faced a second difficult year of weak economic growth. Coupled with that, electricity shortages (and labor strife in the first half of the year) resulted in much weaker GDP growth in the south.

- Asset growth was strongest in Rwanda, up 23%.
- Profits growth was also highest in Rwanda, where they more than doubled (up 145%).
- Returns on equity were strongest in Nigeria, at 20.3%.
- Net interest margins are highest in Uganda, at 16.8%.
- Nonperforming loans rose in the east but fell back in both the west and south.

Despite South Africa having the slowest banking profits growth across our coverage area, the country still accounts for 72% of loans and advances and 67% of total assets, but only 58% of income and profits.

Sub-Saharan Africa banking review: banks shrug off slower growth in the west and south while Kenya grapples with rising impairments

Africa’s banking markets remain immature, in the sense that bank assets as a percentage of GDP, with the exception of South Africa, are very low. Only South Africa’s banking sector has assets in excess of its GDP. Although Nigeria is the region’s second-largest banking market, it holds only US$0.28 in bank assets for every US$1 of GDP. This means Nigeria has considerably fewer banking assets per GDP than what Kenya has, and the ratio is even lower than Tanzania’s.

Nigeria’s bank assets to GDP is lower than initially thought, given their GDP rebasing during 2014, with the resulting GDP being double the size it was previously thought to be.

The banking sector’s growth potential is considerable

The banking sector’s growth potential is considerable

Ratio of bank assets to GDP

<table>
<thead>
<tr>
<th>Country</th>
<th>Ratio of Bank Assets to GDP</th>
</tr>
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<tbody>
<tr>
<td>South Africa</td>
<td>115%</td>
</tr>
<tr>
<td>Kenya</td>
<td>65%</td>
</tr>
<tr>
<td>Tanzania</td>
<td>34%</td>
</tr>
<tr>
<td>Nigeria</td>
<td>28%</td>
</tr>
<tr>
<td>Uganda</td>
<td>27%</td>
</tr>
</tbody>
</table>

Africa’s banking markets remain immature, in the sense that bank assets as a percentage of GDP, with the exception of South Africa, are very low. Only South Africa’s banking sector has assets in excess of its GDP. Although Nigeria is the region’s second-largest banking market, it holds only US$0.28 in bank assets for every US$1 of GDP. This means Nigeria has considerably fewer banking assets per GDP than what Kenya has, and the ratio is even lower than Tanzania’s.
The following developments shaped the banking sector in 2014:

Southern Africa

South Africa
The first collapse of a bank since 2001 occurred during the year. However, this proved to have little impact on the stability of the banking sector, and was the first bank to collapse under the central bank’s recovery and resolution framework.

- Continued weak GDP growth meant another year of single-digit growth in assets.
- Even so, bank earnings grew 11.6%.
- Earnings growth was driven by a favorable combination of:
  - Slowing impairments (although evidence suggests that this may have reversed in the second half of the year)
  - Rising margins
  - Improving efficiency ratios
  - Continued growth in advances (although below long-term trend levels)

East Africa (Kenya, Uganda, Rwanda, Tanzania)

- Rwanda, by far the smallest banking market in the region, saw profits more than double through 2014, up 145%.
- Profits growth in other markets was also impressive, with Tanzania up 29% and Uganda 26.5%. Kenya, being the largest market, reported the slowest growth in the region, at 15.5%.
- Profits growth was solid despite lower margins in three of the four East African markets.
- The average 17.3% rise in banking assets across east Africa proved to be a strong driver.
- In addition, Uganda and Kenya experienced sharply rising impairments, while lower nonperforming loans (NPLs) were reported in Tanzania (albeit after a spike in 2013).

West Africa (Nigeria)

- Slower growth and a high concentration of loans into the oil and gas sector (and aligned industries) meant that banks faced growing risks of loan defaults, although these risks escalated toward the end of the year and will likely feature more visibly in upcoming reporting cycles.
- Nigeria’s Tier 1 banks enjoy the highest returns across the six countries covered in this analysis, with a return on equity (ROE) of 20.3%.
- A 15% rise in loans and advances supported the strong returns, a faster rate than either the east or southern regions experienced.

Bank earnings continue to outpace GDP growth, with Rwanda’s banking profits growth leading the way. On average, bank earnings in the markets covered in this report outpaced GDP growth by a multiple of 6.9 times (unweighted).

Excluding Rwanda, this multiple is an average of 4.3 times.

The banking sector gains a greater share of the economy when its growth outpaces GDP growth. (South Africa’s longer-term average is a multiple of 5.1%, indicating that bank earnings are rising above average growth rates.)
Special topic
Mobile money: from hype to reality
### Mobile money: from hype to reality

In Sub-Saharan Africa, mobile money solutions are crucial. They transform the way banking is conducted and increase financial inclusion, an area in which Africa lags globally, even in comparison with other emerging-market regions. Introducing digital payment platforms could grow GDP by 0.5 percentage points per annum, estimates show. Nigeria’s central bank recognizes the value of minimizing cash circulation and the cost savings (of cash transportation) this can bring.

Thus far, mobile money’s traction across Africa has been a stop-start affair, being more successful where a direct consumer need is met affordably. Rolling out successful product offerings from one country to another has proved difficult, illustrating that each region is unique and has to find its own compelling selling points. The central bank recognizes the value of minimizing cash circulation and the cost savings (of cash transportation) this can bring.

Mobile transactions can be classified into three broad groupings:

- **Mobile banking** entails using a mobile device to remotely access a bank account, primarily for account balance checkups and bill payment services.
- **In mobile payments** a mobile phone is used to perform financial transactions for purchases or sales (either remotely or on-site), retrieve promotion information or coupons, and deliver gift items.
- **Mobile money** is a peer-to-peer application making use of a mobile phone to send money to family or friends at different locations.

### Mobile money characteristics

<table>
<thead>
<tr>
<th></th>
<th>South Africa</th>
<th>East Africa</th>
<th>West Africa</th>
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<tbody>
<tr>
<td><strong>Major mobile banking products</strong></td>
<td>Peer-to-peer (P2P) Peer-to-peer (P2P)</td>
<td>P2P</td>
<td>P2P</td>
</tr>
<tr>
<td></td>
<td>Peep-to-peer (P2P)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Prepaid services</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Account payments</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Penetration rate</strong></td>
<td>11%</td>
<td>Kenya: 68% Uganda: 27% Rwanda: 4% Tanzania: 23%</td>
<td>Nigeria: 13% Ghana: 2%</td>
</tr>
<tr>
<td><strong>Size of market (registered mobile banking customers)</strong></td>
<td>5.5m</td>
<td>Kenya: 15m</td>
<td></td>
</tr>
<tr>
<td><strong>Major players</strong></td>
<td>Big Four banks, mobile and IT companies</td>
<td>Dominated by the largest mobile operator</td>
<td>Banks largely partner with mobile operators. Mobile companies can partner with more than one bank</td>
</tr>
<tr>
<td><strong>Future</strong></td>
<td>Banks add bancassurance offerings to grow revenue and also focus on improving functionality and ease of transacting. Micro-credit possibly follows</td>
<td>Banks seek additional revenue streams; new players enter the lucrative P2P market</td>
<td>The central bank expects 20m Nigerians to enter the formal banking system via mobile money over the next three years</td>
</tr>
</tbody>
</table>

Digital currencies are an additional factor to consider, as they provide a means for facilitating digital transfers and payments. For the moment, they remain outside of formal banking channels and, for purposes of this paper, we have chosen not to include them in our discussion.
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Companies have had varied levels of success in mobile banking, mobile payments and mobile money across Sub-Saharan Africa. While east Africa (specifically Kenya) has had tremendous success in mobile money (using a mobile device to transfer funds across distances), South Africa has largely had greater success in launching mobile banking, allowing clients to access their bank accounts on a 24-hour basis. Mobile payments have also gained traction, with a variety of banks and non-banks providing platforms to process payments using remote devices.

Currently, mobile transactions are largely peer-to-peer (P2P) transfers, accounting for over 70% of the total mobile market. This is followed by bill payments, accounting for 12% of the market.

The success of mobile financial services depends on the regulatory stance

The regulatory environment is critical to mobile financial services, as regulators can either support or limit the market’s growth (and perhaps even lead to its demise). Regulators are sometimes cautious about mobile money initiatives, and other times they are supportive. Largely, a regulator’s approach is driven by its need to protect consumers and ensure prudential compliance, striving to minimize systemic threats to financial services stability.

Nigeria’s regulator is very supportive of mobile platforms, in line with its objective of shifting the country to a cashless economy. This policy is driven by a need to reduce the cost of financial services, given the high costs of cash management. South Africa’s regulator was initially cautious about mobile banking platforms and driven by prudential reporting needs. But there is a growing acknowledgment that it could play a critical role in increasing financial inclusion.

Kenya’s regulator was slow to respond to the rapid public enthusiasm given to M-Pesa but retroactively supported the initiative.

Generally, regulators have become more receptive to mobile banking due to the consumer benefits it provides, as security enhancements limit fraud and provide greater consumer confidence. Even so, the risks of cybercrime remain prevalent and are constantly shifting, requiring ongoing initiatives to secure mobile platforms.

Banks will need to maintain ownership of the mobile financial transactions market

Traditionally, banks have owned the financial payments and transactions space. The launch of the internet made banking more accessible, both in terms of reach and in terms of hours during which one could transact. More recently, ownership of this space is under threat: mobile operators and technology upstarts are encroaching, seeking additional revenue flows in response to slowing voice and data revenue growth.

Banks are not only up against traditional competitors in the mobile space

This means that the need for banks to act is urgent. Banks that fail to launch compelling mobile offerings risk falling behind. South Africa has numerous examples of mobile banking launches that failed. Circumstance played a role. One example is of a platform launched more than a decade ago between a bank and a telecoms operator that failed because it did not address client needs cost-effectively. Partly, this was due to the functionality of technology at the time. As a result, this led to little uptake.

Smart technology is bringing new possibilities

Recently, smartphone technology is becoming more readily available, especially for the unbanked, as costs fall. Joint ventures between banks and telecoms companies are beneficial to both parties. Banks provide the license and therefore the ability to channel deposits, while telecom companies provide platforms. However, many banks are developing in-house expertise or even purchasing companies with the technical skills sets.
Understanding market needs is essential

There is no one-size-fits-all approach to mobile platforms. Kenya has had great success with M-Pesa, but it has proved difficult to roll out outside of eastern Africa, while in South Africa the rollout failed to attract strong interest. In addition, operational expertise is required. Identifying and bringing agents into the system is critical to the business model. Banks are experimenting with various options in setting up agency networks to allow for effective cash-ins and cash-outs, a critical requirement in the money transfer space. This is already working well in east Africa.

In addition, retailers in South Africa have a substantial share of the market, as they have a large footprint stretching far into remote areas, thus providing the infrastructure for cost-effective money transfers.

Affordable pricing is the single greatest benefit to consumers

Another key determinant is pricing. Newly launched mobile platforms are pricing substantially below traditional offerings, partly to reflect lower associated costs but also to attract new clients. Mostly, mobile banking does not levy monthly or annual charges, and fees are incurred only as transactions are conducted. This has long been a major obstacle for the unbanked, who have resisted unaffordable fees. It also provides additional explanation for the success of M-Pesa, which provided a cost-effective means to transfer funds across remote corners of Kenya using a transaction-based charging model.

Costs are a key driver to building a compelling value proposition

In South Africa, banks not only compete with traditional peers but also face increasing interest from retailers – for example, who can make use of a considerably larger footprint, thereby extending their reach beyond what banks can feasibly do. Even with cellular technology allowing for lower costs, the sheer number of unbanked people in lower income groups still allows a retailer to provide a money transfer service to rural areas more cost-effectively than what current technology can. This will likely change, as falling technology costs place more and more smartphone devices in the hands of an increasing population.

Partnerships and alliances means banks are well-positioned

Banks are well-positioned in the mobile platforms space, as regulators are concerned about non-banks accepting deposits. This means non-bank operators need to cooperate with registered banks (or obtain their own banking license, an expensive, and often not worthwhile, investment). This positions banks to partner with non-banking innovators and share mobile-platform revenue streams. The benefits also stem from banks not having to incur their own costs to start up mobile platforms. Various initiatives along these lines are being rolled out in South Africa.

Considerations for Africa

Africa has low income levels, even by emerging-market standards. As a result, business models need to be high volume and low margin, given that mobile payments and transfers are small in value. Again, the success of M-Pesa can be traced to providing a required service affordably to the mass market.

To service this growing market requires that banks focus on cost optimization. Building mobile transaction capability requires capital. In addition, systems need to interface, as banks have already learned that stand-alone platforms do not allow sufficient client intelligence and do not process transactions cost-effectively.

Each region in Africa has unique drivers

While east Africa has received worldwide acclaim with its M-Pesa money transfer service, this does not automatically work in other areas. The rollout of M-Pesa across the region is proving worthwhile, with one dominant telecom company the key driving force. Banks will want to tap into mobile transactions, which have clearly resonated with the public, and earn a share of revenue. The challenge will be to build compelling alternatives to the already established incumbents.
South and southern Africa are moving simultaneously toward facilitating mobile banking and increasing financial inclusion rates. This requires a more complex technology makeover, given that systems must be geared accordingly. That means a much broader conversation about technology transformation, given the legacy systems the established banks face. Even smaller banks will need to make investments to allow the relevant range of consumer touch-points to be easily incorporated.

West Africa’s mobile focus will largely focus on facilitating banking transaction capability. This will be driven by the Nigerian central bank’s requirement to move toward a cashless society. This in turn will benefit financial inclusion as more people are brought into formal financial services platforms. Banks will respond by building suitable technology platforms and identifying best-in-class combinations of in-house technology and non-bank partnerships. Banks may choose not to make the full technology investment on their own and instead seek telecoms and technology companies to provide the expertise. Even so, systems interoperability will be critical, and banks may need to rethink their bricks-and-mortar approach.

The future of mobile money

The potential for mobile platforms in financial services appears unlimited. Many experts believe we are only in the very early stages of mobile financial services and are asking what the next big initiative will be. One possibility is the provision of credit via mobile platforms. This is still very much in its infancy, and traditional banks have approached this market with caution. In the short term, that leaves nontraditional banks the space to innovate and provide desperately needed credit to microbusiness start-ups, a segment that banks tend to shy away from, given that it is largely unsecured in nature. In the longer term, and depending on the success of these new entrants, banks may partner with them in future, as players can mutually benefit. (Banks have larger balance sheets to leverage, and online credit providers have the experience and risk expertise in identifying suitable clients.)

Banks could therefore benefit not only from stronger transactional revenue growth, but also from higher interest income flows, as they make increasing use of mobile platforms to grow their advances books. Thus far, transactional fee income has been the major benefit to banks (and non-bank entrants), but the potential profit flows from lending activities via mobile platforms is likely to be significantly higher.
Economic overview
Economic overview

Slower global growth, but Africa’s prospects are strong

While mature markets showed some evidence of improvement, growth slowed globally in 2014, including in dominant emerging markets (such as the BRICS cluster). Both Brazil and Russia struggled with a weakening growth outlook, while China’s growth slowed to single digits for the first time in a decade. While these negative factors have impacted Africa’s growth prospects, there appears to have been no immediate impact, with growth picking up from 4.3% in 2013 to 4.5% in 2014. The World Bank expects growth to rise further still, to 5.1% by 2017.

Africa’s FDI inflows

FDI project numbers were down in 2014, though both capital investment and jobs surged.

In 2014, Africa registered an 8.4% decline in greenfield FDI projects. This occurred against a decline of 3.6% in FDI projects around the world.

From a low point in 2013, capital investment in Africa recovered sharply. In 2014, FDI into the continent more than doubled to US$128 billion, from US$54 billion in 2013, on the back of several large deals. Average investment size rose to US$175m per project, well above the US$68m in 2013 and slightly ahead of the US$170m in 2008, when capital investment peaked. These capital-intensive projects were largely directed toward coal, oil and natural gas, and real estate, hospitality and construction (RHC).

This was mainly due to the fragile state of the world economy and greater geopolitical uncertainty, particularly regional conflicts in Eastern Europe and the Middle East.

It was also due to slower investments into west Africa, which is feeling the pinch of lower oil revenues, while South Africa suffers from protracted labor strife.

Even so, Africa became the second-largest recipient of capital investment.

There is a US$160b plan by French oil major Total to develop the Kaombo offshore oil project in Angola (in a JV). The project is expected to produce 230,000 barrels per day from reserves estimated at 650m barrels.

An announcement by Greece-based Mac Optic to invest US$10b in Egypt was made. It includes US$4.8b to construct a new refinery with a production capacity of 250,000 barrels per day and US$5.2b to construct a petrochemical plant. Both projects will be situated in the Gulf of Suez.

An agreement with the Nigerian Government worth US$5b was signed by SkyPower FAS Energy. This is a JV between SkyPower Global and FAS Energy, to build 3,000 megawatts of solar photovoltaic (PV) projects in the country.


The Sub-Saharan Africa banking market in 2014

South Africa’s size dominates, but by profitability measures, east Africa is more favorable in return on assets (ROA).

<table>
<thead>
<tr>
<th>2014</th>
<th>2,740.00</th>
<th>89.70</th>
<th>683.50</th>
<th>1,687.00</th>
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<td>Exchange rate</td>
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<tr>
<td>(US$)</td>
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<tr>
<td>US$m</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Total profits</td>
<td>196</td>
<td>1,132</td>
<td>53</td>
<td>224</td>
<td>5,548</td>
<td>2,365</td>
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<tr>
<td>Total assets</td>
<td>7,066</td>
<td>35,657</td>
<td>2,441</td>
<td>13,045</td>
<td>413,339</td>
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<td>16.8</td>
<td>12.5</td>
<td>13.2</td>
<td>13.1</td>
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<td>margin</td>
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<td>Capital</td>
<td>16.7</td>
<td>15.7</td>
<td>17.0</td>
<td>13.7</td>
<td>15.2</td>
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<td>Loan to deposit</td>
<td>47.6</td>
<td>80.3</td>
<td>81.6</td>
<td>74.3</td>
<td>83.2</td>
<td>68.1</td>
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<td>ratio</td>
<td></td>
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</tr>
<tr>
<td>Return on assets</td>
<td>2.9</td>
<td>3.4</td>
<td>2.4</td>
<td>1.8</td>
<td>1.6</td>
<td>2.3</td>
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<td>Return on equity</td>
<td>17.6</td>
<td>21.8</td>
<td>14.3</td>
<td>13.5</td>
<td>17.8</td>
<td>20.3</td>
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<td>Assets</td>
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<td>Loans and</td>
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<td>20,986</td>
<td>1,314</td>
<td>7,224</td>
<td>263,158</td>
<td>67,718</td>
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<td>Deposits</td>
<td>5,004</td>
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<td>10,414</td>
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<td>Nonperforming</td>
<td>5.10</td>
<td>5.00</td>
<td>n/a</td>
<td>3.30</td>
<td>2.50</td>
<td>3.450</td>
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<td>loans ratio</td>
<td></td>
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Best performer

Sub-Saharan Africa banking review: banks shrug off slower growth in the west and south while Kenya grapples with rising impairments
South Africa
South Africa experienced continued currency pressure in 2014, although not to the same extent experienced in 2013. Even so, by year-end, the currency had depreciated some 9% against the US dollar. This in turn fueled slightly higher inflation, although with some relief toward the end of the year, as falling oil prices slowed the pace of increase.

While inflation ticked upward, the country’s GDP growth slowed once again to hit a five-year low. Annual growth slid to 1.5%, considerably below the Government’s medium-term target of 5%. Economists had predicted that the country would grow at 2.5%, but this proved optimistic, as the reality of prolonged labor disputes in the mining sector dragged on for most of the first half of the year.

The central bank raised interest rates twice through the course of the year, responding to the pessimistic stance by investors in emerging markets. South Africa is often flagged for its twin fiscal and trade deficits, which become problematic when sentiment turns negative.

South Africa received some relief, late in the year, from its difficulties in the form of lower oil prices, which helped contain inflation. GDP growth is expected to accelerate from 2014 levels, benefiting from the base effects of a weak first half in 2014 and higher disposable income arising from lower oil prices. However, this may be short-lived, as higher taxes kick in and renewed currency depreciation nudges prices back up.
The banking outlook appears quietly confident

Despite a trend of below-average economic growth for the last few years, banks managed to keep earnings growth in double-digit territory throughout this period.

Partly, this growth remains above expectations because banks have increasingly looked to the rest of Africa as they faced weaker domestic prospects. In addition, they have also benefited from improved efficiency ratios (with focused efforts at ensuring that cost growth is kept below revenue growth). One more favorable factor was a benign impairment environment supporting earnings growth.

In addition, assets have continued growing, although at much slower levels than before the global financial crisis (GFC), reflecting the weaker underlying economy. Slower advances have forced banks to adjust their pricing in line with the rising risks. As a result, margins have steadily risen over the last few years. These positive metrics were reflected in the EY Financial Services Index, our quarterly confidence barometer, which indicates that banking confidence steadily improved through 2014, with the last quarter being particularly bullish for both retail and investment banks.

Analysis of the South African banking sector is based on the largest five banks, which collectively account for 90% of banking sector assets, thus providing a representative view of the market.

Banks grapple with weak domestic demand

South African banks’ concerns have not changed drastically since the previous reporting cycle. Banks face a weak domestic market, resulting in a more competitive environment, as they compete for a greater share of a slow-growth market. The country also faced the collapse of one of its larger Tier 2 banks, which relied on wholesale funding and provided unsecured credit solely to low-income clients. Banks responded to this tougher environment by refocusing efforts on client-centricity and focusing on unique selling points. The banks that have led in this space have benefited from stronger profits growth, higher returns and larger customer numbers.

The key banking financial metrics improved in 2014

Enhancing shareholder value in these circumstances required a focus on managing the “metrics that matter.” As a result, South African banks focused their efforts on:
Managing cost growth to ensure these do not exceed revenue growth, thus allowing the operating jaws to remain positive. Operating jaws were kept positive at most banks in 2014, with revenue growth exceeding expense growth by a comfortable margin for most of the largest five banks.
Sub-Saharan Africa banking review: banks shrug off slower growth in the west and south while Kenya grapples with rising impairments

- Capital adequacy ratio change -100bps
- Highest +30bps
- Average -65bps
- Lowest -120bps

Interest margins continued rising in 2014, with banks becoming more selective about the product and market niches they choose to grow in. In addition, re-pricing in certain product lines (mortgages being the most prominent example) has allowed margins to gradually recover from the low levels of five years ago. Added to this, the two interest rate hikes also played a role in boosting interest margins.

It has become critical to optimally deploy capital, with banks historically exceeding their required capital holdings by a considerable margin. Banks reduced their capital adequacy ratios in 2014, thus optimizing capital more carefully.

- Aligned to cost management programs, banks achieved continued efficiency gains each year. The industry-wide efficiency ratio improved by 100 basis points in 2014, although it remains above pre-GFC levels.

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Credit impairments remain benign. The banking sector benefited strongly from another fall in the credit loss ratio in 2014, falling 17 basis points despite interest rates being hiked twice through the year (albeit moderately). Retail and corporate and investment portfolios improved, thereby driving better impairment trends. In the case of retail, the mortgage and card portfolios improved noticeably, although worsening trends in asset finance partially offset the gains.

Banks are being more selective about which product segments to grow, and that has helped reduce the credit impairment ratio to a nine-year low. Many banks slowed mortgage advances growth, following a drastic rise in impaired loans after 2009. More recently, banks have been reluctant to grow exposure in unsecured lending, largely because the credit risks were deemed to be rising too sharply. The corporate segment has seen much lower impairments over the last five years, and those banks with strong corporate loan portfolios have benefited accordingly.

Due to the favorable initiatives across a number of key metrics, banking sector profits rose 11.6% in 2014, marginally up from the growth recorded in 2013 (+10.9%).
Headline earnings growth ranged between 1% and 22% across the five largest banks.

The combined impact of improved efficiencies, sustained moderate asset growth and lower capital ratios led to stronger industry returns. Overall, the banking sector experienced a rise of 50 basis points rise in ROE, although one bank skewed the results with its extensive increase.
Banks achieved these higher returns even though asset growth remained in the single digits

Amid slow economic growth, companies are struggling to grow in the lending market within reasonable risk parameters. While banks have been more selective in which business lines and clients they are prepared to lend to, they have nevertheless faced very subdued demand, both from the retail and corporate segments. More recently, demand for credit from the corporate sector has been somewhat more buoyant, with a large portion of that renewed demand feeding African expansion plans, rather than domestic market financing needs. High unemployment levels, coupled with rising consumer indebtedness, are keeping consumer credit demand levels weak.

Lending growth slowed sharply after the GFC, remaining weak ever since.

Asset growth remains in high-single-digit territory, in line with lending growth.
Nigeria
Falling oil prices through the second half of 2014, and the impact on domestic economic growth and government revenue, are pressuring the naira (NGN). It lost 18% of its trading value in the six months to end March in one of the sharpest currency declines across the globe. This has considerable implications for inflation, which is likely to rise from its current 8% level to in excess of 10%.

Late in 2014, the central bank attempted to support the plunging currency by raising interest rates for the first time in three years (to 15% from 13%). In addition, the bank hiked the cash reserve ratio for private sector bank deposits to 20% from 15%.

The lower oil prices also put the stock exchange under considerable pressure as investors withdrew to safer markets.

A revised 2015 national budget will cut capital spending, with a lower GDP forecast. Oil still accounts for a sizable 95% of foreign exchange earnings and 75% of government revenue. On the plus side, the non-oil sector is growing more rapidly than the oil sector (at 8% in 2013, although slowing to 7% in 4Q14).

Nigeria’s international creditworthiness remains below investment-grade status, with Fitch and S&P awarding it a BB-rating amid political concerns and a poor record of economic management. Fitch changed its outlook for Nigeria to negative at the end of March.
Banking

Our analysis is based on the six largest Tier 1 banks, which collectively account for approximately 60% of total bank assets.

Slowing oil prices increase credit risks

Slowing oil prices means that banks with significant exposures to the oil and gas (and ancillary) sectors will become more vulnerable to loan defaults. On average, bank loans to the oil and gas sector account for approximately 25% of total loans. But through 2014, the six Tier 1 banks reported solid growth, with profits up a collective 20.9% on the back of good loan growth (+15%). This resulted in stronger returns, with ROEs averaging 20.9% for 2014.

Nigeria remains the Sub-Saharan Africa region’s second-largest banking market, with assets accounting for just under a quarter of the region’s total 23% and with profits accounting for exactly one-quarter.

Gross income rose 16.2% in 2014, slightly ahead of advances growth. The fastest-rising gross income was 21.8% and the slowest was 9.1%. Income growth was supported by higher interest rates, although these were announced in November.

Nigerian banks have become more focused on cost containment since experiencing a credit crisis in 2009, which resulted in major losses for many banks, with some collapsing. Banks have since taken a more stringent approach to credit risk. Operating expenses rose 15.1% across the Tier 1 banking cluster, with the highest growth recorded at 28% and the slowest growth rate in low single digits (3.4%). While this was lower than revenue growth, it was higher than either the eastern or south regions.

Profits grew faster than income did in 2014, up 20.9%, driven by strong loans and advances growth and higher loan-to-deposit ratios (which meant the cost of funding fell during the year).

One bank substantially influenced profits growth, recovering from a spike in impaired loans in 2013 (Ecobank). Excluding Ecobank, the five remaining Tier 1 banks reported more moderate profits growth of 9.7% for the year.
Sub-Saharan Africa banking review: banks shrug off slower growth in the west and south while Kenya grapples with rising impairments

The average loan-to-deposit ratio rose more than 400 basis points to 66.5%, while loans and advances rose a solid 27%.

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Efficiency ratios

The cost-to-income ratio was little changed for Tier 1 banks in 2014, slightly increasing from 61.5% to 61.8%. However, this masks the experience of individual Tier 1 banks, where the variation was considerable. One bank saw a 400bps rise in its ratio while another bank saw a strong improvement, moving sharply in the opposite direction.

Nigeria’s Tier 1 banks held less capital in 2014 although they remain well-capitalized by global and even emerging-market standards. Overall, the capital adequacy ratio fell 110 basis points, but once again, the individual banks differed vastly. One bank saw a drastic 600bps reduction in its capital adequacy ratio while at the other end of the spectrum, one bank saw a 330bps rise.

Capital holdings fell even as the central bank raised its cash reserve requirement late in the year. In addition, banks had to report according to Basel II standards for the first time in 2014. Some banks were contemplating reducing their asset base rather than raising fresh equity in unfavorable market circumstances.

Lower capital levels, in turn, supported stronger ROEs, with Tier 1 banks reporting an average rise of 90bps (although ROAs were flat at 2.7%).

Once again, the averages distort the significant differences between the banks. Ecobank saw a strong recovery after bad-debt charges peaked in 2013, leading to a 1,020bps improvement in ROE in 2014. On the other hand, four banks reported falling ROEs, ranging between 120 and 265 basis points.

In conclusion, Nigeria’s Tier 1 banks were able to shrug off the impact of falling oil prices late in 2014. On all key metrics, the banking sector performed strongly, boosted by strong capital levels and more effective credit risk management, keeping NPLs resilient.
Sub-Saharan Africa banking review: banks shrug off slower growth in the west and south while Kenya grapples with rising impairments

East Africa
Economic review

Currency depreciation was noticeable through 2014, after the previous few years of relative currency stability. By emerging market standards, where currencies have depreciated rapidly against a strengthening US dollar, the falloff was moderate. Only the Ugandan shilling posted a loss greater than 10%.

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<th>TZS</th>
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<th>RWF</th>
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Non performing loans to total advances

Currency conversion rates (source: Oanda.com)

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<td>1,687.0</td>
<td>89.7</td>
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Kenya
Kenya benefited from continued strong growth in 2014, despite security concerns arising from Al-Shabaab. In June, the World Bank cut Kenya’s 2014 growth forecast by 0.5% to 4.7%, attributing the cut to drought, insecurity, weak budget execution and tighter global credit. Final growth is expected to be stronger. A diversifying economy meant that real estate and financial services contributed more to the stronger growth.

With inflation remaining comfortably within the central bank’s target band, there was room for interest rates to fall, with the key lending rate lowered by 100bps to 16% in October.

Like other emerging market currencies, the Kenyan shilling faced downward pressure toward the end of the year (and continuing into 2015), but the scale of the decline was not significant and less than what neighboring Uganda or Tanzania experienced.

**Banking:** Profitability remains strong, boosted by strong margins and increasing credit demand. But large banks are losing market share.
Sustained economic growth was strongly supportive of the banking sector. Sector assets grew 18% to US$35.6b, up from 16% in 2013 in line with deposits, loans and advances growth.

Profits growth lagged asset growth, up 15% for the year. This was due to sharply higher bad debts and interest expenses. All but 5 of the 43 registered banks reported profits during 2014.

Net interest income grew at a slower pace than assets, up 12% in 2014, with interest expenses rising more rapidly than interest income. This may well have been caused by more intense competition for deposits among the largest banks, where the cost of funding (from deposits) rose visibly. In addition, the central bank introduced a reference rate for the first time, which becomes the base rate for banks to determine pricing and which will be adjusted only once every six months.

Non-interest income grew 8%, even though fees and commissions increased at double that rate (17%).

Bad-debt provisions increased a sharp 46%. Bad debts are largely concentrated in the tourism and agriculture sectors, which were both hit by the impact of Al-Shabaab’s activity and unfavorable weather conditions respectively.

Profitability

The higher impairment charges resulted in both return on equity and return on assets falling from 2013 levels. ROA stood at 3.4%. ROE for banks in 2014 was 21.8%. In line with ROA, large banks lead in ROEs, with a 26.2% return, followed by medium-sized banks at a noticeably lower 18.9% return.

The lower returns are also in line with lower net interest margins, down 100bps, albeit after a strong rise in 2013. This lower net interest margin was driven by higher deposit rates, up 10bps, which in turn impacted gross yields on assets, which fell 30bps.

The cost of funding rose

Interest margin squeeze was also driven by higher deposit rates, which rose to 3.9%, up 10bps from 3.8% in 2013. Medium-sized banks experienced a marginal decline in their cost of deposits, although they nevertheless still pay a considerable excess to large banks.

Largest banks are the most optimal in operating efficiency

Operating efficiencies averaged 12.9%. Large banks benefit from their size and are thus the most efficient banks, followed by medium-sized banks and small banks lagging. The gap between the most and least efficient bank’s operating efficiency ratio stood at 19% (the most efficient being 9% and the least efficient at 28%).
Capital adequacy levels decline

Capital adequacy levels declined in 2014 (to 15.7% from 16%), but Kenyan banks remain well-capitalized by global standards. The regulator is pushing for banks to hold capital in excess of the required minimums, and bank regulators in surrounding countries are also upping the capital requirements.

Large banks account for just under half of total industry assets, but their share is down 2.8% from 2013, with medium-sized banks gaining in importance. This is mirrored in the large banks’ share of deposits, which also lost ground during the year.

Larger Kenyan banks continue to benefit from scale economies. They have a greater reach across more business lines and product markets and hence have more diversified portfolios. They are therefore able to achieve greater efficiencies than their smaller peers and are more profitable as a result. However, their share of the banking market is declining over the longer term, and this is similar to the situation in neighboring Tanzania.

The large banks continue to benefit from their scale, recording higher ROEs.

The large banks also benefit from lower deposit costs, sometimes paying less than half of what smaller and medium-sized banks need to in order to attract funds, but they faced more intense competition for deposits last year and lost market share at the expense of the midsize banks. Competition is likely to increase in the year ahead, as both foreign and local banks aim for greater presence and share of market.
Sub-Saharan Africa banking review: banks shrug off slower growth in the west and south while Kenya grapples with rising impairments

Tanzania
The current account deficit narrowed to 9.7% of GDP last year, from 10.6% in 2013. Lower oil prices led to sharply lower domestic fuel prices, benefiting consumers and business, although this was later in the year. Tanzania’s fuel bill remains a drawback and makes up the single largest import, accounting for 35% of total imports, driving the country’s current account deficit. Tanzania’s net current transfers fell 38% in 2014 following a corruption scandal in the power sector that resulted in a number of donors withholding aid.

Banking profits growth slows on rising bad debts and weaker revenue growth

Net profits (after tax) rose at a CAGR of 38.5% between 2010 and 2014, which was faster than asset growth. This was driven by solid net interest income growth of 51.2%. Bad debts rose considerably slower during this period, up 25.6%. Of the 49 registered banks, 34 reported profits during the year, with the remaining 15 banks declaring losses.

Between 2010 and 2014, bank assets grew at a CAGR of 33.4%. Banking sector assets increased 16% in 2014, slightly higher than 2013’s 14%, but well below the four-year CAGR of 33.4%. Loans and advances outpaced overall asset growth, rising 49.1% during the same period.

Deposits growth was marginally weaker than asset growth, up 29.9%. Customer deposits increased 15% in 2014, up from 12% in 2013. Banks were therefore able to increase their loan-to-deposit ratios and deploy more deposits to loans.

This meant Tanzania’s banks used a greater share of deposits in extending loans, which supported a higher loan-to-deposit ratio (74.3%, up from 72.6% in 2013). This is within the Bank of Tanzania’s maximum threshold of 80%.

Sustained asset growth and the higher loan-to-deposit ratio allowed banks to post higher returns, with both ROA and ROE up by 20bps and 100bps, respectively. In addition, lower bad-debt costs, coupled with stable capital holdings, also supported the stronger returns.

Large banks are losing market share, mostly to medium (Tier 2) banks

Large banks’ share of total assets continues to decrease, to 66% in 2014 (from 69% in 2013 and 72% in 2012). This follows a strong drive by medium-sized banks to capture a greater share of the market.

Even so, two large banks still dominate the deposit market, accounting for 38% of total deposits, while large banks collectively account for 80% of total bank deposits.

Economic review

In Tanzania
The share of total assets by medium-sized banks increased to 27% (25% in 2013 and 23% in 2012). NBFI’s share of total assets has remained flat at 4% in 2014 (3% in 2012 and 4% in 2011). Regional and small banks’ share of total assets increased to 3% in 2014 (2% in 2013, 2012 and 2011).

From an operational perspective, the large banks undoubtedly benefit from their sheer scale. As a result, their efficiency measures considerably outperform those of the other banks. This makes it very difficult for smaller banks to compete, as their pricing is unlikely to be as favorable as what the large banks can offer.
Uganda
Economic review

GDP growth remains solid, but a depreciating currency is concerning

Growth in 2014 averaged 6.1% in Uganda, ahead of the SSA average of 5.7%. This was lower than 2013 levels and is forecast to slow further in 2015, although it should remain strong nevertheless.

The fiscal deficit is narrowing and was well within IMF norms (3%) in 2014. The currency is forecast to depreciate further in 2015 and indeed has already depreciated in the first four months of the year, along with its neighbors’ currencies.

Bank earnings were given an uplift from a strong economy

Rapid growth strongly supported bank earnings, which rose 26.4% during the year, only trailing Rwanda. This means each 1% rise in GDP sees a 4.3% rise in net profits after tax, one of the highest multiples across the markets covered in this report. Of the 24 registered banks, 18 reported profits and 6 reported losses.

Asset growth was slower than profits growth, at 12%, despite stronger loans and advances growth of 16%. Profits were higher due to a substantial fall in bad-debt provisions and losses (down almost 70% from 2013’s levels). Deposits growth was in line with loans growth, resulting in a flat loan-to-deposit ratio of 47.8%, substantially below all other markets covered in this report and lower than neighboring Rwanda, which has a far less developed banking sector.

Uganda’s large banks dominate the market, as they do in neighboring Tanzania. The large banks earn substantially higher returns. ROAs averaged 2.9% for the sector overall, with large banks earning ROAs considerably ahead of any other banking market.

Similarly, Uganda’s large banks dominate the deposits market, accounting for more than 70% of industry deposits. This leaves the medium-sized banks with a 20% share of the deposit market and small banks less than 10%.

Banking growth continues unabated, again with the large banks benefiting most. While large banks similarly dominate in Tanzania and Kenya, they gained additional market share in Uganda in 2014, indicating that concentration levels are rising. Growth potential will likely be driven by higher loan-to-deposit ratios, as the ratio is currently substantially below the regional average.
Rwanda
Economic review

Rwanda's profits growth is driven by a strongly favorable macro environment

Rwanda's banks grew profits 146% during 2014, substantially outperforming its neighbors, albeit off a small base – the country's banking market is just 0.6% of South Africa's when measured in assets. Even by regional terms, Rwanda makes up only 4.2% of total banking assets. Profits account for an even smaller share of regional totals, amounting to 3.3% of the east region's earnings.

However, very few banking markets have the potential to grow as strongly as Rwanda's, with rapid economic growth supporting escalating profits. Economic growth in 2014 was 7.0% (according to World Bank data), up from 2013’s 4.6%. Agricultural productivity enhancements and sustained public investment initiatives are some of the drivers behind the higher growth. In addition, a recovery in foreign aid, after a shortfall in the previous two years, also drove the stronger growth.

Inflation remains modest, at 4.4%, and the expectation is that inflation will accelerate slightly but remain below the 5% mark. Higher food prices are the major cause of rising inflation. Rwanda's drive to build an industrial base continued to pressure the current account (and will continue to do so for a while yet, as the demand for capital purchases exceeds the country's exported products).

The strong banking sector profits growth does follow a somewhat weaker 2013 performance, when profits were nearly halved amid squeezed interest margins. To a large extent, the sharp profits growth follows significantly higher revenue streams (both interest and non-interest revenue). Even significantly higher bad-debt charges and provisions (which more than doubled from 2013 levels) did not hurt the bottom line.

Profits were driven by increasing banking penetration (supporting strong asset growth of 28% during the year) and the fact that Rwanda's banking sector is one of the smallest, even by African measures, allowing for more rapid growth than more established banking markets.

Deposits growth was in line with assets growth, with customer deposits up 27%.
In addition to the favorable economic circumstances, interest margins were also strongly up from 2013 levels, growing from 9.9% in 2013 to 13.2% last year. This margin grew as interest revenue rose more rapidly than interest expenses, even though the central bank reduced the bank rate from 7% to 6.5% in June 2014. The central bank has subsequently made public comments about the need for commercial banks to reduce their lending rates and for consumers to push for more favorable borrowing rates.

Profitability rose sharply, with ROAs doubling (to 2.4% from 1.2%) and banking ROEs nearly doubling (to 14.3% from 7.3%).

Rwanda is close to achieving its 2020 objectives to reduce poverty and increase employment levels, which will continue to support very strong banking fundamentals. Banking profits will be supported by a larger market, strong industrialization initiatives and a favorable regional economic bloc, which is facilitating stronger trade.
What this means

Banks are investing in distribution channels, focusing on customers and building their presence across Africa.

Banks are more focused than ever on building their capacity and reach, as they simultaneously ensure they have the best-in-class technology platforms that allow them to compete more effectively. Each region, and indeed each country, has different needs, and each bank needs to identify its unique mix of physical branches versus technology-enabled access.

In line with this, banks recognize that the fast-changing digital world requires a suitable range of distribution channels and methods of contact. The implications of these changes mean that customers demand seamless services, 24 hours a day, and technology needs to be suitable to meet this purpose.

In addition, more banks are speaking about being very selective in the business lines and products they choose to operate in, and they are purposely holding back from market segments that are less lucrative or considered more risky. One prominent example of this is the personal loans (unsecured lending) market, where most banks have slowed down the pace at which loans were granted. This was to some extent a reflection of concerns about the growing risks involved, but in addition, it reflects ambitions to manage lending portfolios prudently.

Banks that already have a strong African network plan to leverage these to the fullest and aim to build scale in those markets. This ambition will allow those banks to become critical pan-African banks, with sizable scale across their selected markets.

Lastly, and critically, banks are increasingly adding to their product ranges and are particularly active in promoting bancassurance and wealth management offerings. These have become a key driver of earnings over the last few years as the transactional banking market has become more saturated. These offerings will become even more critical going forward as competition in the banking market becomes more fierce and the growing middle class demands wealth offerings as their income levels and assets rise in value.

Banks will need to make a new set of choices

Africa’s major banking markets remain promising, with growth prospects among the highest globally.

Banks will therefore find the competitive space intensifying, mostly from regional players building scale or increasing their geographic footprints. (Global banks may or may not have the appetite for extending their reach, depending on their capital needs and their strategic intentions.)

The large banks in the three largest markets (South Africa, Nigeria and Kenya) will be most aggressive in expanding into neighboring markets, as they aim to establish their presence and obtain early-mover advantages. Regional economic groupings will also stimulate expansion, as closer ties between countries provide for operations to be rolled out more easily.
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