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NIGERIAN BANKING SECTOR REPORT

BANK RECAPITALISATION

CATALYST FOR A $1 TRILLION ECONOMY?

JULY 2024

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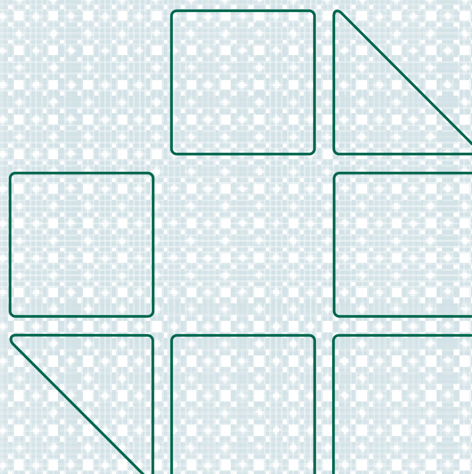
NIGERIAN BANKING SECTOR REPORT

RECAPITALISATION

CATALYST FOR A $1 TRILLION ECONOMY?



JULY 2024

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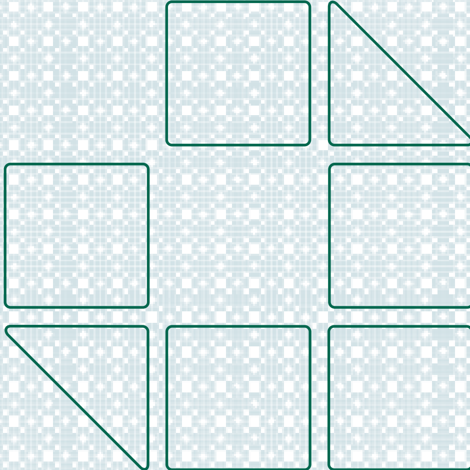
EXECUTIVE SUMMARY



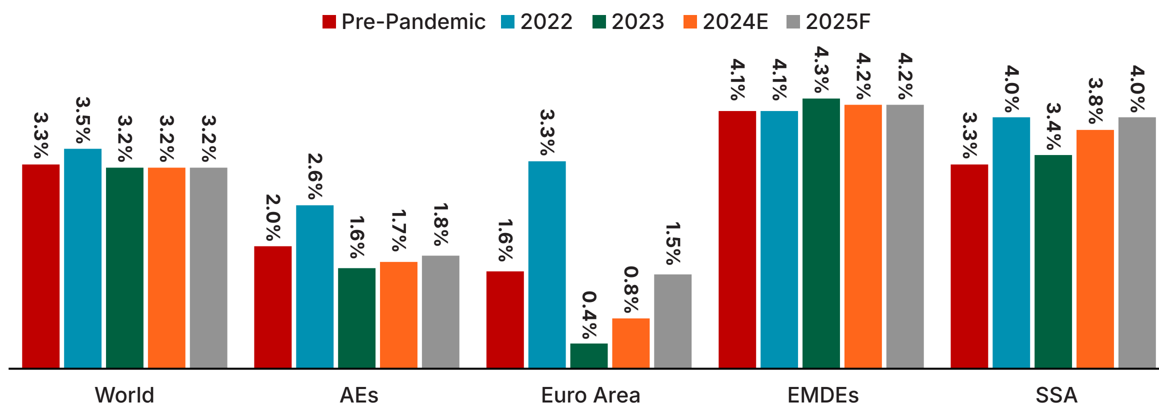
Executive Summary

Global Economic Review & Outlook

As outlined in our 2023 Nigerian Banking Sector report themed "Getting Nigeria to Work Again!", the prevailing macroeconomic headwinds of elevated prices, currency volatility, and escalating debt crisis posed major risks to the global economy and financial sector health. In response, global systemic central banks adopted a higher-for-longer interest rate policy to steer global inflation toward target levels. Against this backdrop, headline inflation eased to its pre-pandemic level in most economies towards the end of 2023. Despite the monetary tightening, global economic activity was resilient in the review period, coinciding with falling inflation – thanks to a post-pandemic expansion of the global supply chain. We posit that the greater-than-expected rise in the labour force amid robust employment growth supported productivity and, in turn, disinflation in Advanced Economies (AEs) and several leading emerging markets. As global inflation converges toward target levels and central banks pivot toward policy easing, we expect the tightening of fiscal policies (notably, upward review of tax regimes) aimed at boosting fiscal capacity to weigh on growth momentum given lingering geopolitical tensions.

On these backdrops, the IMF projects global growth at 3.2% in a blue-sky scenario for both FY:2024 and FY:2025 – a rate below the pre-pandemic average of 3.8% (2000 – 2019). The outlook reflects the divergent recovery across regions given limited success in curbing inflation in developing economies, contrasting effective monetary policy transmission in AEs. For the latter, IMF's growth outlook brightened slightly to 1.7% and 1.8% in 2024 and 2025 respectively (2023: 1.6%) due to the upward revision of growth expectations in the US and Euro area. In the US, growth is projected to increase to 2.7% in 2024, before decelerating to 1.9% in 2025, as gradual fiscal tightening and softening labour markets slow aggregate demand. For the Euro area, output recovery from c.0.4% in 2023 to 0.8% and 1.5% in 2024 and 2025, reflects the easing policy environment and dissipating effect of the Russia-Ukraine war on the region's productivity. Elsewhere, a steady growth rate of 4.2% in Emerging Markets and Developing Economies (EMDEs) in 2024 and 2025 is underpinned by impressive fortune across Middle East & Central Asia and Sub-Saharan Africa (SSA). However, emerging and developing Asia would experience a growth drag due to growing fiscal strains. Importantly, higher crude oil prices (Nigeria and Angola) and improved earnings on commodities (Ghana and Cote d'Ivoire) should lift SSA growth from an estimated 3.4% in 2023 to 3.8% and 4.0% in 2024 and 2025 respectively.

Chart 1: Global Economic Growth Review and Projection



Source: IMF, Afrinvest Research

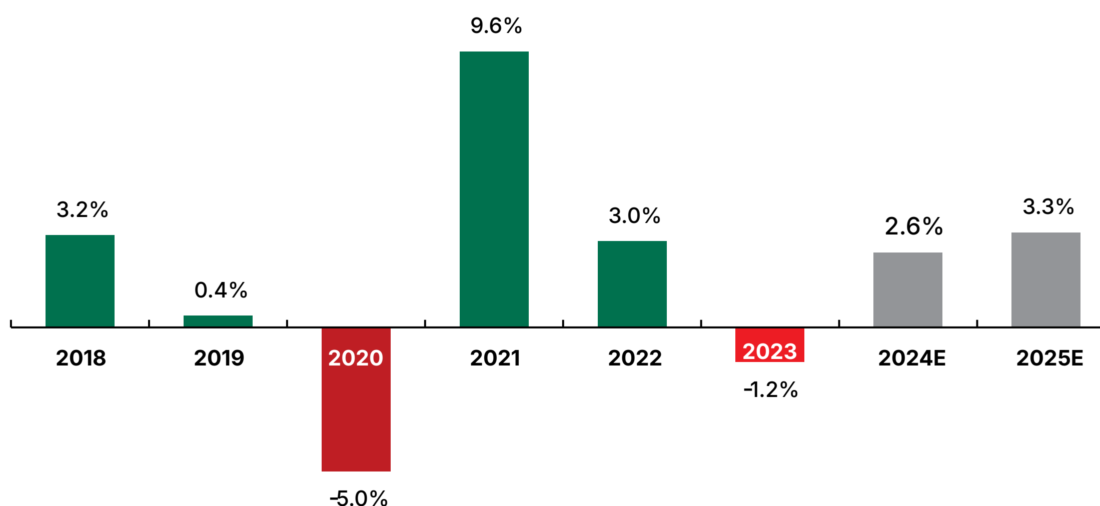
Meanwhile, since the Second World War, global merchandise trade has witnessed a contraction only twice: in 2009, at the height of the global financial crisis (GFC), and in 2020, during the COVID-19 pandemic. Charmingly, the global merchandise trade rebounded in 2021, surpassing the pre-pandemic peak, on the back of fiscal & monetary stimulus and supply-chain recovery. Barely two years later, global goods trade contracted 1.2% y/y relative to a 3.0% expansion in 2022. The downturn was instigated by higher shipping insurance premiums and energy costs owing to increased pirate attacks along major shipping routes (Strait of Hormuz) and geopolitical conflicts. Additionally, China's capacity underutilisation and worsening trade protectionism added to this scourge.

Looking forward, the World Trade Organisation (WTO) anticipates a rebound of 2.6% and 3.3% in global trade in 2024 and 2025, respectively. The prognosis hinges on expectations of de-escalating global tensions and continued disinflation, resulting in improvement in real income and aggregate demand. In terms of regional imports, Asia (+5.6%) and North America (+1.0%) should support global demand for goods trade, trailed by South America (+2.7%), Middle East (+1.2%), Africa (+4.4%) and Europe (+0.1%). However, the Commonwealth of Independent States (CIS) are expected to contract by 3.8% y/y. Meanwhile, Africa's exports (+5.3%) are anticipated to grow faster given the depressed level since the pandemic. Also, CIS (+5.3%), North America (+3.7%), Asia (+3.4%), South America (+2.6%) and Middle East (+2.2%) should post moderate export growth. Lagging, European export growth is expected at 1.7%. Overall, the outlook for global trade in 2024 is cautiously optimistic due to potential downside risks such as reinflation, escalation of geopolitical tensions, and global finance polarity.

Global Monetary Policy

Consequent to the high inflationary environment, global systemic central banks had to maintain their hawkish monetary policy stance at the cost of a potential economic downturn. However, the global economy remained resilient, posting a 3.2% y/y output growth in 2023, mainly supported by divergent monetary policy plays by central banks. In AEs, economic activities were supported by lower real interest rates as central banks either raised nominal interest rates (US Fed and ECB) against inflation expectations or kept the policy rate near zero (Bank of Japan). In contrast, central banks in EMDEs raised interest rates relatively fast, leading to earlier increases in real interest rates. Nonetheless, structural gaps and FX quagmire dampened potential economic growth. Meanwhile, inflation inched closer toward target levels in most AEs and a selected few EMDEs as real policy rates began to increase, with the expectation that policy rates will decline in the second half of the year.. These expectations have led to a decline in long-term borrowing rates, rising equity markets, and an easing in overall global financial conditions though, funding is still more expensive relative to pre-pandemic times.

Chart 2: Goods Volume Registers Third Contraction Since World War II



Source: WTO estimate, Afrinvest Research

In the US, the Federal Open Market Committee (FOMC) in its May 2024 meeting held the overnight federal funds rate for the sixth consecutive time at the range of 5.25% – 5.50% to drive the attainment of its 2.0% inflation and full employment targets. Thus far, consumer price inflation (CPI) has slowed to 3.3% y/y in May. Nonetheless, CPI initially moderated to 3.1% y/y in November 2023 and January 2024 before surging to 3.5% y/y in March 2024 due to increases in shelter and energy costs. The unsteady recovery underscores the uncertainty around inflation, given the strong labour market (relatively, stable unemployment rate range between 3.7% – 3.9%) and exogeneity of energy pricing. In the second half of the year, we expect the US Feds to cut the funds rate with the upper bound at 4.4%.

In SSA, the Central Bank of Nigeria (CBN) raised the policy rate by 150bps to a record high of 26.25% in May 2024, following a cumulative increase of 600bps in February and March, to curb spiraling inflation. Despite these efforts, inflation maintained an uptrend, reaching 33.95% in May, due to structural challenges, FX pressures, supply constraints, liquidity trap, and lack of synergy between monetary and fiscal policies. Elsewhere, Ghana's inflation eased to 23.1% y/y in May 2024 from 38.1% y/y in September 2023, following the Bank of Ghana's decision to hold the interest rate at 29.0% in January 2024. Looking ahead, as the AEs anticipate lower interest rates, EMDEs assets should witness increased appetite, barring countries with heightened currency volatility.

Global Banking Sector Performance

After teetering from the effect of global contagion (following accelerated monetary policy normalisation), the global banking sector appears to have turned problems into opportunities. In our previous BSR edition, we highlighted that growing and sizable unrealised investment losses from deflating bond valuations (IMF estimates around 13.0% of total banks assets in held-to-maturity securities), combined with liquidity concerns and negative real estate spillovers from China remained potent threats, even after regulators helped placate depositors' fear in the wake of the failures of Silicon Valley Bank (SVB), Signature Bank and Credit Suisse Bank. Defiantly, banks have leveraged the high-interest and yield environment, strong capital and liquidity buffers accumulated over the years, and robust implementation of effective regulatory frameworks, such as Basel III, to sustain profitable banking. This bounce-back was also supported by the resurgence in consumer spending, investment, and trade which lifted the broad economic outlook.

In 2024, the possibility of an end to the current tight interest rate cycle could consolidate the banking sector's emergence from its worst scare since the GFC, while a lower inflation rate would reduce the risk of loan defaults. In addition, recovery in bond assets valuation, net margin preservation from cheaper deposits and technology-facilitated cost efficiency could provide support for lenders. The optimism, notwithstanding, re-inflation risks, widening economic & political polarities globally, and negative effects of climate change could be key risks to the financial sector, compounding challenges of global debt overhang.

Domestic Macroeconomy

Our 2023 BSR "Getting Nigeria to Work Again!" marked our final assessment of the domestic macroeconomy and the banking industry landscape under the leadership of former President Muhammadu Buhari (May 29, 2015, to May 29, 2023) and Mr. Godwin Emefiele (Governor of the CBN from June 2, 2014, to June 9, 2023). In the same vein, the report presented our maiden pragmatic recommendations for the then newly emerged leadership of President Bola Ahmed Tinubu (PBAT) and Dr. Olayemi Cardoso (Governor of the CBN) in their quest to give Nigeria a refreshing start. In our recommendation to the fiscal authority, we argued that reform initiatives rolled out or proposed in policy blueprints such as the Policy Advisory Council Report (PACR) of PBAT, would fail to achieve high impacts without institutional reforms. Our prognosis was informed by the root cause analysis of prior reform programmes' failure. For the monetary authority, our recommendations were mainly to revert to orthodoxy, supported by firmer fiscal and monetary policy coordination.

Barely a year into the tenure of the new administrations, preliminary outcomes of reforms undertaken have produced a cocktail of experiences for the Nigerian populace. For context, upon assumption of office on May 29, 2023, President Bola Ahmed Tinubu announced a self-imposed mandate of growing the economy to $1.0tn in the next eight years (2022-year end: $472.6bn, World Bank). The ambitious target was anchored on broad-based reforms and an all-inclusive

transformation initiative. Top on the administration's reform agenda was the elimination of the multiple subsidies regime, the securing of oil installations, the de-escalation of the tense business environment, and the resetting of the monetary policy sector to inspire local and foreign investors' confidence as well as the restoration of price and exchange stability. Based on current realities, the economy is yet to find a clear path to turning the corner.

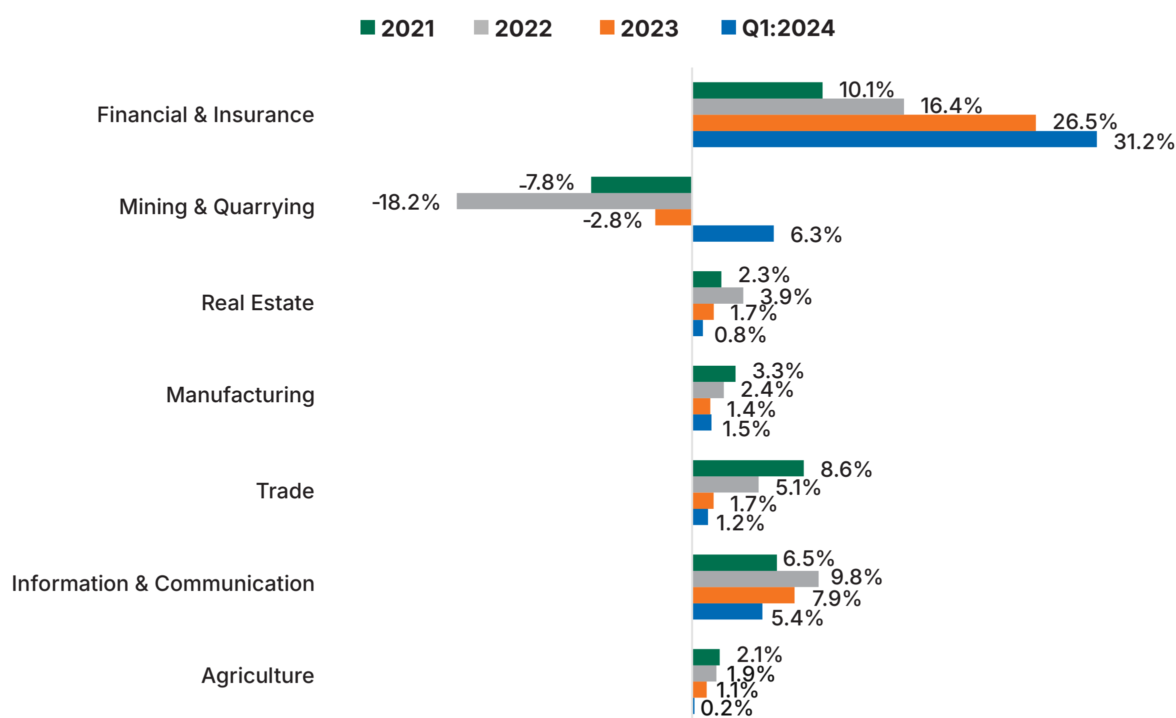
On one hand, the slack in the progress level can be linked to the natural time lag required for policy reforms to manifest gains, and negative pass-through from the tough external environment. On the other hand, weak institutional capacity to drive reform goals (as emphasized in our 2023 BSR) also dealt a major blow. For instance, while the pains from the PMS and exchange rate subsidies removal quickly permeated the economy, fiscal capacity to substantially cushion the pains from the reforms have been largely under-mined by the weak institutional capacity to secure economic assets and businesses (to achieve higher outputs and earnings), uphold the rule of law, and block public sector leakages.

Away from the broader macroeconomic matters, the financial institutions' activity – a sub-sector under the services economy and the proxy for the banking sector GDP – has remained resilient, expanding by 18.4% in real terms between Q3:2023 and Q1:2024, to emerge as the fastest growing sector among Nigeria's seven largest GDP sub-components.

We attribute this performance to increased investment in vertical and horizontal business expansions, rapid growth in earnings from digital channels (aided by a reduction in physical cash in circulation), favourable interest rate environment, and positive spillover effect from Naira devaluation (owing to net FCY asset holdings).

Looking ahead, we expect growth in the broader economy to range between 3.0% and 4.0% in the near term (in a base case scenario), owing largely to weak institutional capacity to translate reform goals into visible gains. Meanwhile, we expect the banking sector growth to remain firm over the near term, even as industry players commence capital-raising activities to meet up with the new recapitalisation directives.

Chart 3: Three Years Growth Trajectory of Nigeria's Seven Largest Sector GDP



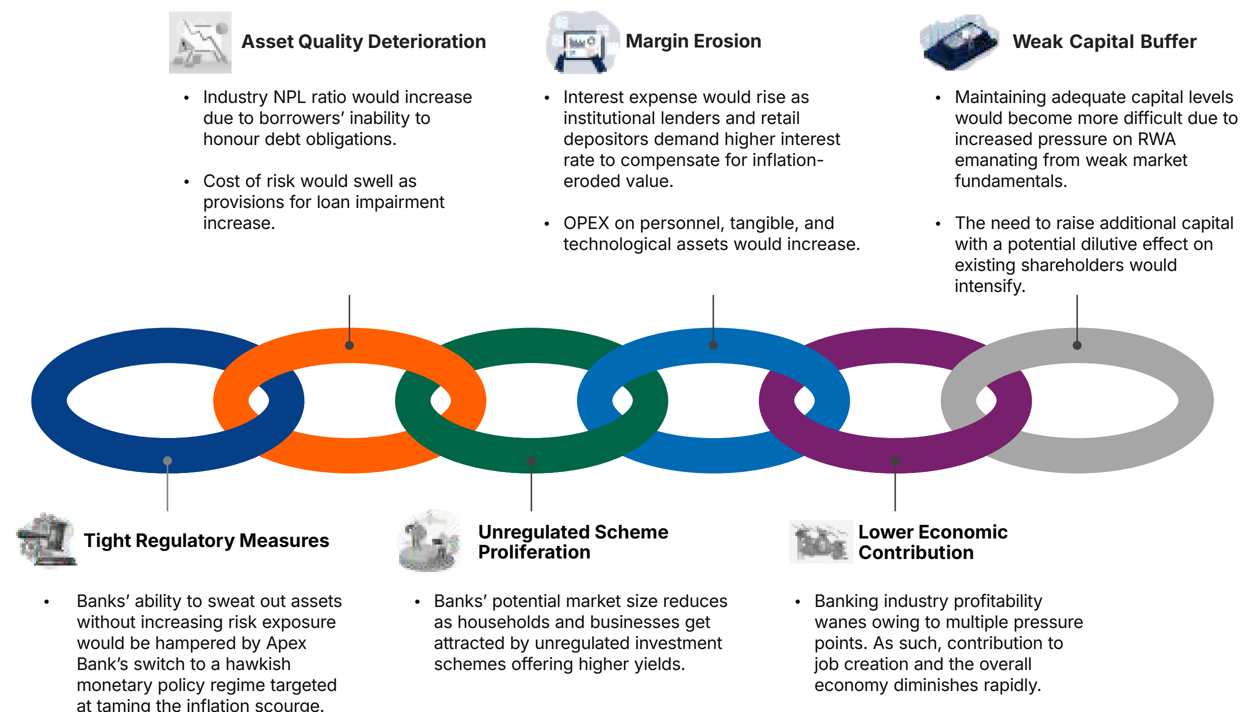
Source: Afrinvest Research

Price Levels Trajectory: Can Banks Continue to Outperform the "Value Thief"?

There is no gainsaying the fact that the domestic economy is facing its worst inflation predicament in more than three decades. In the twelve months to May 2024, inflation surged from 22.8% to 34.0% (averaging 2.4% m/m from 1.7% previously), driven by the negative knock-on effects of multiple reforms (amidst weak fiscal buffer to ease the burden), legacy structural challenges, and spillovers from the pressured external environment. According to the World Bank estimate, over 4.0m more Nigerians have fallen below the poverty line to reach 104.0m people (i.e. about 46.0% of the population now lives below $1.90 per day) due to erosion of purchasing power in the last twelve months. However, the finance and insurance sector's performance (the proxy for the banking sector) has largely defied this trend. For instance, the sector's growth which printed at 10.0% and 16.4% in 2021 and 2022 firmed up to 26.5% in 2023. This was aided by sustained growth in digital channels usage (up 55.0% y/y to ₦600.0tn, NIBBS), optimisation of the tight interest rate environment for trading & loans pricing (ex. UBN and UNITY, industry interest & trading income rose 84.2% and 307.0% y/y), and favourable Net Open Position (this crystalised into significant revaluation gains estimated at about $1.7bn in 2023). Nevertheless, the future looks bleak for the banking sector if the high inflation scourge is not demystified in the near term due to its interconnectedness to other segments of the economy.

Given the highlighted risks that could ensue from a prolonged high inflation episode, we recommend that banks should strive to enhance their risk management framework, scale-up investment in cost-effective digital channels, and explore new business opportunities in both lateral and vertical segments to enhance resilience against systemic risks. Overall, we maintain that concerted fiscal and monetary policy efforts that would holistically address structural bottlenecks (notably, insecurity and infrastructural gaps), optimise FX inflow channels, block leakages, and strengthen liquidity management remain the lasting solution to Nigeria's high inflation predicament.

Chart 4: Why Prolonged High Inflation Rate is Bad for the Banking Industry



Source: Afrinvest Research

Fiscal Policy Review & Outlook: Overly Optimistic 2024 Budget Targets Dim Performance Expectations... Negative Ripples Loom for Banking Business

Our assessment of the 2023 actual budget (including supplementary provisions) points to sustained underperformance quoted in ambitious projections. Data from the budget office revealed that the burgeoning cost of governance vis-à-vis the snail-paced growth in revenue accretion has further put Nigeria on the cusp of fiscal crisis. For context, although actual revenue outpaced the budgeted by 7.6% to ₦11.9tn on the support of firmer oil & other minerals and non-oil tax revenue, aggregate expenditure accentuated to ₦18.8tn (up, 31.8% y/y) due to increase across all cost elements. On the back of the heightened cost levels, the actual deficit tracked higher by 26.6% y/y to ₦6.9tn, plugged by domestic (including Ways & Means) and external borrowing. Resultantly, the share of FG's debt in total public debt stock rose 44.6% y/y to ₦87.3tn (89.7% share of total public debt stock) by year-end.

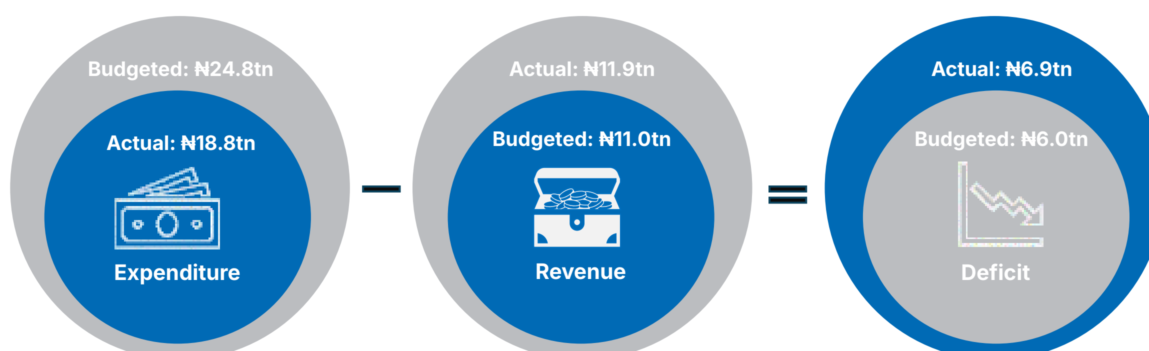
Sadly, the 2024 budget of "Renewed Hope" was also premised on overly optimistic revenue assumptions. This reality has increased the probability that actual budget performance could mirror the historically disappointing pattern, especially on CAPEX spending. For instance, the expectation of a 43.9% (that is, ₦8.0tn) share of the projected revenue from oil & other minerals is unrealistic. Our submission is based on the incessant sabotage in the oil-rich Niger-Delta region, output drawdown for the recent crude-tied loan facility (the $3.3bn Afrexim Bank loan is collateralised with 90,000bpd crude oil for 5 years), and OPEC+ imposed output ceiling of 1.5mbpd beginning from May through year-end.

Hence, budget shortfalls are expected to be financed by domestic and external borrowings, with the former estimated to account for up to 66.8% (₦6.0tn) share. We estimate fiscal deficit, total public debt stock, debt-to-GDP, and debt-servicing-to-revenue rate to exceed ₦13.0tn (budgeted: ₦9.2tn), ₦130.0tn (Q1'2024: ₦121.7tn), 55.0% (2023: 42.3%) and 60.0% by 2024 year-end. Furthermore, we estimate that the FG's expansive borrowing plan could rub-off negatively on banks' deposits (big tickets) given the attractive yields on risk-free papers as compared to interest on banks' deposit that are usually pegged between 10.0% and 30.0% of the MPR. Overall, we believe banks would continue to battle heightened risks of asset deterioration, partly induced by the consumption-tilted budgetary patterns.

Monetary Policy

After a three-month vacuum of substantive leadership at the apex bank, President Tinubu's choice candidate, Dr. Olayemi Cardoso, formally assumed office on September 22, 2023. His appointment followed the unceremonious removal of Mr. Godwin Emefiele as the governor of the CBN. While Nigerians and other stakeholders expected the new Cardoso-led CBN to be swift with reform rollout, the apex bank management opted for a calculated approach to unveiling its game plan. Unsurprisingly, the priority focus areas of the new CBN leadership perfectly mirrored the President's reform blueprint which centered on three

Chart 5: 2023 Budget Scorecard



Source: FMFBNP, Afrinvest Research

core ideologies – pro-market reforms, institutional realignment, and sectoral capacity optimisation for accelerated growth. On the back of this, Mr. Cardoso designed key priority areas around; (i) sanitising the FX market, (ii) pursuing price stability, (iii) ending quasi-fiscal interventions, (iv) reversing capital controls, (v) effectively managing system liquidity and enhance financial sector soundness, (vi) preserving and growing the external reserves, and (vii) recapitalising the banking sector to drive the attainment of a $1.0tn GDP size by 2032. Major policy actions taken so far by the Cardoso-led CBN, preliminary impacts, and our recommendations to optimise future outcomes are captured below.

Chart 6: Cardoso's Policy Blueprint

S/N	Key Priority Area	Major Policy Action Since Assuming Office	Impact on the Economy	Missing Piece and Recommendation
1	Sanitise the FX market	I. Sustained the policy on the collapse of the previous multiple FX segments into the Investors & Exporters (I&E) window implemented by the Shonubi-led interim CBN management. II. Streamlined the number of BDC operators to 1,583 from over 5,000, using regulatory tightening measures. III. Resumed the periodic sales of FX to approved BDCs at a discounted rate, while pegging mark-up margin to 1.5%. IV. Set Net Open Position (NOP) ceiling of 25.0% short (FCY assets to liabilities) and 0.0% long (FCY assets to equities) for banks. V. Suspended the use of FCY as collateral for Naira loans.	I. What should have been a short-term pain from this policy action has become endemic, due to the weak FX reserve war chest to adequately meet up with market demand. II. CBN supervision of BDC operations has been enhanced, and compliance has improved due to higher stakes of the operators (the minimum capital requirement for a tier-1 and tier-2 BDC have been raised to ₦2.0bn and ₦500.0m, respectively from a previous uniform baseline of ₦35.0m). III. This (iv) supported a sizeable FX liquidity boost in February 2024 (unlocked about $2.5bn to $4.0bn immediately, given the 24-hour compliance deadline set on January 31), as banks move to realign their positions. IV. This policy (v) should result in a modest FX liquidity boost by the end of the 90-day deadline set for realignment by all affected parties beginning from July 10, 2024.	I. Standalone, these policies (i-v) will only deliver short-term relief on the FX debacle. II. For the FX market to experience sustainable tranquillity, traditional FX inflow sources - oil production, remittances, and foreign portfolio investment - must be revitalised by supportive fiscal policies such as improved security of oil assets, elimination of multiple taxation for oil & gas players, incentivising diaspora to remit through official channels, introduction of a project-tied diaspora bond, elimination of policy impediments in the business environment, as well as improvement on global anti-corruption perception. III. Additionally, potential alternate sources of FX such as expanded non-oil output and talent asset exports should be given the appropriate fiscal, monetary, and trade policy supports to deliver long-term gains. IV. For extended short term reliefs, we advise exploring the options of bilateral loans, natural resource-tied loans, debt-for-nature swaps, and asset concessions.

S/N	Key Priority Area	Major Policy Action Since Assuming Office	Impact on the Economy	Missing Piece and Recommendation
2	Pursue price stability	I. Tightened MPR by a cumulative 725bps to 26.25% in the four months to May 2024. II. Announced the stoppage of excessive deficit financing (through Ways & Means) above constitutionally allowed limit of 15.0% (formerly 5.0%) of previous year revenue. III. Handed 1.2m bags of fertilizers (remnants from the disbanded Anchor Borrowers Programme - ABP) worth ₦100.0bn to the Ministry of Agriculture to boost productivity.	I. Inflation rate has remained stickily high due in part to fiscal frugality and demand-supply imbalance. II. Also, the anticipated cooling-off impact of the policy tightening (in the short-midterm) have been impaired by the negative pass-through effect from energy goods price volatility, structural bottlenecks on productivity, and FX quagmire. III. The potential gains from the disbursed fertilizers are likely to manifest in the medium to long term, barring any act of sabotage.	I. For the MPR tightening to be fully impactful, the fiscal side (in addition to fixing legacy structural challenges) would need to cut down on consumption spending which has earned Nigeria the titles of “a consuming nation” and “the most expensive democracy in the world”. II. Deliberate effort should be channelled into improving critical infrastructure such as power, roads, storage facilities, and cargo clearance systems to boost local productivity and promote healthy competition. III. We advise against a tighter-for-longer policy stance, as this would lead to economic stagnation in no distant time.
3	Stop quasi-fiscal interventions	I. Suspended the APB, the RT-200-FX, and the Naira-4-Dollar programme.	I. This action has eradicated the conflict of policy goals that was prevalent during the last CBN administration.	I. There has been no clear-cut initiative on how to make available affordable capital to players in critical sectors such as Agriculture and Manufacturing affected by these actions. II. Futuristically, the recent move by the National Assembly (NASS) to tinker with the CBN's independence by making it answerable to the Minister of Finance could bring back the dark days of large-scale deficit financing and quasi-fiscal interventions by the CBN thereby tarnishing the ongoing efforts targeted at restoring CBN's credibility.
4	Reverse capital controls	I. Cleared valid FX backlogs worth about $4.8bn. II. Lifted FX restriction on the 43 items barred from the official window since 2016	I. This action (i) has restored some confidence in the credibility of the CBN in the sight of local and foreign investors and fostered improved liquidity in the FX market. II. This action (ii) has aided the narrowing of the differential between the official and parallel market rates. However, exchange rates remain generally pressured due to constrained supply from the CBN.	I. Coordinated monetary and fiscal actions that would boost inflows of FX from cheap and sustainable sources such as exports, FDIs, and remittances should be urgently pursued for the CBN to sustain this market-oriented stance.

S/N	Key Priority Area	Major Policy Action Since Assuming Office	Impact on the Economy	Missing Piece and Recommendation
5	Effectively manage system liquidity and enhance financial sector soundness	I. Increased CRR to 45.0% from 32.5% previously. II. Resumed OMO bills auction after an 8-month break (Jan:23 – Sept:23) at more market reflective rates. III. Improved the rates offered on T-bills and bonds to better reflect inflation dynamics. IV. Affirmed prolonged usage of excess CRR debit punitive measures. V. Lowered the LDR to 50.0% from 65.0% previously. VI. Removed the ₦2.0bn ceiling in the SDF window. VII. Released guidelines on the operations of bank accounts for virtual assets service providers (VASPs).	I. Liquidity in the banking sector has been closely managed since Cardoso assumed office, leading to the OPR and OVN rates averaging 18.8% and 19.67% respectively in the 9 months to June 2024 as against single digits in the preceding 12 months. II. Succeeded in luring some high-yield-seeking foreign portfolio investors in Q1:2024 (over $1.0bn inflows recorded according to CBN) thereby supporting short-term FX liquidity respite. III. Also, actions ii and iii have raised the borrowing cost of the government and increased the potential cost of financial recklessness to the fiscal authority. IV. Actions iv, v, and vi have lowered both the risk of liquidity build-up and rising NPL in the banking sector. V. Action vii should help improve the ease of monitoring and coordination of the operations of VASPs by CBN and SEC for the overall interest of the country.	I. While these strategies (i-vi) are potent to deliver near-term anchoring of inflation rate and financial system stability, we posit that prolonged deployments would snowball into economic stagflation with a negative knock-on effect on the financial sector. II. As per action vii, we believe there is room for the CBN and SEC to harmonise and upscale their management strategy for the digital assets industry as Nigeria cannot afford to play catch-up in this fast-growing segment of the global financial industry with its numerous nuances.
6	Recapitalise the banking sector	I. Redefined and raised the minimum qualifying capital for commercial, merchant, and non-interest banks based on license authorisation (see the thematic section for a detailed breakdown).	I. The banking and other financial services businesses have been set on capital raising mode over the coming 2 years. II. This development should help spark positive momentum on the domestic bourse beginning from H2:2024 and enhance cross-border capital flows into Nigeria equity assets.	I. We expect to see pockets of M&A activities and license downgrades by crowd-out players. II. Even in the post-recapitalisation period, the ability of the banking sector to positively support the attainment of the $1.0tn GDP would be contingent on the successes recorded on fiscal reforms, price stability, and business-friendly policies.

S/N	Key Priority Area	Major Policy Action Since Assuming Office	Impact on the Economy	Missing Piece and Recommendation
7	Preserve and grow the FX reserves	I. Introduced an initial 50.0% ceiling on FX cash pooling for IOCs, while the cash balance would only be accessible after 90-days. II. Suspended FCY cash payment for PTA and BTA applicants. III. Removed allowable limit on rates quoted by IMTOs. IV. Agreed with NNPC to domicile a significant proportion of its revenue and other banking services with the CBN	I. This should help reduce capital repatriation pressure on the CBN reserves. II. This has helped to reduce the prospect of FX round-tripping. III. This should help incentivise the willingness to remit inbound FX flow through the official channels. IV. This should reduce leakage channels and support accretion rate of the reserves.	I. We hold that enhancing crude oil production and boosting non-oil export earnings through supportive fiscal and monetary policies are key to attaining and sustaining this goal.

Source: CBN, Afrinvest Research

While our assessment highlights some of the missing pieces in the strategy of the Cardoso-led CBN to reform the monetary sector, there is no denying the fact that the new CBN administration's priorities and policy framework are a complete departure from the unorthodox strategy deployed during Emefiele's regime.

Battle for the Soul of the Naira… Near Victory or Failed Quest?

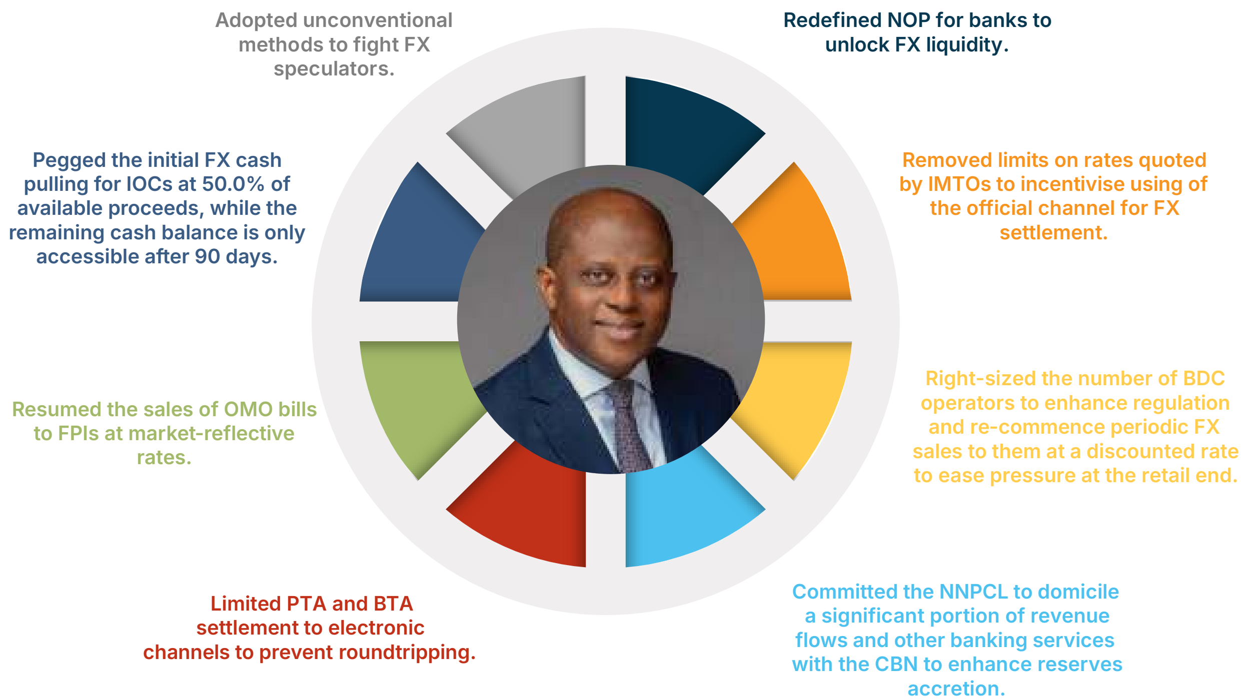
No doubt, 2023 would go down in history as one of Nigeria's most turbulent years on the exchange rate front. On June 14, the interim CBN leadership announced the collapse of all FX segments into the I&E window and re-introduced the “willing buyer, willing seller” model amongst others. This announcement in its basic terms implies the change in the FX management system to a “crawling peg” from “managed float”. On the back of this development, the CBN official FX rate fell 29.0% on June 14 to ₦660.04/$, thereby narrowing the differential between the parallel market and the official rate to ₦92.96 from ₦283.33 the prior day. By the end of June 2023, the differential between the official and parallel market rate had diminished to ₦2.75 – a level last seen in the pre-COVID period.

However, following the delay in market direction guidance (Dr. Cardoso did not provide clear communication to the market in his first 60 days in office), the FX market capitulated to speculative activities.

Precisely, the official and parallel market rates which closed the month of June at ₦769.25/$ and ₦772.00/$ respectively weakened to ₦813.67/$ and ₦1,150.00/$ (differential: ₦336.33) on November 23. By the time the Cardoso-led CBN administration would convene for its first Monetary Policy Committee (MPC) meeting on February 25 and 26 2024, the official and parallel market rates had weakened to record levels of ₦1,665.50/$ and ₦1,830.00/$ respectively. Additional pressure points on the FX reserves owing to the decline in total direct remittances, stagnated crude oil production and settlement of FX backlogs fuelled the escalation. To salvage the situation, we have seen the CBN deploy numerous but well-coordinated supply and demand side management policies since the turn of 2024.

While we commend the efforts of the CBN at addressing the FX challenges, its limited capacity to influence the supply-side factors remains the missing piece in Nigeria's FX solution puzzle. Historically, net inflows from crude oil & gas exports and remittances were Nigeria's FX reserves' largest non-debt accretion sources. Since inflows from the crude oil & gas segment capitulated in 2015, the ability of the CBN to supply the market adequately has weakened. Worse still, policies (majorly fiscal) aimed at optimising local production capacity (especially, non-oil exports) over the last decade have largely been poorly implemented, thereby stoking a continued increase in the demand for imported goods and services.

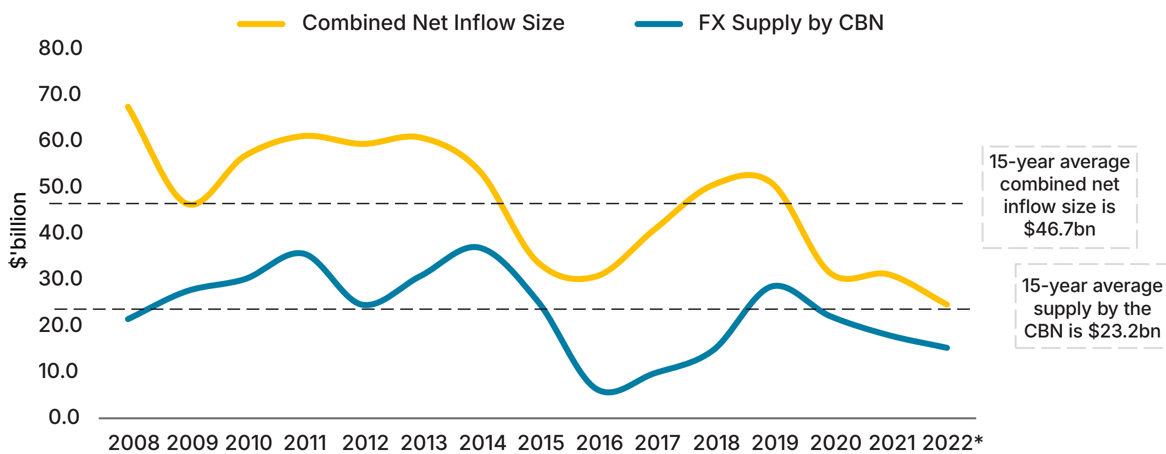
Chart 7: Cardoso's FX Market Rescue Policies



Source: CBN, Afrinvest Research

Based on the foregoing, we hold that effective execution of fiscal reforms that include solving the problems of insecurity, poor infrastructure, unfriendly business environment, and weak legal system remains the only foundation upon which the CBN can achieve a lasting solution to the recurring FX crises.

Chart 8: CBN's Capacity to Supply FX Remains Constrained



NB: 2022 Numbers were 9M annualised

Source: CBN, Afrinvest Research

Banking Sector Review & Outlook

The reforms initiated in 2023, following the commencement of a new political cycle and key changes to core economic management teams, promised to steer the economy back on track – but not without significant pains. As earlier captured, overdue-but-poorly-implemented policy decisions to remove energy subsidies and overhaul the exchange rate management system, among others, resulted in immediate price and currency volatilities. These, along with sharp interest rate hikes in H2, toughed headwinds for businesses operating in an economy without adequate infrastructure support, rife with insecurity, and in dire need of sector-specific policy rework. Expectedly, real sector players suffered historic underperformance as firms booked significant losses owing to FX and interest rate pressure, as well as pressure on sales.

In contrast, banks gained ₦2.6tn from FX trading and revaluation owing to favourable net FX positions. Also, "reforms" targeted at accelerating the cashless economy drove a sharp upturn in deposits, up 71.7% to the highest levels in well over a decade and positioned banks to rake significant gains from MPR hikes earlier in the year. As such, listed banks under our coverage (ex-Unity and delisted UBN: UBN was delisted in 2023 and Unity's FY:2023 earnings were not released as at the time of writing this report) recorded a combined 3.0x surge in EPS to ₦11.5 from ₦3.7 in 2022. Likewise, the financial institutions sector emerged as the second-fastest growing sector in 2023 (28.9% vs 17.2%), with a GDP acceleration, unlike many other sectors that faced either growth slowdowns or declines.

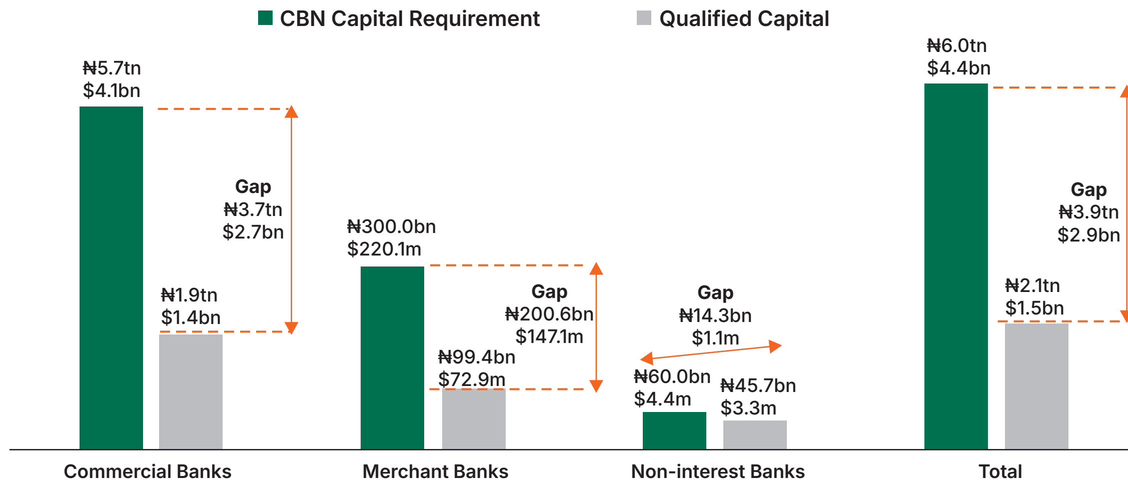
Akin to the contrast between banks and real sector players, we identified significant disparities in outcomes within the banking sector – with critical implications for competitiveness as banks begin recapitalisation. This disparity is reflected in the uneven distribution of profits, with major banks (FUGAZ) accounting for 79.3% of industry PBT and 80.8% of industry PAT, up from 69.0% and 71.1% respectively in 2022. While differences in scale economies and brand strength partially explain these outcomes, declining competitiveness could upend credit drive toward a trillion-dollar economy. Notably, Tier-2 banks tend to focus more on credit creation than Tier-1 banks. For example, the Loan-to-Deposit Ratio (LDR) for Tier-1 banks was 47.2% while Tier-2 banks allocated 61.3% of deposits to loans. Understandably, riskiness in the domestic economy has intensified over the past year, leading Tier-1 banks with substantial loan portfolios and a high NPL ratio (4.4%) to adopt a more conservative stance. This emphasizes the need for policymakers, both in the financial and the public sectors to synchronize efforts towards derisking the real sector so banks can adequately fund the trillion-dollar economy ambition, having adequately recapitalised. That said, the banking industry outlook remains broadly positive albeit as we anticipate continued EPS expansion buoyed by cost efficiency of industry players, attractive yield environment, and optimisation of the industry's robust balance sheet.

Banking Thematic Section

Recapitalisation... Catalyst for a One-trillion Dollar Economy?

The Nigerian banking sector has witnessed several recapitalisation episodes in a bid to shore up minimum capital required to compete locally and globally. The most recent round of recapitalisation was targeted at strengthening the financial system and aiding the government's $1.0tn economy by 2030. Away from the agenda, this became pertinent following the clear erosion of banks' capital buffer post- 2010 from a real and FX perspective compared to 2010 levels. Using 2023 average, the existing minimum capital size has lost 77.1% and 76.5% in FX and real terms, respectively. To shore up the capital gap, the CBN considered the impact of macroeconomic headwinds on banks' risk profiles and financial positions in defining the new threshold. Regarding the practicality of fulfilling the new capital threshold, the CBN deviated from prior recapitalisation practice, having defined eligible capital as solely paid-up share capital and share premium while excluding other capital components (retained earnings, other reserves, and Tier-1 capital). Juxtaposing the eligible capital with listed banks' FY:2023 data (ex. ETI Nigeria and Unity), ₦2.8tn needs to be raised to meet up with the required level. With a 24-month deadline to March 2026, banks are left to either inject the deficit capital through new issuance (public offer, right issues, and private placements) or structured capital injection from Holdco through debt or opt for M&A deals or upgrade/downgrade license category.

Chart 9: Summary of Capitalisation Gap for the Banking Industry



Source: Company Fillings, Afrinvest Research Estimation

The idea that reforming a banking system can propel economic growth has been a key area of discussion for decades (McKinnon, 1979; King & Levine, 1993). Proponents argue that a healthy financial system is the top ingredient for economic progress (Levine, 2001; Beck & Levine, 1999), while the other side of the debate is the idea that entrepreneurship or technological innovation takes precedence in the discussion of production and productivity (Schumpeter, 1934). In general, banks are accepted as playing vital roles in addressing information asymmetry, providing support to derisk sectors & economies, incentivising entrepreneurship & innovating to democratize access to financial products & services, and contributing to wealth creation. Against this backdrop, efforts to reform a banking system whether through financial liberalisation, recapitalisation, restructuring, enhanced regulation or technological innovations are understood to have some positive bearing on broad economic progress. Assuming that reforms such as recapitalisation, alongside sustained growth in the banking sector underpinned by robust regulation, enhance the sector's significance within an economy, what insights can Nigeria glean from the experiences of MINT countries, particularly Indonesia?

With comparable starting points, Indonesia's economic growth surged ahead of Nigeria's thanks to strategic reforms. In the 1980s, Indonesia liberalised its economy to fuel growth. However, loose regulations and rampant corruption triggered a financial crisis in the late 1990s. In response, Indonesia enacted a bank recapitalisation program that sanitised the banking system, laying the groundwork for strong economic expansion in the subsequent years. This case study highlights the essential role of a sound financial sector in promoting sustainable economic progress. While banking recapitalisation is instrumental to economic growth and development, it is necessary to prioritise robust yet market-supportive regulations. This ensures that as banks increase their capital and expand their assets, these resources are deployed responsibly. Furthermore, the banking industry must uphold its independence while aligning with fiscal objectives such as the trillion-dollar ambition. The misstep of the Indonesian banking regulator involved loosening rules to facilitate growth-oriented fiscal agenda. Away from these, the Nigerian banking environment appears to be conservative towards credit creation because of potent economic and credit risks stemming from price & currency instability, tough business operating environment, weak infrastructure base, and insecurity. It is therefore important for the government and CBN to work together to reduce these risks to encourage lending to aid the timely attainment of the $1.0 trillion economy target.

Shifting gears to how banking recapitalisation can support infrastructure expansion, being the bedrock of nation-building and economic development. According to the National Integrated Infrastructure Master Plan (NIIMP), a total infrastructure investment of $2.3tn is required over the period of 23 years to

bridge the infrastructure gap. We expect bank recapitalisation to be instrumental to boosting infrastructure development in Nigeria. By increasing banks' lending capacity, recapitalisation should mirror the positive effects seen in South Korea after its financial crisis. This, along with a more stable financial system, would attract investment in infrastructure projects. Equally important, we emphasize the need for additional government reforms to strengthen regulations and mitigate economic risks, creating a more attractive environment for infrastructure investment.

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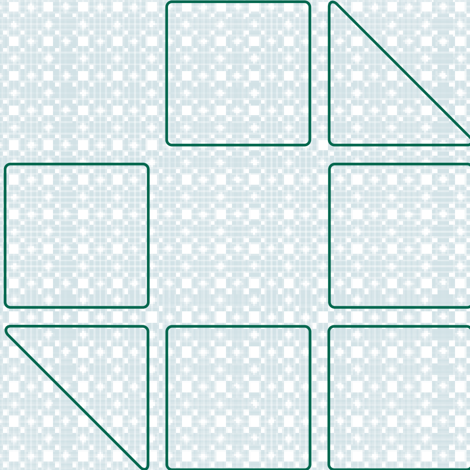

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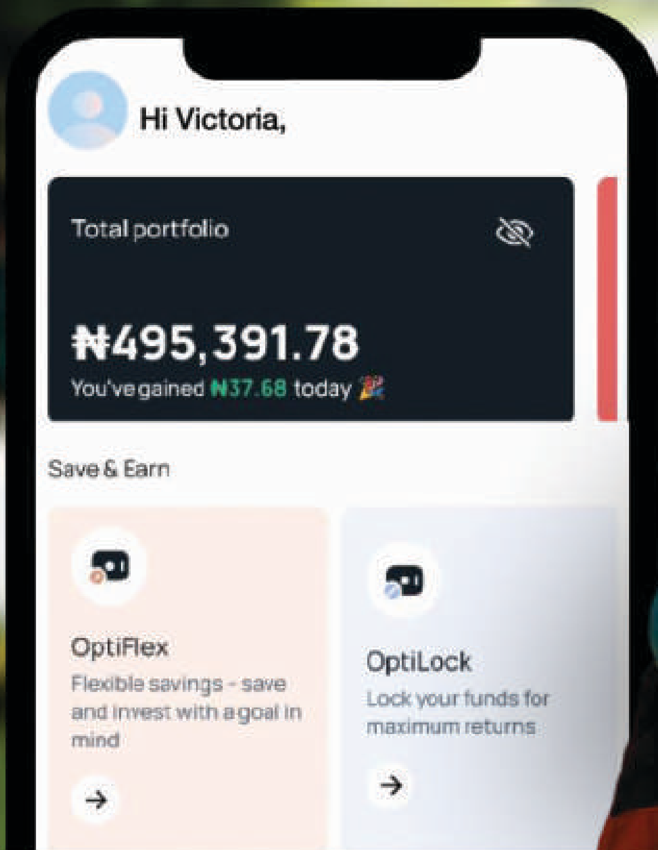

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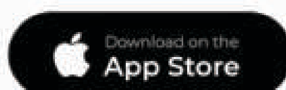

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