Moody's Investors Service

Rating Action: Moody's assigns first-time ratings to Kenya's Equity Bank and Co-op Bank

Global Credit Research - 30 Jun 2017

Limassol, June 30, 2017 -- Moody's Investors Service (Moody's) has today assigned first-time B1/Not Prime global local-currency deposit ratings to Equity Bank Kenya Limited (Equity Bank) and the Co-operative Bank of Kenya Limited (Co-op Bank). Moody's has also assigned both banks Counterparty Risk (CR) Assessments of Ba3(cr)/Not Prime(cr), global foreign-currency deposit ratings of B2/Not Prime and b1 baseline credit assessments (BCAs) and Adjusted BCAs. On the Kenyan national scale, Moody's has assigned deposit ratings of Aa1.ke/KE-1 to Equity Bank and Aa2.ke/KE-1 to Co-op Bank. All long-term global scale deposit ratings carry a stable outlook.

Equity Bank's and Co-op Bank's B1 global local-currency long-term deposit ratings are fully aligned with the B1 (Stable) rating of the Kenyan government. Both banks reach this rating level solely based on their standalone strength, as indicated by their b1 standalone BCAs, Moody's highest ratings in Kenya.

More specifically, the primary drivers and key similarities of Equity Bank's and Co-op Bank's standalone credit profiles are their strong loss-absorbing and liquidity buffers to withstand their respective weakening asset quality in the context of a difficult operating environment. Among the challenges facing the banks, Moody's notes that a seasonal drought has affected agriculture and power generation, elections have delayed investments and lending rate caps have constrained banks' flexibility to price risks.

Despite Equity Bank's lending focus on small- and mid-sized enterprises, which has been challenged by the operating environment, Moody's notes Equity Bank's defensive response by meaningfully reducing loans and shifting its resources towards the purchase of high-yielding government securities.

In contrast, Moody's expects Co-op Bank to pursue a more aggressive loan growth strategy despite the challenging operating environment following a period of internal reorganisation and strategic transformation that has given the bank new tools and confidence to increase market share. Nevertheless, Co-op Bank's focus on stronger borrowers, such as Savings and Credit Co-operative Organisations and salary-assigned government personnel, should help contain asset quality pressure arising from pocket exposures to weakening sectors, such as in the trade sector.

Although Equity Bank and Co-op Bank are systemically important and Moody's attaches a very high probability of government support in case of need, their ratings do not benefit from any uplift because their BCAs are already at the government's rating level.

RATINGS RATIONALE

An overarching credit factor behind the ratings assigned today is the Kenyan operating environment. Moody's 'Weak --' Macro Profile assessment reflects Kenya's strong economic growth prospects, supported by a steady flow of infrastructure investment and population growth. At the same time, it captures pressure on banks' operating conditions stemming from pockets of asset quality deterioration arising from the adverse effects of a recent drought, reduced investments ahead of national elections to be held in August, as well as the recent introduction of a regulatory limit on lending rates which will affect some of the banks' loan growth and profitability. The complete Kenya banking macro profile can be seen on www.moodys.com.

The other key drivers and detailed rationale are presented on a bank by bank basis below.

EQUITY BANK KENYA LIMITED

Equity Bank's B1/Not Prime global local-currency deposit ratings capture the bank's standalone credit strength reflected in a b1 BCA, which is at the same level as the Kenyan government issuer rating. Equity Bank's BCA reflects (1) its strong brand recognition, established domestic franchise, and its extensive use of digital and alternative distribution channels which supports high and resilient profitability, and (2) its solid liquidity buffers and resilient funding profile supported by its granular retail depositor base. These strengths are balanced against the aforementioned challenging operating environment that leads to elevated asset risks, particularly for the SME segment (accounting for 55% of Equity Bank's loans). At the same time, Moody's expects any further asset quality deterioration to be manageable, supported by the bank's response in meaningfully reducing loans and instead purchasing high-yielding government securities.

BASELINE CREDIT ASSESSMENT (BCA)

Equity Bank has a solid domestic franchise as the second largest bank in Kenya with total assets of KES394 billion ($3.8 billion as of end March 2017) and a strong brand recognition. Equity Bank has had success in penetrating Kenya's rural areas and under-banked population, and it maintains the country's largest market shares in SME lending, diaspora remittances and merchant banking. The bank also reports a growing share of the transactional mobile banking payments where it is currently the second largest player in the market.

Moody's therefore expects that Equity Bank's profitability metrics will remain strong, supported by its low cost funding, an increasing proportion of non-interest income, and an efficient cost structure with the extensive use of digital and alternative distribution channels. The bank's net income to average assets stood at 4.3% during the first quarter of 2017 and its pre-provision income to average assets at 6.7%, both of which are amongst the highest in Kenya's banking system. Profitability has remained strong, despite a decline following higher loan loss provisions and Kenya's loan interest rate capping in September 2016, which in turn led to a reduction in lending margins and in the overall loan book.

Equity Bank's BCA is also underpinned by its granular deposit funded profile, as the bank benefits from the country's largest retail depositor base. Market funding accounts for a fairly low 11% of tangible banking assets, primarily in the form of US dollar funding from Development Finance Institutions. With Equity Bank experiencing a strong deposit growth over the past 15 months, in conjunction with lower loan balances, Equity Bank's liquidity ratios have improved significantly as of March 2017, with liquid assets at a strong 39% of total banking assets and net loans at a fairly low 72% of customer deposits.

Finally, Equity Bank's BCA balances these strengths against elevated assets risks. Moody's expects further asset quality pressure for banks in Kenya in general, and the SME sector in particular, given increasing stresses from lower consumer disposable income, government and large corporate arrears, and tighter credit conditions. Accordingly, Moody's expects pressure on Equity Bank's asset quality. Equity Group Holding Limited's problem loans, excluding interest in suspense (a good proxy for Equity Bank's problem loans), have already deteriorated to 6.3% of gross loans as of March 2017, from 2.7% as of end 2015. At the same time, Moody's expects any further asset quality deterioration to be manageable, supported by the bank's defensive response in meaningfully reducing risk-taking and loan balances.

NOTCHING CONSIDERATIONS

Equity Bank's B1/Not Prime global local-currency deposit ratings are derived from its b1 BCA. The bank's BCA is at the same level as the Kenyan government's issuer rating of B1, reflecting its strong standalone credit strength. Equity Bank is systemically important (it has a 10% deposit market share) and Moody's attaches a very high probability of government support in case of need. However, its ratings do not benefit from any uplift because its BCA is already at the government's rating level. Nevertheless, Moody's assumptions of support makes its deposit ratings less sensitive to a potential downward movement in the bank's BCA.

Equity Bank's global foreign-currency deposit ratings of B2/Not Prime are constrained by the country ceiling for such deposits, which captures foreign currency transfer and convertibility risks.

Equity Bank's CR Assessment of Ba3(cr)/Not Prime(cr), prior to government support, is positioned one notch above the b1 Adjusted BCA reflecting Moody's view that its probability of default is lower than that of deposits. Moody's believes that senior obligations represented by the CR Assessment will be more likely preserved in order to limit contagion, minimize losses and avoid disruption of critical functions.

Finally, Equity Bank's Aa1.ke/KE-1 national-scale rating maps at the middle of the corresponding range (a global-scale rating of B1 maps to Aaa.ke-Aa2.ke on the national scale). The Aa1.ke national-scale rating indicates that it is strongly positioned compared with other domestic issuers and is one of the strongest credits within Kenya. The bank has showed willingness and flexibility to reduce risk-taking in the context of a challenging operating environment while it also maintains slightly stronger profitability and liquidity buffers than rated peers.

CO-OPERATIVE BANK OF KENYA LIMITED

Co-op Bank's B1/Not Prime global local-currency deposit ratings capture the bank's standalone credit strength reflected in a BCA of b1. The bank's BCA is placed at the same level as the B1 (Stable) Kenyan government issuer rating and reflects its (1) domestic franchise and transformation strategy, which has strengthened profitability and its funding profile, and (2) high capital levels. These strengths are balanced against an increasingly challenging operating environment that leads to elevated asset risks.

At the same time, the bank's transformation agenda continues to support improvements in its infrastructure and distribution channels, the migration of customers to alternative distribution channels, efficiency improvements, strengthened credit and risk management capabilities and improved services quality levels.

BASELINE CREDIT ASSESSMENT

Co-op Bank's BCA is supported by its strong profitability and deposit funded profile, which benefits from its entrenched domestic franchise (as the country's third largest bank in terms of assets and a fairly large customer base) and the ongoing benefits from its transformation strategy.

Accordingly, Moody's expects Co-op Bank's profitability metrics to remain strong, with a pre-provision income at 5.8% and a net income at 3.5% of average assets during the first quarter of 2017. While lower lending margins and high loan loss provisions will weigh on profitability, Moody's expects profitability to remain supported by continued efficiency and cost of funding improvements, and growth in loans and non-funded income. Additionally, while Co-op Bank is primarily deposit funded, with market funding standing at a relatively low 7% of tangible banking assets as of March 2017, Moody's expects ongoing improvements to lead to a further diversification in its deposit base and address some of its current weaknesses, such as high depositor concentrations and the higher cost of funding compared with its larger domestic peers.

Co-op Bank's BCA is also underpinned by its solid capital buffers that support its overall solvency position. Moody's calculates the bank's tangible common equity at 16.3% of adjusted risk-weighted asset as of March 2017 (Moody's adjusts risk-weighted assets to include 100% of Kenyan government securities), and expects that the bank will maintain high capital given its strong internal capital generation, through profitability in the next 12-18 months, which will mitigate the growth in risk-weighted assets.

Finally, Co-op Bank's BCA balances these strengths against an increasingly challenging operating environment which leads to elevated assets risks. Co-op Bank's problem loans, excluding interest in suspense, have deteriorated to around 4.2% of gross loans as of March 2017, from 3.3% as of end 2015 and the bank expects a further deterioration to 4.5% by the end of the year, given the challenges in the operating environment. While Co-op Bank's asset quality remains better than its larger rated domestic peers, a reflection of its corporate focus including lending to Kenya's Savings and Credit Co-operative Organisations, and salary-assigned personal lending, the deterioration is a reflection of the more challenging domestic operating conditions. Moody's also expects elevated asset risks as the bank pursues a more aggressive loan growth strategy, despite the challenging operating environment, following a period of internal reorganisation and strategic transformation that has given the bank new tools and confidence to increase market share.

NOTCHING CONSIDERATIONS

Co-op Bank's B1 global local-currency long-term deposit rating is at the same level as its b1 BCA. Co-op Bank's BCA is in line with the Kenyan government's B1 issuer rating, reflecting its strong standalone credit strength. Co-op Bank is systemically important (with a 9% deposit market share) and Moody's attaches a very high probability of government support in case of need. However, its ratings do not benefit from any uplift because its BCA is already at the government's rating level. Nevertheless, Moody's assumptions of support makes its deposit ratings less sensitive to a potential downward movement in the bank's BCA.

Co-op Bank's global foreign-currency deposit ratings of B2/Not Prime, are constrained by the country ceiling for such deposits, which captures foreign currency transfer and convertibility risks.

Co-op Bank's CR Assessment of Ba3(cr)/Not Prime(cr), prior to government support, is positioned one notch above the Adjusted BCA of b1 reflecting Moody's view that its probability of default is lower than that of deposits. Moody's believes senior obligations represented by the CR Assessment will be more likely preserved in order to limit contagion, minimize losses and avoid disruption of critical functions.

Finally, Co-op Bank's national-scale ratings of Aa2.ke/KE-1 indicate that it is one of the strongest credits within Kenya. Co-op Bank features a strong solvency profile and deposit-funded liability structure.

STABLE OUTLOOK

Equity Bank's and Co-op Bank's global long-term deposit ratings carry a stable outlook, which balances the risks in the operating environment, against the banks' strong loss-absorption buffers and the stability afforded by their retail funded deposit base.

WHAT COULD MOVE THE RATING -- UP/DOWN

Positive pressure could be exerted on both banks' ratings following an improvement in the country's operating environment and an improvement in the banks' asset quality metrics. However, any upgrade of the banks' ratings would need to be preceded by an upgrade in Kenya's B1 rating, that acts as a constraint.

Negative pressure could be exerted on both banks' ratings if there is a deterioration in the overall operating environment leading to a weakening in the banks' profitability, capitalization and credit risk profiles.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks published in January 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

Moody's National Scale Credit Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale credit ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale credit ratings, please refer to Moody's Credit rating Methodology published in May 2016 entitled "Mapping National Scale Ratings from Global Scale Ratings". While NSRs have no inherent absolute meaning in terms of default risk or expected loss, a historical probability of default consistent with a given NSR can be inferred from the GSR to which it maps back at that particular point in time. For information on the historical default rates associated with different global scale rating categories over different investment horizons, please see https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1060333 .

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