

# African banking in the new reality

Swift action and a focus on three imperatives could strengthen African banks and support recovery.

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**The sudden and severe crisis** brought on by the COVID-19 pandemic has dealt a cruel blow to African countries, threatening the lives and livelihoods of millions and causing a rapid economic contraction. This has had knock-on effects for industries across the continent, including banking. Now, as companies and leaders start to look toward recovery, new analysis from McKinsey provides some optimism.

Government data and financials released by banks in four major economies on the continent (Kenya, Morocco, Nigeria, and South Africa) show that, despite a resurgence of the virus, the pandemic's impact on African banks in 2020 was less severe than initially expected. And given the important role that banks play in the broader economy and society in Africa, this in turn could signal a faster recovery for the continent.

Unlike many past economic shocks, the COVID-19 crisis is not limited to banking; it is a humanitarian crisis and a crisis of the real economy, with banks being affected by cascading credit losses and uncertain demand. In developed markets, we estimate that the average return on equity (ROE) for banks could dip below 1.5 percent in 2021 before recovering to precrisis levels of around 9 percent by 2024—this equates to five years of returns effectively lost for the banking sector.<sup>1</sup>

The impact on African banks is likely to be less severe. While the average ROE for African banks fell by 50 percent—to 7 percent in 2020, from 14 percent in 2019—we expect this to rebound to near precrisis levels within the next three years if economic recovery on the continent follows the scenario that a majority of global executives believe will most likely unfold.

Drawing on McKinsey's global research, as well as from real-world examples from across Africa's banking sector, this article builds on [our analysis in June 2020](#) to provide insights and analysis to help shape and accelerate this recovery.<sup>2</sup> We believe that a focus on three imperatives—centered around productivity, risk management, and scaling up technology—could help banks build core strength and resilience in the new reality.

### **A rapid recovery has helped cushion the blow to banking**

A year into the COVID-19 crisis, we now have a better picture of the pandemic's economic impact on the continent. McKinsey has developed nine global macroeconomic scenarios, which reflect a range of virus-containment, public-health, and economic-policy responses. The early consensus of global executives had been that the two scenarios most likely to prevail would be A1 (a recurrence

## **Despite a resurgence of the virus, the pandemic's impact on African banks in 2020 was less severe than initially expected.**

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<sup>1</sup> See *McKinsey Global Banking Annual Review 2020*, on McKinsey.com.

<sup>2</sup> See François Jurd de Girancourt, Mayowa Kuyoro, Lorris Nazon, Youness Raounak, and Dina Tagemouati, "African banking after the crisis," June 29, 2020, McKinsey.com.

of the virus and muted world recovery) and A3 (a contained virus and global growth returning in 2021).<sup>3</sup> It is now evident that the actual impact of the pandemic in 2020 for most major African economies was somewhere in between these two trajectories.<sup>4</sup> South Africa was an exception; existing weaknesses in that economy, coupled with a strict nationwide lockdown, led to a fall in GDP in line with our A1 scenario. This relative clarity has allowed us to refine our analysis and outlook for African banking in several key respects.

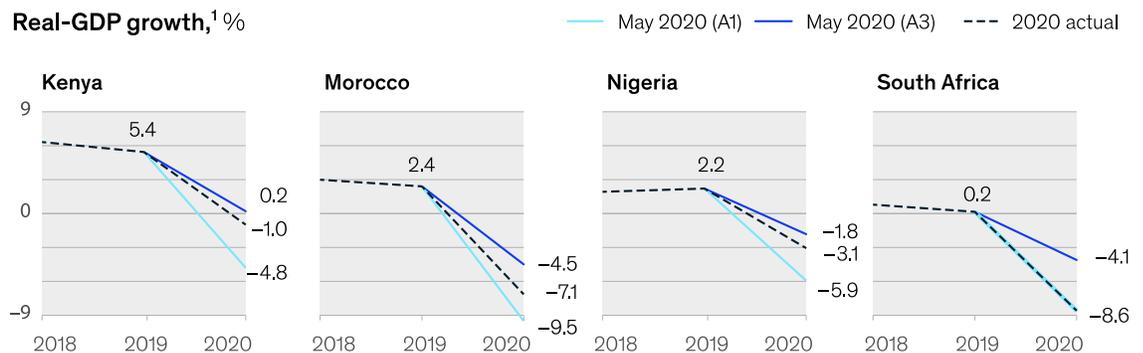
Real GDP across the four major markets we assessed declined by 6 percent in 2020—roughly halfway between estimates of 8 percent (A1) and 3 percent (A3).<sup>4</sup> While the virus was resurgent, its impact on banking revenues after risk costs was less severe than expected. Postrisk revenues declined by 18 percent in 2020, compared with 21 percent estimated in the A1 scenario on the back of a combination of factors, including government fiscal interventions and the easing of lockdowns.<sup>5</sup>

In Kenya and Morocco, for example, the relaxation of lockdowns and curfews in mid-2020 slowed the expected economic decline, despite challenges in the agricultural sector, including locust swarms in Kenya and drought in Morocco. In Nigeria, the partial recovery of oil prices and the lifting of restrictions also led to a gentler decline in GDP of –3.1 percent, between the A1 and A3 estimates of –5.9 and –1.8 percent, respectively (Exhibit 1).

Government support programs—including moratoriums on repayments and credit infusions such as loan-guarantee schemes—combined with low interest rates and a decline in nondiscretionary spending played a key role here, helping to increase affordability and to support loan and deposit volume growth.<sup>6</sup> The sharp fall in interest rates together with lower transaction volumes and fee waivers led to a decline in client-driven interest and fee revenues.<sup>7</sup> Overall, lower economic activity and higher unemployment have increased banks’ risk on loans, leading to higher loan-loss provisioning.

Exhibit 1

### Government interventions helped limit real GDP decline in Africa in 2020 to between the A1 and A3 scenario, despite a resurgent virus.



<sup>1</sup>December 2020 GDP is based on IMF and Central Bank of Kenya, Bank Al-Maghrib, Central Bank of Nigeria and South African Reserve Bank estimates. Source: Central Bank statistics; McKinsey analysis, in partnership with Oxford Economics

<sup>3</sup> Since June 2020, McKinsey has been polling global executives every six weeks about their views on the economy. Initially, the A1 and A3 scenarios were voted as the most likely to prevail. In the January 2021 poll, A1, B2, and B3 were seen as the most likely trajectories for the pandemic. In this article, we have chosen to focus on the A3 and A1 scenarios as an optimistic case and a central case scenario, respectively. For more information on the McKinsey scenarios, see ["The coronavirus effect on global economic sentiment,"](#) January 29, 2021, McKinsey.com.

<sup>4</sup> Measured by aggregate decline of real GDP in four countries: Kenya, Morocco, Nigeria, and South Africa.

<sup>5</sup> Revenues after risk costs are aggregated for Kenya, Morocco, Nigeria, and South Africa and include only client-driven income. They don't capture income related to trading and treasury activities, which could be significant (ranging from 5 to 10 percent) and varied across countries and banks in 2020.

<sup>6</sup> Examples of government support initiatives include: Damane Oxygene in Morocco, which provided optimal financing conditions to companies negatively affected by the pandemic, leading to the state's guaranteeing 80 to 95 percent of loans; South Africa's 200 billion rand (\$13 billion) COVID-19 loan scheme targeting small and medium-size enterprises; and the 50 billion naira (\$121 million) loan scheme to households and micro-, small-, and medium-size enterprises in Nigeria at 5 percent interest rates.

<sup>7</sup> Estimate based on third-quarter results for banks in Kenya, Morocco, and Nigeria and half-year results for South Africa.

## African banks could return to precrisis levels of postrisk revenues by 2022

Despite seeing stronger revenues after risk costs, African banks are facing a challenging path to recovery. Increasing risk, lower-for-longer interest rates owing to all-time-high government debt levels, and subdued demand are likely to be the major headwinds facing banks as they start to look beyond the crisis.

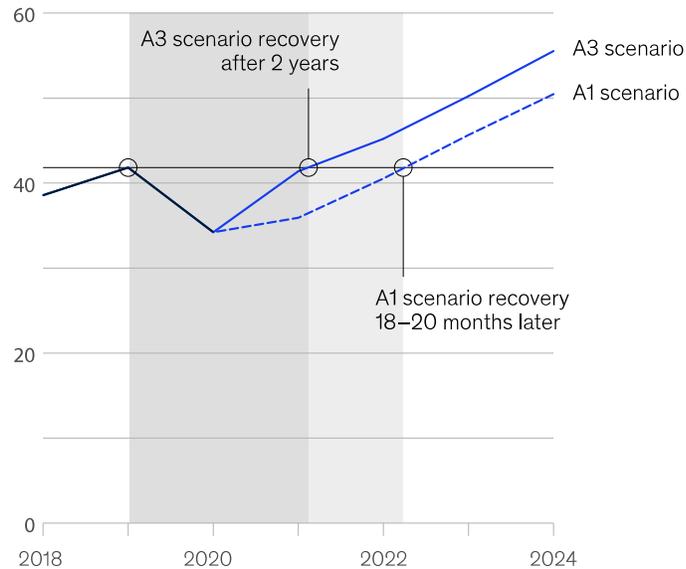
The speed of recovery will vary depending on the scenario that unfolds. Under the A3 scenario, which assumes a partially effective government policy

response and an optimized healthcare response that effectively controls the virus's health impact, revenues after risk costs could rebound to precrisis levels by as early as 2022. However, a slower recovery—as posited by the A1 scenario, which assumes partially effective economic interventions and an effective public-health response with localized recurrences of the virus similar to what we have already seen across the continent—may not see revenues recovering until 2023 (Exhibit 2).

Exhibit 2

### Under the A3 scenario, revenues could bounce back by 2022, while recovery could take another 18-20 months in the A1 scenario.

**African<sup>1</sup> banking revenues<sup>2</sup> after risk costs, fixed 2019 \$ billion**



<sup>1</sup>The above analysis is based on the aggregate of the following countries: Kenya, Morocco, Nigeria, and South Africa.

<sup>2</sup>Includes client-driven retail and corporate banking revenues; does not include asset-management revenues. 2020 figures are based on Q3 reporting for banks. Source: Banks' annual reports; Central Bank statistics; Panorama—Global Banking Pools by McKinsey

In plotting their path to recovery, banks in each country will face their own set of challenges. Future growth in revenues after risk costs are likely to differ significantly by country and will depend largely on volume growth and on the normalization of provisioning levels. Depending on which scenario prevails, growth in revenue after risk costs could vary between 9 and 21 percent compound annual growth rate over the next four years, off a low base in 2020.

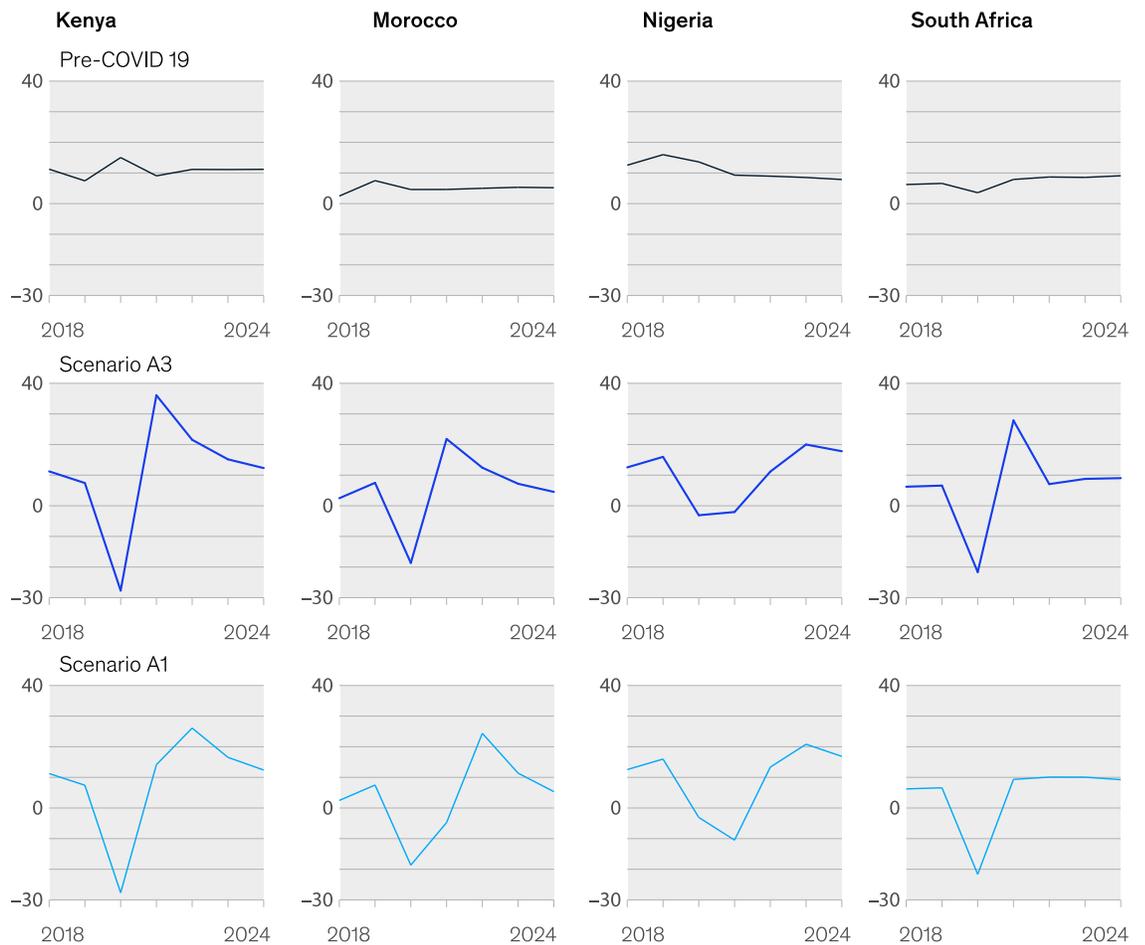
Under the A1 trajectory, a gradual normalization of risk costs and volume growth could help drive recovery in South Africa and Kenya in 2021, while in Nigeria and Morocco a further increase in risk provisioning could continue to drive down postrisk revenues (Exhibit 3).

McKinsey's analysis suggests that, for most banks, the level of provisioning undertaken in 2020 is likely to influence the shape and pace of recovery of revenues after risk costs in each country.

Exhibit 3

**Depending on which scenario unfolds, CAGR in revenues after risk costs could vary by between 9 to 21 percent over the next four years.**

**Growth in revenues after risk costs,<sup>1</sup>%**



<sup>1</sup>Does not include asset-management revenues and only inclusive of retail-banking and wholesale-banking revenues; 2020 figures are based on Q3 reporting for banks.  
Source: Banks' annual reports; Central Bank statistics; Panorama—Global Banking Pools by McKinsey

Historically, falling GDP can be correlated with a rise in nonperforming loans (NPLs), and we therefore expect NPLs to increase in all countries in 2021—yet not all banks are equally prepared. Third-quarter 2020 results for Nigeria, Kenya, and Morocco and half-year results for South Africa show that the level of provisioning varies significantly by bank and country.<sup>8</sup> In South Africa and Kenya, banks have already increased loan-loss provisions by more than 200 percent since 2019 to cover for potential bad debts. As a result, they may see improved results in 2021 (that is, return to normal provisioning levels). However, if the historical correlation between declining GDP and rising NPLs holds, then it is likely that banks in Morocco and Nigeria may need to further increase provisioning levels in 2021,

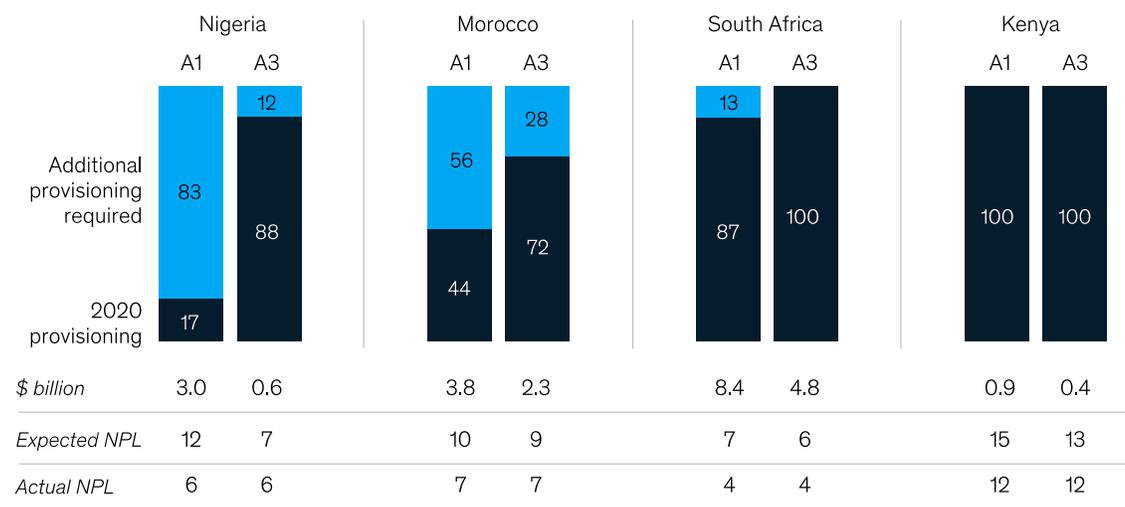
as the current loan-loss provisions in those countries may not adequately cover the expected increase in bad debts, especially in the A1 scenario.

The gap in expected NPL increase is much wider between the two scenarios in Nigeria than in any of the other three countries. The A3 scenario assumes that the 2016–17 crisis, precipitated by falling oil prices, led to a major cleanup of banks' books and strengthened risk-management processes, thereby sufficiently preparing banks for future crises. However, under an A1 scenario, NPLs in Nigeria could rise steeply if forbearance measures are rolled back and stress in the oil and gas sector ramps up (Exhibit 4).

Exhibit 4

### Loan loss provisions by banks in Kenya and South Africa in 2020 could adequately cover an expected increase in nonperforming loans in 2021.

Expected increase in nonperforming loans (NPL) by 2021,<sup>1</sup> % share (by scenario)



<sup>1</sup>2020 figures are based on Q3 reporting for banks.  
Source: Banks' annual reports; Central Bank statistics; Panorama—Global Banking Pools by McKinsey

<sup>8</sup> Source: McKinsey Panorama Global Banking Pools, banks' annual reports, central banks' statistics.

## Three imperatives to power the recovery and growth of African banks

Given the still uncertain trajectory of the pandemic, African banks cannot afford to leave their recovery to chance. If risks are not mitigated, our estimates suggest that the African banking market could lose more than \$48 billion in cumulative postrisk revenue by 2024, leading to multiple years of returns below the cost of capital.<sup>9</sup>

While many African banks have already acted boldly to manage the economic fallout of the pandemic and to protect the lives and livelihoods of their staff and customers, now is the time to turn their focus toward growth and resilience postpandemic. Lessons from the 2008 economic crisis suggest that, in times of crisis, speed is everything. Banks that reacted quickly and decisively during that crisis fared much better in the long term.<sup>10</sup>

In our previous article, we provided detailed ideas and analysis for banks' response strategies.<sup>11</sup> We revisit these here, outlining three imperatives and drawing particular attention to the opportunity for banks to structurally review their cost base and operating models. These adjustments remain fully within their control.

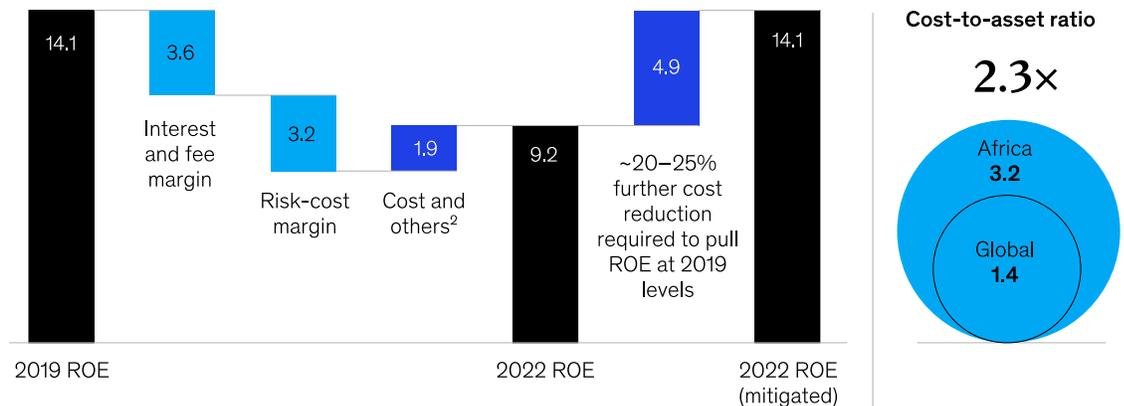
### 1. Build a productivity engine

The cost-to-asset ratio of African banks is more than twice the global average. The impact of this on ROEs has been masked to some extent by high banking margins helped by high interest rates, but now that rates have been cut, the need to address the root cause of this imbalance is acute. Based on our estimates, banks will likely need to increase their operating efficiency by at least 20 to 25 percent to restore their precrisis ROE (Exhibit 5).

Exhibit 5

**Based on input from risk, a return to precrisis ROE for most banks may require a 20 to 25 percent reduction in operating costs.**

Africa<sup>1</sup> ROE decomposition for A1 scenario COVID-19 impact, %



<sup>1</sup>Based on four countries, ie, Kenya, Morocco, Nigeria, and South Africa.

<sup>2</sup>Includes impact of cost, leverage and one-time COVID-19-related donations of Moroccan banks in 2020.

Source: Panorama—Global Banking Pools by McKinsey; S&P Global Market Intelligence

<sup>9</sup> This figure is the potential lost revenue, calculated as a delta of cumulative postrisk revenues between pre-COVID-19 projections and gradual recovery scenario projections.

<sup>10</sup> Robert A. Weigand, "The performance and risk of banks in the U.S., Europe and Japan post-financial crisis," *Investment Management and Financial Innovations*, December 2016, Volume 13, Number 4, pp. 75–94, businessperspectives.org.

<sup>11</sup> François Jurd de Girancourt, Mayowa Kuyoro, Lorris Nazon, Youness Raounak, and Dina Tagemouati, "African banking after the crisis," June 29, 2020, McKinsey.com.

The productivity imperative for banks comprises four main levers:

**Reset third-party spend:** Banks have already reduced costs in 2020 by setting up spend control towers to manage demand and clean sheeting to understand supplier margins better, but leaders need to maintain the momentum here. In cases where demand has increased, such as telecoms and remote working, banks could establish policies to seek volume discounts. For categories where demand has reduced, such as travel and events, banks could use policies to manage demand and reduce fixed costs.

**Move to minimum viable central functions:** Moving to a truly zero-based structure requires that self-service and the automation of processes are fully embraced. In human resources and finance, many banks are already on a path to achieving 30 percent productivity gains through such initiatives, with significant opportunities for other functions such as risk and compliance remaining.

**Reconfigure the physical network and embrace the shift to digital channels:** The McKinsey Financial Insights Pulse Survey conducted in October 2020 found that most consumers expect to increase their use of digital and mobile banking services after the crisis.<sup>12</sup> Yet there is a wide range in measurable digital performance among African banks—for example, the percentage of the total customer population who are active on the bank's digital channels. Banks could capitalize on the widespread adoption of electronic channels by accelerating end-to-end digitization and continuing to drive channel migration.

**Embed new ways of working:** Like other service industries, banks could consider implementing, on a permanent basis, the fast decision making and agile ways of working experienced during lockdown. For example, by leveraging digital collaboration tools and implementing agile methodologies, banks could accelerate the delivery of projects, improve remote working, offer broad access to online training, access larger talent pools, and maximize the use of cross-functional teams.

## 2. Scale up technology

Technology has an essential role to play in helping banks to deliver on the productivity imperative and unlock future growth. However, today's IT models are challenged with less than 10 percent of technology spend driving value-adding business functionality; this implies a significant untapped opportunity.

Our analysis indicates that banks could double the productivity of their IT engine by pulling on modern levers; newer-age technology platforms and ways of working have reached a tipping point where banks can deploy them at scale. In the short term, banks could look for ways to do more with less by leveraging technology to simplify and automate infrastructure provisioning and software delivery and by taking a more granular approach to managing and prioritizing demand. In the longer term, banks will likely need to move to a platform-oriented architecture and automated infrastructure underpinned by the use of public cloud—as regulators become increasingly open to this. Leading banks are already showing the potential to reduce costs by more than 20 percent through such initiatives.

A step change in IT infrastructure and associated productivity gains and cost savings could, in turn, enable banks to shift their attention to the growth agenda. Currently, around 70 percent of technology capacity is directed toward maintaining the current IT infrastructure for daily operations, fixing bugs, and working on known or surfaced technical debt. With these resources freed up, chief information officers could reinvest in new capabilities such as digital-first sales and servicing, growth through analytics, and new products delivered faster, as well as explore new ecosystems and adjacencies. Ultimately, by scaling up their technology, banks may be able to serve increasing demand at lower cost.

## 3. Strengthen the risk-management muscle

In the context of the crisis, banks have an imperative to optimize their cost of risk and to reduce the cost of risk management. Digital and analytical tools

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<sup>12</sup> Umar Bagus, John Euart, François Jurd de Girancourt, and Michael Panek, "Financial decision-maker sentiment: South Africa," October 5, 2020, McKinsey.com.

hold significant potential in helping banks to do so while also positioning them for a future return to growth. For example, the use of analytics and real-time reporting—using even the relatively sparse data sets that all banks have—could transform risk detection. In recent work with an East African bank, an early-warning system for small- and medium-size enterprise (SME) clients was built using just account transaction data that could identify potential defaults between one and three months in advance. Enriching these systems with additional data sources, including publicly available data, as well as data sets from proprietary partnerships, could help banks gain a more acute understanding of market and customer dynamics and open up new avenues for differentiation.

The adoption of digitized lending journeys and collections could also streamline operations, enabling banks to make better risk decisions at lower cost. Leading banks have significantly reduced their cost of risk management by embracing new technologies and processes. To make optimal use of these tools, however, most African banks may need to rewire traditional operating models and boost their digital capabilities. A fast track to achieving this could be for banks to partner with fintechs, an increasing array of which, both on the continent and globally, are looking to collaborate, not compete, with banks. These players offer both digital skills and off-the-shelf solutions that can be deployed rapidly.

As the pandemic subsides, the most advanced banks may be able to leverage their enhanced risk muscle and new analytical capabilities to rapidly capture new growth opportunities as economies return to health. This could include lending into previously untapped segments such as SMEs and the nonsalaried workforce, where banks have struggled in the past to assess risk. Some players are already moving quickly. One South African bank, for example, has taken an equity stake in a nonbank lender with innovative credit-scoring capabilities and a novel business model to serve SME customers better.

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The COVID-19 crisis will not leave the banking sector unscathed. The past year has seen the acceleration of seismic trends ranging from deglobalization and a radical shift in the macroenvironment to transformed customer expectations. As African banks chart their paths to recovery in this new reality, they can heed the lessons from the 2008 global financial crisis and act swiftly to manage elements that are within their control to shape their recovery and growth trajectory. This could be critical not just for restoring ROEs to meet the needs of shareholders and to better serve their customers, but also in enabling the recovery of the broader continent. As key drivers of stability and liquidity, banks are essential for Africa now more than ever.

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For further information on McKinsey's scenario analysis and the drivers of COVID-19-related impact on African banking revenues and returns, please contact the authors on [McKinseyAfrica@mckinsey.com](mailto:McKinseyAfrica@mckinsey.com).

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