FDC Economic Bulletin

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# AMCON: Financial Loss but Economic Profit

The announcement of an astronomical loss of N304.3billion for 2015 by AMCON, a sum 8.12% higher than the total revenues shared by the governments of the federation in April, was startling. But what everyone forgets is that the financial loss is nothing compared to the economic profit and benefits to the society. Also that AMCON was a product of a global crisis of unprecedented magnitude.

The global financial crisis of 2008-2009 may be a distant memory but the ramifications are still having a major impact on most economies including Nigeria. The probability of an economic and financial crisis happening simultaneously is very rare and is a one in a 100 year probability. These events usually have grave and widespread consequences. This is why there was a global coordination to prevent both the contagion and debilitating effects of the crisis. In a well-synchronized effort, advanced, emerging and developing economies harmonized their policies to contain the crisis and prevent its spread. In the last few years, may countries have taken drastic steps to mitigate the impact of bad loans on their banking system. These include safe-guarding deposits, providing emergency liquidity, partial or complete bank nationalization and the creation of "bad banks". These are institutions established to acquire toxic assets, such as non-performing loans (NPLs). The United States' Troubled Assets Relief Program (TARP) and Northern Ireland's National Asset Management Agency are examples of such 'bad banks'.

In Nigeria, AMCON was set up as an economic stabilizer and financial shock absorber. As AMCON announced its results showing a significant operating loss, analysts are still scratching their heads to make sense of why, how and what next. When the Central Bank of Nigeria (CBN) injected N620 billion into distressed banks in 2009, AMCON purchased toxic assets of approximately N3.7 trillion. Its efforts brought stability to the Nigerian financial system alleviating liquidity and insolvency problems of affected banks and improving the NPL ratio from a high of 34.3% in 2009 to 5.5% in 2015.

Despite its successes, there are concerns that AMCON may not be profitable before its sunset clause in 2023. With just seven years to its winding down, there are economic difficulties impeding its recovery efforts and increasing its likely losses. There still exists a "moral hazard", whereby banks would be willing to take additional risk, knowing that the potential costs of taking such risks will be borne by the regulator or stabilizer.

AMCON was set up as an economic stabilizer for the Nigerian banking industry to overcome the crisis of confidence, liquidity and governance of 2008. Its positive impact on the economy at large should not be underestimated.

## Facts and Figures

AMCON's financial performance for 2015 is evidence of a difficult operating environment and the peculiarity of accounting standards that does not recognize the intrinsic value of a sinking fund in determination of its current financial condition. Analysts were not surprised at the reporting of a loss because of the deteriorating macro-economic condition. However, the magnitude of the loss may have confounded a few.

Gross earnings declined to N141.1billion for the period from N413.7billion, representing a 65.6% decrease from the prior year. The decrease was due to a significant shortfall in interest and non-interest income. Interest income declined sharply as a result of the 45.4% reduction in its loan book size. The impact of a 40.14% decline in interest income on operating profits was cushioned by a 12.54% improvement in interest expense. Negative net revenue from funds (NRFF) showed that interest expenses improved in 2015, but still remained higher than income.

Credit loss expense improved by 47.9% from N125.7billion to N65.49billion. However, loans and advances declined by 45.4% to N240.2billion from N440.38billion. The 70% improvement in total operating expenses did little to improve profits due to lower gross earnings. As a result, a N302.1billion loss was recorded for the financial year.

Most profitability indices also deteriorated in 2015. Balance sheet total assets as at December 2015, stood at N789.4billion compared to the previous year's N1.45trillion, representing a 45.7% decline. This was partly due to the reduction in corporate lending from N421.7billion to N238.7billion (as a result of pay downs) and a general reduction in the value of total liquid assets on a marked to market basis. Total liabilities stood at N5.01trillion while total equity remained negative at N3.78trillion. And while losses after tax show trace improvements with an increase of 17.4% between 2012 and 2014, AMCON's overall loss from inception amounts to N4.5trillion.

Finally, the non-performing loans ratio deteriorated to 93% from 57% for the period under review, thus emphasizing the correlation between recoveries and the performance of the broad economy. Debt repayment took a hit as the economic environment worsened in 2015. Further deterioration in the institution's financial condition was due to significant exposure to distressed sectors such as the power and oil and gas sectors.


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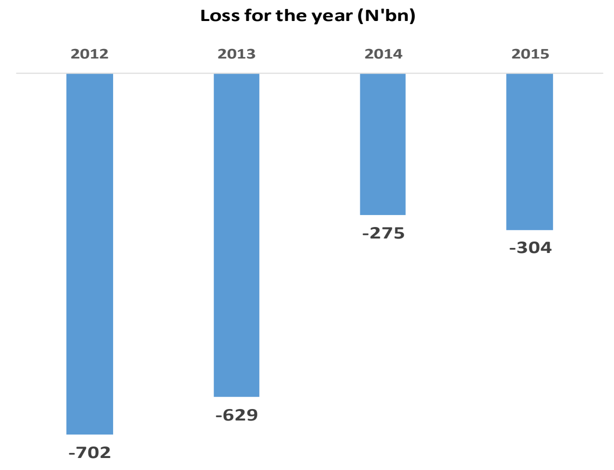
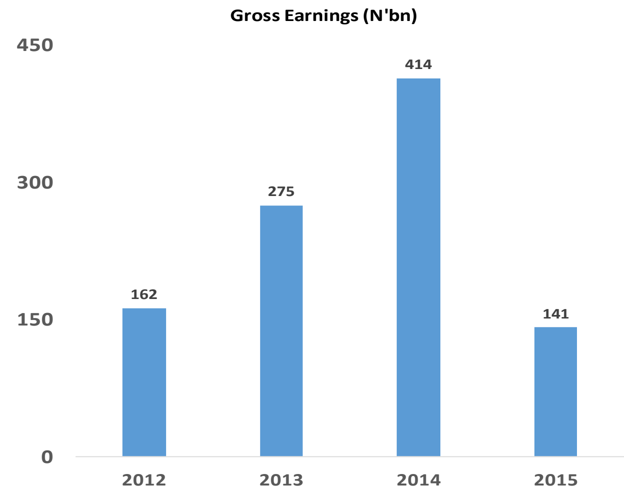
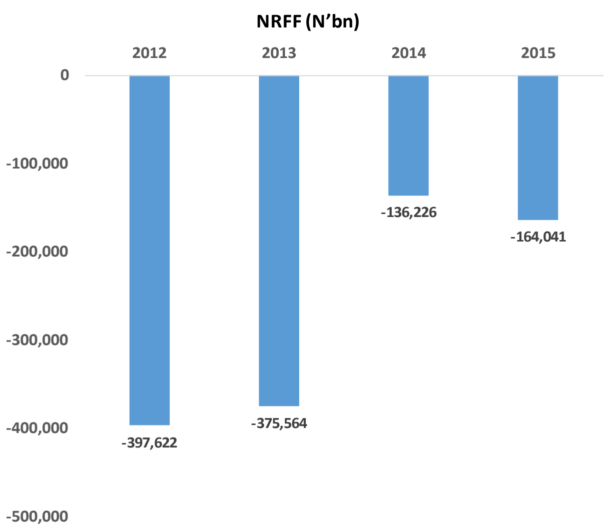
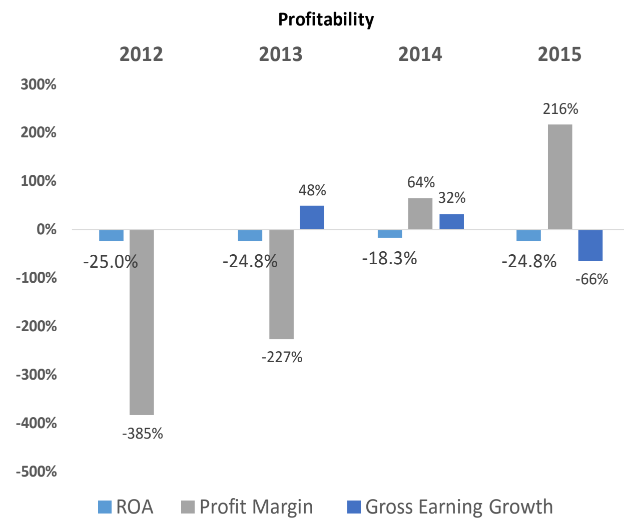
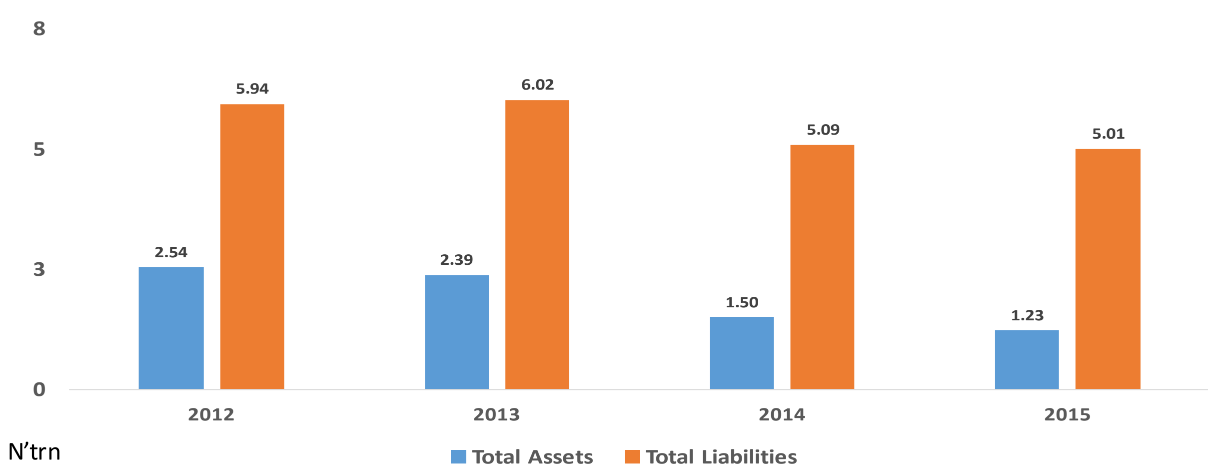
# 2015 Financial Snapshot




*Source: Company Data and FDC Think Tank*

It is clear that AMCON's financial performance for the period was far from par, but if we review the benefit AMCON has delivered and costs it has averted it helps put the poor performance in context. Without AMCON, a major market meltdown would have coincided with a recession and an erosion of domestic and international confidence. Markets, most especially the Nigerian Stock Market and real estate would not have been spared. A crash would have been inevitable. To better understand AMCON's performance we need to put it in context of the general economy's performance, as well as the performance of the banking sector.

## Economic Review

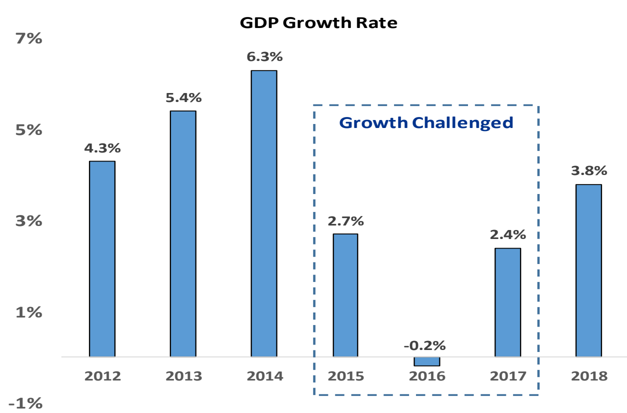
The world's output declined to a five-year low of 3.1% in 2015 and the path to recovery has been disappointing given the billions of dollars injected by nations to boost output growth.

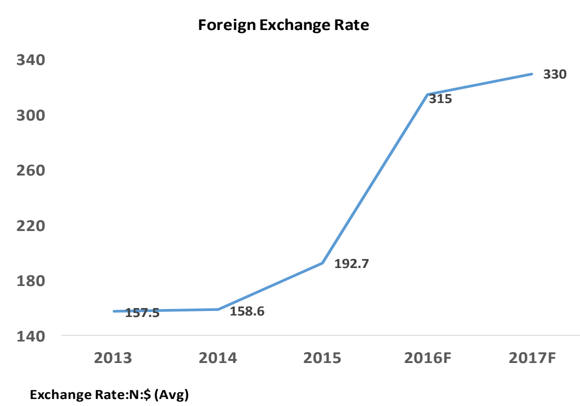
The Bank of Japan (BOJ) and the European Central Bank (ECB) continued with their massive monetary stimulus by reducing interest rates to negative territory. While there were exceptions to the bleak outlook, such as the United States where the GDP growth rate improved to 2%, many economies suffered in 2015, especially those economies dominated by oil. Nigeria's economic output slowed to 2.7% due to depressed oil prices and oil production disruptions. Both factors negatively impacted government revenues and have fed into the soundness of the country's financial system.

The build up to the general elections saw investments stall as investors adopted the wait and see approach pending the outcome of the elections. The process and results of the election were received with optimism. However, this goodwill is gradually being eroded due to the lack of a clear policy direction and the government's response to the challenges befalling the country. These actions have resulted in capital outflows by foreign investors in the capital market. The NSE index was battered to 28,642.25 from 34,657.15 representing a 17.36% loss for the 2015 financial year.

This weak economic environment means that corporate earnings and profitability suffer a significant decline. As a result, companies struggle to keep up with loan payments and by extension AMCON's asset recovery exercise is impaired.

### Setting the Context—Economic Conditions




*Source: NBS, CBN and FDC Think Tank*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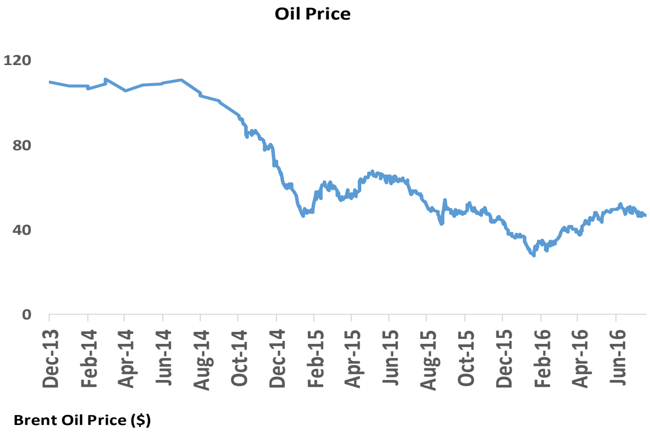


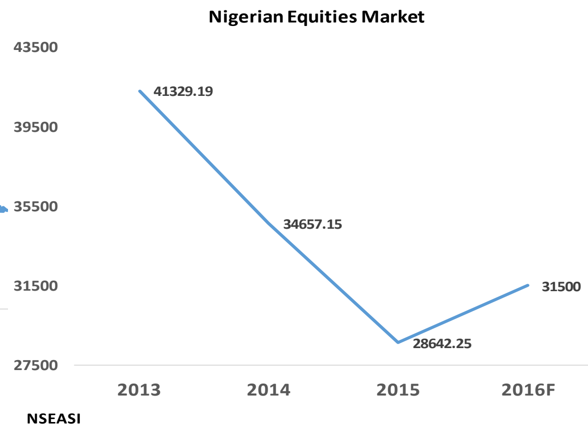


*Source: Bloomberg and FDC Think Tank*

## Banking Industry Review

For most part of the year, banking liquidity was affected by further tightening by the CBN's policies through the increase in rates and the increase in Cash Reserve Ratio (CRR). There was also the introduction of the Treasury Single Account (TSA), which saw most of the cheap funds leave the banking system. Another major event for banks was the further reduction of COT. All of these put further pressure on the earning ability of banks for the period.

There were also issues of capital adequacy as industry asset quality deteriorated. This was reflected in the increase in loan loss expenses and NPL ratios. Mounting pressures on asset quality increased due to exposure to distressed sectors – power, oil and gas - which on the average accounted for about 26% of the total loan book size of the Nigerian banking sector. Industry NPLs rose from 3% in 2014 to 5.5% in 2015.

The year was also characterized by increased regulatory actions by the CBN. A number of defaulting banks were fined for non-compliance with the TSA. Others were fined for concealing Ministries', Departments' and Agencies' (MDA) funds. Other actions include the exclusion of 41 items from access to foreign exchange in the foreign exchange market, the prohibition of cash deposits into domiciliary accounts and the restrictions on the use of naira-denominated cards abroad. All of these contributed to a negative outlook on banking sector earnings for the year.

Going forward, divergence in earnings is expected between Tier 1 and Tier 2 banks as most Tier 2 banks tend to be more vulnerable and have a shortage of loss absorbing capital. In addition, industry profit before tax is projected to decline on an average to -9% and -11% for full year 2016. Given the current interplay of economic activities and the depreciating naira, we are of the opinion that some banks will find it difficult to meet their maturing bond obligations. All these will lead to further pressures on industry profitability.

The road ahead for the banking industry will indeed be challenging and painful given the prevailing situation. For AMCON to emerge from this economic black hole pain free stringent regulatory oversight on banks and a possible review of sinking fund contribution by Deposit Money Banks, which was initially stipulated at 0.3% of total assets but presently at 0.75% of total assets. At this level (0.75% of total assets), and a less optimistic assumption excluding interest accrued on funds that these provisions are made yearly until the activation of the sunset clause will enable AMCON realize an estimate of aboutN2.36trn. This could help offset AMCON's accumulated losses when wound down.

## Is AMCON's Job Done

From AMCON's inception in 2010 to December 2015, N644billion in cash and asset forfeiture has been realized. Of the N3.7trillion in acquired assets, 57% (N2.1trillion) have been restructured. From this restructured volume, N1.26trn has been fully settled. The institution has struggled with a number of troubled assets and achieving recoveries. This has led them to explore more aggressive recovery strategies. However, an estimated N9.1trilion of assets would have been wiped out if AMCON did not intervene in the 10 affected banks. These banks would have been declared insolvent and their capital levels inadequate to cover their credit risk exposure. It is also likely that healthy banks would have been affected as a result of panic and contagion.

The social cost of AMCON's non-existence would also have been debilitating. Unemployment would have spiked. There would have been widespread fear and an unprecedented rise in poverty levels combined with a lack of confidence in the financial system.

These findings show that the social benefits of AMCON's intervention were far in excess of the accumulated financial losses.

The future performance of AMCON is highly dependent on the performance of the broad economy. Projections for GDP in 2016 and 2017 point to a slow down in the economy. If these projections are actualized, the ability of AMCON to realize recoveries will be greatly impaired. Equity valuations of its holdings in distressed companies would remain depressed and further dampen exit values.

However, there seems to be light at the end of the tunnel as 2018 is projected to be an inflection point of the Nigerian economy. This should signify the beginning of an improved performance for AMCON. Recoveries will improve and asset valuations will be enhanced.

In the meantime, the management of AMCON, will focus on aggressive NPL recoveries through the use of an Asset management partners, further restructuring of bad debts bearing in mind that their future performance will still have an impact on Nigeria's financial system stability.

Nigerian banks have suffered from the slump of commodity prices, and slowing economic growth. Concerns about asset quality, capital adequacy and cost of risk have all contributed to the sector being one of the hardest hit sectors.

There may be fears of further financial distress following the recent recessionary trends in the economy. Further deterioration of the economy may lead to an extension of the sunset clause and this is likely to be a subject of National debate

It is believed that the future performance of AMCON will still have an impact on financial system stability. These fears could be allayed by the benefits of setting up the resolution cost trust fund popularly known as the sinking fund.