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Prepared by an IMF staff team led by Luc Eyraud and comprised of Irina Bunda, Jehann Jack, Tarak Jardak, Rasmane Ouedraogo, Zhangrui Wang, and Torsten Wezel

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Executive Summary

Compared to other regions, sub-Saharan Africa (SSA) has historically recorded high levels of nonperforming loans (NPLs) in the banking sector. NPL ratios have exceeded 10 percent on average since the mid-2010s. They have been particularly elevated in commodity producers and fragile states. The structurally high level of NPLs in SSA can be explained by a range of factors, including government arrears creating debt repayment difficulties for domestic suppliers, macroeconomic volatility, poor credit risk management practices, and a legacy of problem loans that remain unresolved or are not written off partly because of weak legal systems.

The COVID-19 crisis is expected to increase NPLs even further. Two waves of rising NPLs have already occurred in SSA in recent decades: one in the 1990s in the wake of commodity price shocks and fiscal crises and another following the global financial crisis (GFC). The COVID-19 pandemic is likely to mark the beginning of a third wave. The empirical analysis presented in this departmental paper demonstrates that NPL trends are highly correlated with macroeconomic conditions. If history repeats itself, the crisis experienced by SSA countries should lead to a large deterioration of loan portfolios, once regulatory forbearance and other exceptional support measures expire. Holding other factors constant, the 2020 growth collapse could trigger an increase in the average NPL ratio of the SSA region by up to one-third in the medium term.

High and rising NPL ratios can severely limit the ability of the banking sector to provide new credit and support the economy. Using both country- and bank-level data, this paper provides new evidence that NPLs in SSA hamper credit and growth. The negative effect of NPLs on credit to the private sector is observed at both banking system and individual institution levels, with banks that hold large NPL portfolios providing on average fewer loans. The

policy implication is clear: for banks to play a supporting role during the post-COVID economic recovery, they must clean up their balance sheets.

To deal with the expected impact of the COVID-19 crisis on credit quality, countries could contemplate a three-pronged sequential strategy focused on managing, resolving, and preventing problem loans:

- *Managing*. In the short term, banks should prioritize dealing with their customers' diminished capacity to repay. Banks should recognize the deterioration of their assets' quality by applying rules in force related to loan classification and provision. To address the negative impact of higher NPLs on banks' capital, supervisors should allow the use of capital buffers (where they exist) and monitor capital restoration plans for the banks that fall below regulatory norms.
- *Resolving*. Once the economic situation stabilizes and exceptional relief measures are gradually withdrawn, it will become possible to assess the full impact of the crisis on banks' portfolios. The recovery period will be the right time to shape and implement resolution strategies. Supervisory oversight and regulation should incentivize banks to reduce the size of their NPL portfolios. The experience of SSA countries with NPL resolution measures has been mixed, partly because of legal and financial constraints, inefficiencies in debt collection of asset management companies (AMCs), regulatory capture, and political economy factors.
- *Preventing*. Once countries have implemented comprehensive resolution strategies, they should shift their focus toward preventing a re-accumulation of new arrears, which could undo past efforts. This is most likely the area in which the SSA region needs to put the greatest effort. The range and effectiveness of preventive actions remain limited, in part because credit bureaus and collateral registries have a narrow coverage.

Expectations should be realistic about the NPL reduction targets and their payoff in terms of new credit. The task of cleaning up banks' balance sheets is a difficult one. Although previous episodes of rapid reductions have occurred, NPL ratios in SSA countries are generally highly persistent and slow moving. Large reductions have usually been achieved over several years in the context of accelerated write-offs, NPL sales to public entities, and other forms of bank restructuring operations. Simulations conducted in this paper suggest that removing 1 dollar of NPLs from banks' balance sheets in the region would create, on average, space for about 50 cents of new loans. Some policy measures can amplify the effectiveness of NPL resolution strategies, such as legal and regulatory reforms meant to lower the cost and duration of contract enforcement, targeted approaches that prioritize removing legacy NPLs, tax regimes that do not discourage NPL write-offs, as well as more-specific and better-designed rules for bank restructuring and resolution.