Economic Commentary

MPC Increased Cash Reserve Ratio by 500bps to 27.5%

Summary

In our MPC Preview (See report: **Dovish stance but hawkish actions**), we had argued that the CBN's recent unusual debit of Deposit Money Banks (DMBs) with 'excessive' bids at both OMO and SMIS FX auctions could result in the institutionalization of a higher CRR this year. The Monetary Policy Committee at its first meeting of the year raised the CRR by 500bps to 27.5%, while maintaining other variables (MPR at 13.5%, Liquidity Ratio at 30% and asymmetric corridor at +200/-500bps around the MPR).

While this should result in additional 5% CRR debit across banks, it is still unclear if the current effective CRR will be taking into account when debiting banks. With total banking sector local currency deposits of ₦16.6 trillion, we estimate additional CRR charge of ₦831 billion. However, as system liquidity currently stands at ₦435 billion, we do not rule out the liquidation of some banks' bills to fund the excess. Accordingly, we expect short term adjustment in interbank rates before further moderation on liquidity surfeit in the coming weeks. However, we do not see a likely repricing of loans across the banking sector given the limit created by the LDR policy and the short-term nature of this spike.

The MPC Justification for CRR Increase

According to the CBN Governor, 9 members out of 12 voted to increase the CRR by 500bps to 27.5%. The committee's argument largely focused on the impact of the exclusion of the nonbank financial institutions and individuals from investing in OMO securities and the impact maturing OMO securities attributed to these class of investors could have on the overall system liquidity. The committee stated that the increase in CRR would help combat possible monetary induced inflation while retaining the benefits of the CBN's loan to deposit ratio policy.

We believe the policy will help the CBN achieve two goals: 1) reduce cost of liquidity mop-up within the banking system and; 2) combat possible foreign currency speculation induced by the impending liquidity. While we believe the policy is counterintuitive and could increase banks' CRR weighted average cost of funds, the materially lower rates will largely mute the possible repricing of loans as banks scout to meet the LDR limit to avoid further sterilisation of funds as CRR. Also, with banks cautious of possible debits when bidding for FX, we see CBN achieving some control and limiting possible FX speculations.

Muted impact on rates in the medium term, but liquidity will remain buoyant

In our NOVA Economic Outlook (NEO) H1 2020 (See report: **NOVA Economic Outlook H1 2020**), we had estimated prior to the restriction of corporates and individuals from participating in OMO (effective 23 October 2019), corporate and individual holdings represented 43% of total OMO securities.

Also, we stated that out of the OMO holdings prior to the restriction, a total of ₦9.83 trillion is due for maturity in 2020, with ₦7.16 trillion due for maturity in H1 2020. We believe this number signifies another sizeable increase in system liquidity over H1 2020. As such, we expressed our concerns over maturing holdings by corporate and individual which are not eligible for a rollover. For context, overlaying the percentage holding on the maturity, we estimated corporate and induvial holding of maturing OMO bills at ₦4.2 trillion over 2020, with ~73% due in the first half of the year.

By our estimate, assuming all maturing OMO securities by corporates and individuals are deposited with DMBs, and the apex bank conducts OMO auction to mop-up the liquidity, even with a rate moderation by 200bps, we estimate the cost of mop-up by the apex bank at ₦521 billion. However, a CRR charge of 27.5% reduces the cost to ₦487 billion, which is still sizeable and suggests further unusual debit of banks bidding excessively at OMO and FX auctions. As mentioned above, with the LDR policy likely to limit the impact of the higher CRR on loan rates and further depression in rates with the influx of maturities, we do not see a transmission impact to higher rates both for fixed income securities and money market rates in the medium term. However, we expect short term adjustment in interbank rates before further moderation on liquidity surfeit in the coming weeks.

On liquidity, with the expected maturities largely dominating the NTB, Bond and corporate instruments, we see further crunch in yields, at least for the rest of over H1 2020 wherein the maturities are dominant. However, if FX pressure intensifies (due to an unexpected decline in crude oil prices), we do not rule out an upward adjustment in the OMO rates to make it more attractive for foreign portfolio investors given the sizeable liquidity at the NTB compared to OMO. As it stands, the higher than expected foreign portfolio inflows so far in January, with CBN now a net buyer at the Investors and Exporters Window, will further allow for lower OMO rates in the interim.

Some Information from the Communique

- The banking system non-Performing loans (NPLs) ratio improved from 6.6% in October to 6.1% in December 2019.
- Over the last six months, aggregate credit grew by N2.0 trillion. Sectoral distribution of credit between May 2019 and December 2019 are as follows: manufacturing (₦446.44 billion), General Retail and Consumer (₦419.02 billion), General Commerce (₦248.48 billion), Agriculture, Forestry and Fishing (₦160.94 billion), Information and Communications (₦156.47 billion), Finance and Insurance (₦129.87 billion), Construction (₦86.54 billion), and Transportation and Storage and (₦68.61 billion), amongst others.