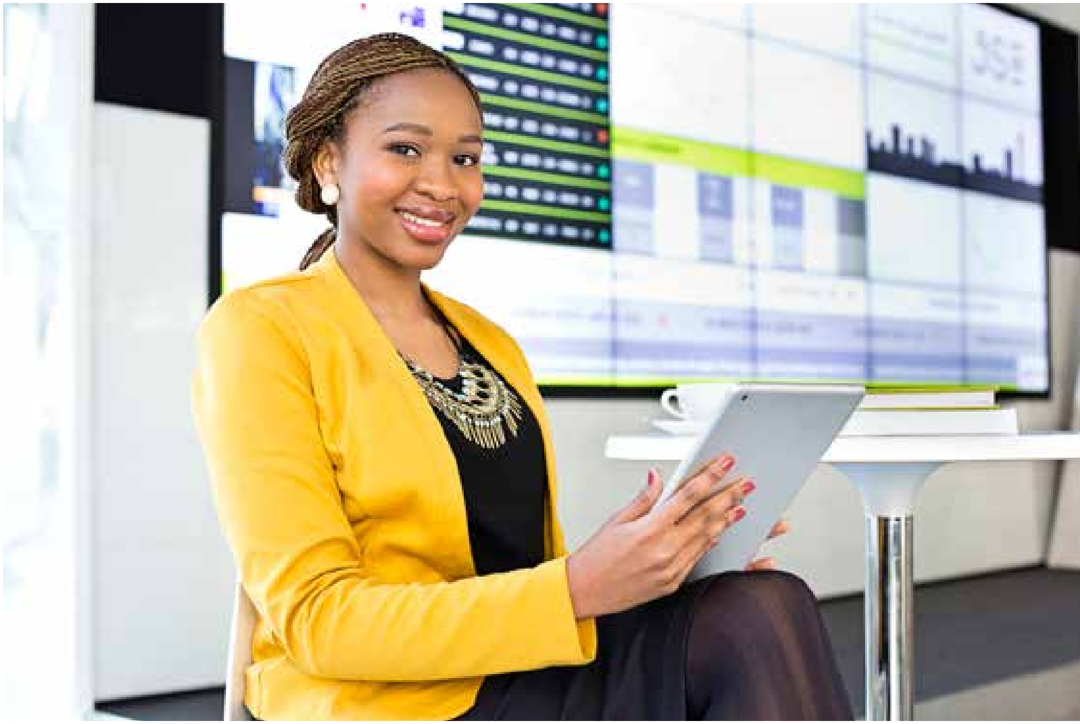
Navigating a volatile landscape

Major banks analysis – South Africa



PwC analysis of major banks' results for the reporting period ended 31 December 2014

March 2015

pwc

www.pwc.co.za/banking

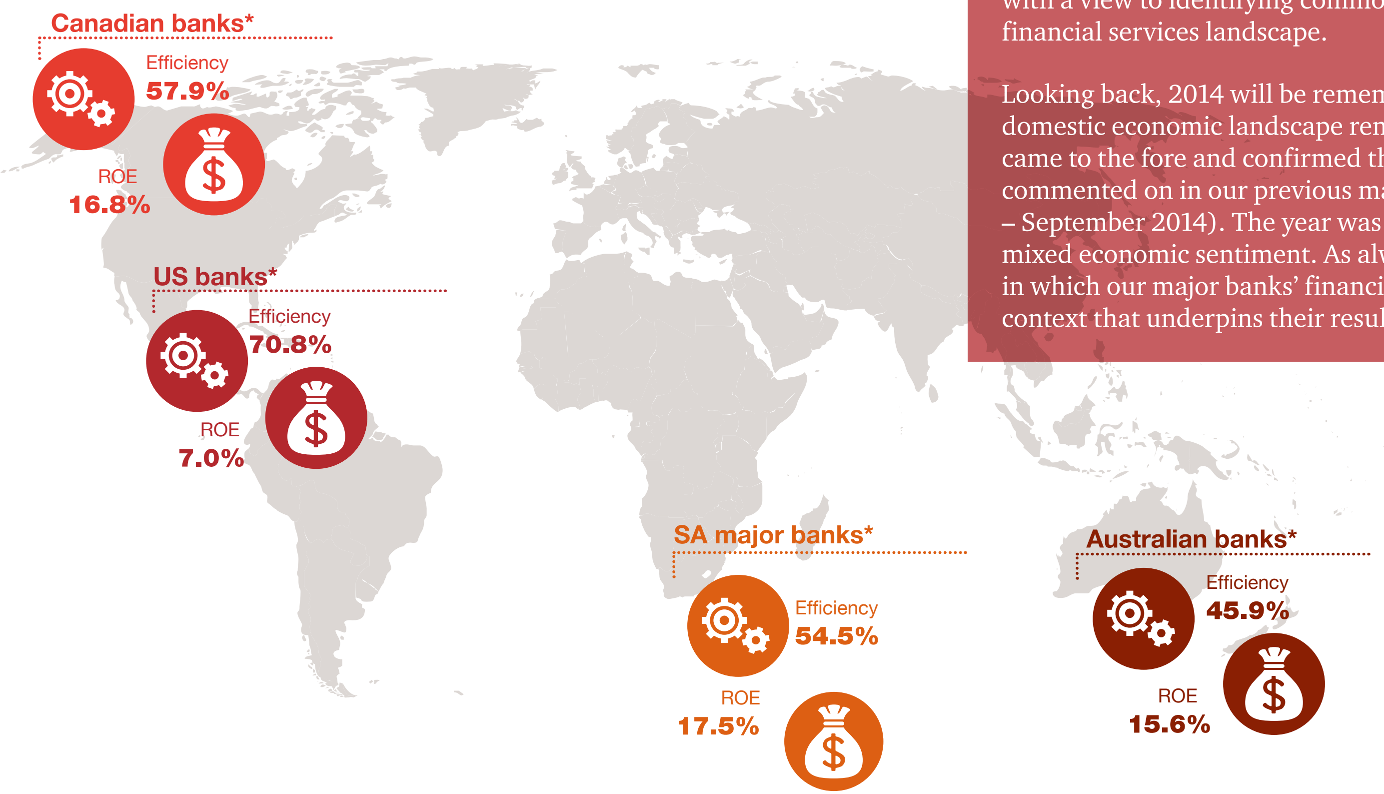
Contents

1. *The big picture*

Combined results overview

This analysis presents the combined local currency results of South Africa's major banks (Barclays Africa Group, FirstRand, Nedbank and Standard Bank). This analysis is unique in that it aims to aggregate the results of the major banks, with a view to identifying common trends and issues currently shaping the financial services landscape.

Looking back, 2014 will be remembered as a year in which the global and domestic economic landscape remained difficult to navigate. Various factors came to the fore and confirmed the level of heightened forecast risk that we commented on in our previous major banks analysis (Stability amid uncertainty – September 2014). The year was characterised by volatility, uncertainty and mixed economic sentiment. As always, the economic and operating environment in which our major banks' financial results have been achieved provides the context that underpins their results.



SA major banks at a glance*

*Combined headline earnings up **8.5%**

*Total operating income up **10%**

*Bad debt expenses up **0.4%**

*Operating expenses up **6.8%**

***Analysis of the major banks in these territories conducted by PwC**

While macroeconomic factors matter more than ever, the banking industry, both locally and globally, now finds itself firmly in the grasp of a rapidly changing world. In challenging and uncertain economic conditions, customer expectations continue to evolve and intersect with new technologies – requiring banks to focus harder on decisions associated with their channels, cultures and operations to meet changing customer needs. In parallel, the global banking regulatory landscape has continued to see a raft of new proposals being issued for comment, while regulators further develop their supervisory approaches and place renewed focus on market conduct practices. Taken together, the far-reaching regulatory reform agenda now has very real implications for the strategic and operational decisions that need to be captured as part of banks' responses, which we unpack in further detail in the Capital and Funding section of this publication.

Alongside these industry developments, we believe that culture within financial services firms is an increasingly decisive variable that will rise in prominence in setting bank strategy for the future. From sharper customer-centricity to more assured control over risk, a winning culture can deliver distinctive competitive advantages. We summarise our global thinking on this important topic in the section entitled Forging a winning culture.

"According to our 18th Annual Global CEO Survey, new risks are emerging that are directly impacting banking executives:

79%

of BCM CEOs see cyber risk,

78%

see geo-political uncertainty and

65%

see social instability as threats to growth."

PwC's 18th Annual Global CEO Survey
Key findings in the banking and capital markets industry

A key macroeconomic issue that contributed to economic volatility during 2014 was the potential implications of geopolitical events in parts of Eastern Europe and Asia – particularly the situation in Russia and Ukraine, as well as ongoing conflict in the Middle East. There is always a risk that these problems could escalate further, raising risk premiums in international financial markets with adverse knock-on effects on various economies. Moreover, continued uncertainty persists about both the timing and pace of rising interest rates in the world's largest economy, the US, and the further implications of this for monetary policy decisions in emerging markets. Additionally, doubts over the success of the recently expanded quantitative easing (QE) programme in the eurozone remain. At the same time, new questions about Greece's future, and potential contagion in the region, are now back on the international economic agenda following recent negotiations on amendments to the terms of Greece's bailout programme. Each of these factors adds to macroeconomic uncertainty that, in turn, impact cross-border trade and capital flows, and weigh on general investor sentiment.

One of the major surprises of 2014 came during the latter half of the year when global oil prices began to plunge. This prompted many commentators to re-evaluate the significant successes seen across Africa in oil and gas exploration over the last decade and re-think the sustainability of the oil boom on the continent. From the perspective of the domestic banking industry, the rapid price decline in the market prompted our banks to look deeply at their oil and gas exposures, both direct and indirect, and consider their implications on provisioning strategies. All of the major banks have commented on the fact that they believe that their exposures in this area are adequately provided for.

Our global research[1] shows that GDP growth in the eurozone, one of South Africa's key export markets, has followed a familiar trend. After disappointing growth in the middle of 2014, the engine room of the region, Germany, bounced back to post quarter-on-quarter growth of 0.7% in the final quarter of the year. However, consistent with recent form, the other two core economies lagged far behind – with the French economy growing by 0.1%, while Italian growth was flat. This year, we expect the eurozone to be buoyed by low oil prices, a weak euro and the European Central Bank's (ECB) expanded QE programme – combining to provide our projected eurozone growth of 1.2% for 2015.

While the US recovery continues at a healthy pace, China and India are also still growing strongly, although the significant growth rates seen in these two countries in recent years have slowed. Given the recent developments in commodity prices, a low oil price could boost manufacturing output in the eurozone, Japan and the US. Our main scenario assumption is that the oil price will average around \$55 per barrel in 2015, which is around 50% lower than in June 2014. This is generally expected to have a positive impact on the output of the major net oil importing economies like the eurozone, Japan and the US. However, the effects of a low oil price will not be felt evenly across different sectors of the economy, both locally and globally. Some large corporations may not feel the benefits straight away due to having hedged against higher oil prices or being bound by long-term contracts with their suppliers. Households may also have to wait for oil price cuts to be passed down the supply chain to consumers. Domestically, the effects of a lower oil price will be offset by higher fuel levies set to be imposed on the local consumer.

As the advanced economies continue to adapt to a changing macroeconomic landscape that is difficult to forecast with any sound measure of certainty, there are divergent views on monetary policy accommodation that will be taken by certain key central banks. This will continue to result in emerging market headwinds through expected higher future global interest rates and ongoing periods of volatility in capital flows, particularly for economies like South Africa, which are largely dependent on international trade and capital flows to fund domestic deficits.

To provide a sense of scale to these global monetary policy trends, it is worth noting that the ECB has announced plans to carry out an expanded QE programme, involving the purchase of government bonds. Specifically, the ECB is expected to boost its balance sheet by €60 billion per month beginning in March 2015 and extending until at least September 2016. If the programme finishes in September 2016, it will have increased the ECB's balance sheet by over €1 trillion. We expect QE to provide some boost to economic growth prospects in the short term, but without structural reforms it will not raise the longer-term growth potential of the eurozone economy. Across the Atlantic, in the US, where QE is in the process of unwinding, most market commentators are anticipating an interest rate increase to happen in the second half of 2015.

[1] PwC Global Economy Watch – February and March 2015

Domestically, the rand exchange rate witnessed a cycle of significant volatility during 2014. Although some exchange rate volatility can be attributed to adjusting expectations of the timing of the first US interest rate increase since the global financial crisis, unique domestic factors also contributed. Specifically, these included continually weak economic growth projections, energy supply concerns, sizeable deficits on both the current and fiscal accounts, and actions by some credit rating agencies to revise the country's external credit ratings and outlook.

In addition to currency volatility, South Africa's economic and business environment remained challenging in 2014 with a number of structural concerns raising external negative perceptions of the country's economic prospects.

The year was characterised by significant energy supply concerns and periods of protracted labour unrest in key output sectors of the economy. Despite a relatively positive fourth quarter, with quarterly GDP growth recorded at 4.1% following a lacklustre 1.4% in the third quarter, broad concerns about the domestic economy performing significantly below its potential persist. This theme continued into 2015 with local business confidence falling marginally in the first quarter of the year on the back of energy supply constraints counteracting the benefit from lower oil prices[2].

2 The RMB/BER business confidence index (BCI) fell by two points to 49 the first quarter of 2015

Major banks' performance

It is against the backdrop of this complex and challenging operating environment that the major banks have posted admirable results for the current period under review. Collectively, the banks reported a combined increase of 8.5% in headline earnings against the comparable period to reach R30.0bn. The key contributors to headline earnings growth continue to be strong with net interest income growth of 13.2%, non-interest revenue growth of 6.6% and stable impairment charges that amounted to a relatively flat 0.4% increase against 2H13. When compared to the first six months of the year, the combined impairment charge of the major banks fell by 13.6%, reflecting focused risk management, workout and collection efforts across the banks.

While revenue growth remains a strategic objective for all of the major banks, not all of them succeeded to the same extent in growing revenue at a rate faster than cost growth during 2014.

Asset quality

Muted growth in gross loans and advances continues to reflect both the focused approach adopted by the major banks to the quality of credit written and constrained credit appetite by consumers in the context of challenging domestic economic conditions. Gross loans and advances grew 3.0% for the six months to December 2014, similar to the growth of 3.0% noted in the first half of the year. Consistent with our observations for the six months to June 2014, growth in gross loans and advances continues to be stronger in the corporate and investment banking sector than the retail sector.

From a credit quality perspective, all of the major banks continue to highlight their decisions taken in previous years to adopt a more risk-focused approach to the origination of high-risk portfolios, while continuing to provision appropriately and adequately price for the higher levels of risk inherent in these portfolios. These efforts have favourably impacted the major banks' results in the current period.

Combined non-performing loans (NPLs) fell 2.4% against the first half of the year, and 1.1% against 2H13. The increased quality of credit portfolios and the impact of stringent collection strategies have resulted in combined credit impairments falling for the six months to December 2014, but increasing marginally when compared against December 2013. However, there are certain idiosyncratic and bank-specific factors driving the year on year increase which we unpack further in the Asset Quality section of our analysis.

While impairment charges for three of the four major banks decreased during 2014 compared to 2013, one bank saw an increase in impairment charges as a result of management increasing provisions.

Net interest income

From a net interest income perspective, the benefit of increased endowment impact continued to favour margins as a result of a further 25 basis point increase in the repo rate by the South African Reserve Bank (SARB) in September 2014, on the back of two 25 basis point increases in the first half of the year. While balance sheet portfolio changes continue to reflect individual strategic decisions, the banks' combined net interest margin improved by 17 basis points against 2H13 to 4.64%. This is an admirable achievement in light of the fact that asset margins have been under pressure as lower-yielding wholesale advances grew faster than more margin-favourable retail advances. While expectations for increasing interest rates are dependent on a range of macroeconomic factors, the banks continue to position hedging strategies to reflect expectations of a flat or upward trending rate cycle.

Non-interest revenue

Non-interest revenue (NIR) continues to show underlying drivers consistent with those reported previously. While NIR growth remains driven by net fee and commission income, we still see strategic focus being placed on growing the asset management and wealth franchises of the major banks. Ongoing efforts to migrate customers to electronic and mobile channels continue to positively impact electronic transactional volumes in both the retail and corporate transactional banking sectors. However, intense pricing competition in transactional banking continues to counteract the direct increase in revenues that would otherwise have been experienced given the growth in volumes. Looking ahead, the revised card interchange rates, which came into effect in mid-March 2015, are expected to present additional pressure on net fee and commission income from this important product stream.

Ongoing efforts to migrate customers to electronic and mobile channels continue to positively impact electronic transactional volumes in both the retail and corporate transactional banking sectors. However, intense pricing competition in transactional banking continues to counteract the direct increase in revenues that would otherwise have been experienced given the growth in volumes.

Additional key features driving growth in non-interest revenue include:

- Net fee and commission income grew by 6.2% when compared to 2H13 but by 8.4% against 1H14. While still reflecting positive growth, these figures illustrate the highly competitive transactional banking environment in South Africa, across both the retail and corporate sectors. It is evident that regulatory pressure continues to result in the banks realigning their strategic priorities and seeking to make the most of the attractiveness of the transactional banking environment in South Africa;

- Trading income showed a reversal in the lacklustre growth seen in previous periods, and grew by 7.3% against 2H13. Given current financial market volatility and mixed macroeconomic landscape, this is an admirable trading performance. Interestingly, we continue to note the positive impact of realisations of private equity investments for FirstRand; and

- Revenue from wealth management products and bancassurance continues to show a very positive growth trend, boosted by the non-occurrence of high weather-related claims seen during the first half of the year. While a number of the banks are increasing their focus on growing revenues from their wealth and asset management franchises, the implications of the Retail Distribution Review (RDR) will impact on fee income in this sector.

Efficiency

Cost containment remains an important focus for the banks, while they continue to invest in human capital and enhancement of their IT capabilities to respond to customer demands, heightened concern over cybercrime and regulatory requirements. However, the paths taken by the major banks to respond to the IT challenge diverge and the related impact on their cost bases remains an interesting differentiating factor. The benefit of the focus on costs has been seen in the improvement of the banks' combined cost-to-income ratio to 54.5%, compared to 56.6% in 2H13. As they continue to expand across Africa, the negative impact of dollar-based costs in a weak rand environment will continue to place pressure on operating costs.

Capital and funding

Divergence in return on equity (ROE) levels remains a continuing theme that we have observed in the current reporting period. While maintaining or improving ROE levels remains a priority for all of the major banks, the combined ROE of 17.5% remained flat compared to 2H13. This reflects admirably on the diverse earnings pools and through-the-cycle resilience of the banks given their strong and established franchises.

The impact of higher capital requirements being phased in under Basel III has continued to influence regulatory capital levels in line with expectations. Consequently, the combined capital adequacy ratio of the major banks of 15.3% (15.9% at 2H13 and 15.4% at 1H14) reflect solid capital buffers and the prudent approach to capital management taken by them over the years. Capital generation on the back of organic earnings growth has continued to assist the banks in maintaining strong levels of capital adequacy and, together with a continued focus on risk-weighted assets optimisation, results in all of the banks being comfortably in compliance with minimum required capital ratios.

Stakeholder expectations

During 2014, the South African banking sector was tested by the curatorship of African Bank Limited (ABL), a significant unsecured lender in the domestic banking industry. To maintain the stability of the domestic banking system, the SARB instituted a number of support measures, including placing ABL under curatorship.

However, we understand that there has been repricing in the market of debt issuances since ABL was placed under curatorship. The combined strength of the banking system ensured that the crisis has been managed.

The regulatory trend globally continues to reflect elevated levels of supervisory attention being placed on banks' compliance and market conduct activities, with a number of large, internationally active banks having been subject to high-profile penalties in 2014. Considering South Africa's move to a Twin Peaks model of financial regulation, it is expected that rigorous application of market conduct supervision of banks will continue to gain in intensity.

Consistent with increasing regulatory scrutiny of compliance and market conduct activities, the SARB has also highlighted the importance of robust anti-money laundering and countering the financing of terrorism (AML/CFT) controls through penalty action taken early in 2014 against all the major banks. All the banks have since been engaged in efforts to strengthen these controls, including compliance capabilities more broadly.

Internal responses

Innovation within the major banks continues to be a strategic lever driving both volumes and values. All of the banks continue to place customer centricity at the heart of their innovation strategies to enhance their channel and product offerings in response to an increasingly electronic and mobile consumer – across both the retail and corporate sectors.

"93%

of BCM CEOs see mobile technologies as important, more than the cross-industry average of

81%"

PwC's 18th Annual Global CEO Survey
Key findings in the banking and capital markets industry

Enhancing IT architecture and systems remains high on the strategic agenda of the major banks as they gear up to realise future growth expectations. At the same time, external and broader stakeholder groupings continue to influence banks' focus on IT systems. Sophisticated and dangerous developments in cybercrime in the recent past have added to a growing global concern around bank vulnerabilities to potential cyberattacks and have escalated IT resilience to the top of the boardroom agenda. At the same time, regulators across the globe are focusing on banks' IT architecture and principles around IT governance, with a considered focus on ensuring high-quality risk data is produced to the same degree of reliability as financial reporting data.

Rapid advancements in data interrogation and analytical technologies will continue to present a range of opportunities for banks that can leverage sufficiently granular data into actionable insight to make more informed strategic decisions and better predict customer expectations, while responding to changing customer needs.

Similarly to our observations in previous periods, the major banks' December 2014 results presentations reaffirmed their commitment to significantly expanding their footprint, product and customer capabilities in African markets beyond South Africa. While individual bank strategies remain nuanced, the stated objective of enhancing and diversifying earnings' contribution from their operations across the continent remains a central strategy.

Domestically, concerns around electricity supply constraints in South Africa will also weigh on bank strategy in the short to medium term, as power outages also impact our banks' ability to maintain operations and serve their customers. Appropriately responding to these challenges will also consume management time and attention.

Prospects

Given the relatively sustained performance of the US economy in recent quarters, market speculation about when the Federal Reserve will raise interest rates continues. Most analysts expect this to happen in the second half of 2015, particularly given that the Federal Open Market Committee has dropped the term 'patient' from its forward guidance statement.

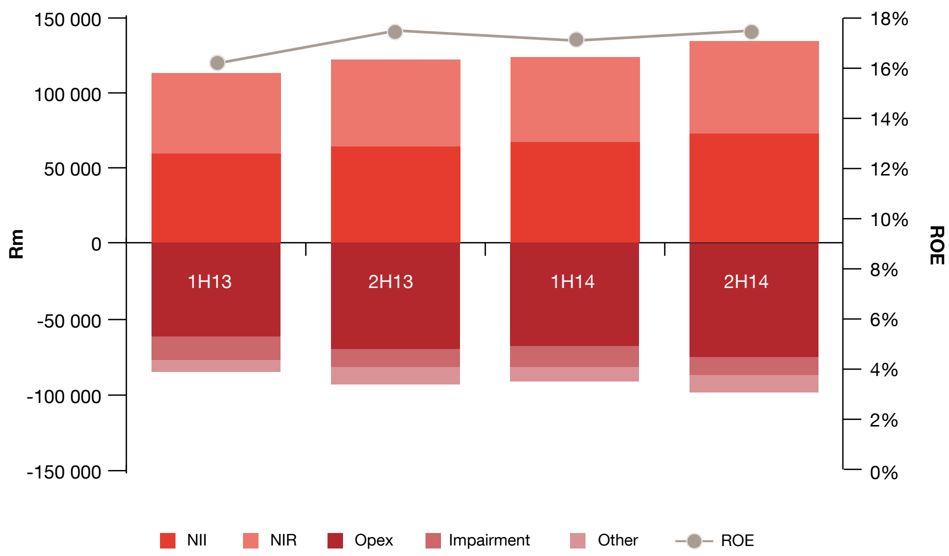
The prospect of interest rate hikes in the US will have important implications for the South African economy. In particular, higher interest rates in the US would likely add to the current rand/dollar weakness and directly contribute to inflationary pressures. Given expectations for higher fuel prices and possible acceleration in food inflation as a result of maize shortages in South Africa, the inflationary outlook will continue to trend on the upside. Consequently, market expectation will be that the SARB will act to arrest domestic inflationary concerns through a possible increase in the repo rate from its current level of 5.75% in the second half of 2015. An upward trend in the interest rate cycle, in turn, will influence bank profitability and provisioning strategies as even a modest upward turn in rates will be expected to place further strain on South African households and increase debt service costs for consumers with already high debt-to-income ratios.

Diversifying the earnings' contributions from the banks' operations outside South Africa will continue to be a strategic focus area for all of the banks, though each will look to execute on these ambitions in different ways. Domestically, our major banks continue to benefit from strong franchises, diverse earnings pools, prudent provisioning and strong levels of capital adequacy. However, all of the major banks emphasised a cautiously optimistic outlook for their short-term prospects, as heightened forecast risk and uncertainty will continue to characterise the global and domestic economic environment over the short to medium term.

Combined results for six-month periods (Rm)

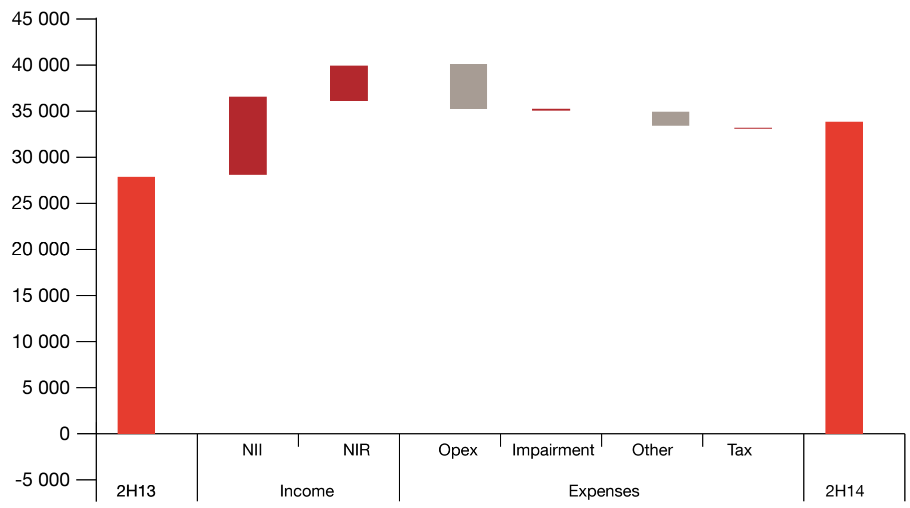
	2H14	1H14	2H13	1H13	2H14 vs 1H14	2H14 vs 2H13
Net interest income	72 740	67 091	64 277	59 374	8.4%	13.2%
Non-interest revenue	61 812	56 975	57 995	53 936	8.5%	6.6%
Total operating income	134 552	124 066	122 272	113 310	8.5%	10.0%
Total operating expenses	-76 853	-69 964	-71 985	-63 738	9.8%	6.8%
Core earnings	57 699	54 102	50 287	49 572	6.6%	14.7%
Impairment charge	-12 038	-13 927	-11 985	-15 413	-13.6%	0.4%
Other income/(expenses)	2 224	998	1 008	851	>100%	>100%
Discontinued operations	-2 713	-1 032	–	–		
Income tax expenses	-11 318	-9 676	-11 415	-8 151	17.0%	-0.8%
Profit for the period	33 854	30 465	27 895	26 859	11.1%	21.4%
Attributable earnings	31 191	27 448	27 784	24 268	13.6%	12.3%
Headline earnings	29 984	27 826	27 642	24 612	7.8%	8.5%
Return on equity	17.5%	17.1%	17.5%	16.2%	0.4%	–

Figure 1.1 Combined income statement of the major banks



Source: PwC analysis

Figure 1.2 Key drivers of combined profit and loss



Source: PwC analysis

2. Economic outlook

By Dr Roelof Botha, economic advisor to PwC

Financial sector continues to perform

In 2014 the economic sector relating to finance, real estate and business services consolidated its position as the largest contributor to the country's GDP, commanding an impressive 20.6% share of total value added in the economy.

At the turn of the century, this share was 18.6%. In the process, South Africa is gradually approaching the status of a post-industrial emerging market economy. Since 2000, the share of the tertiary sectors of economic activity has increased from 64.9% to 68.1%.

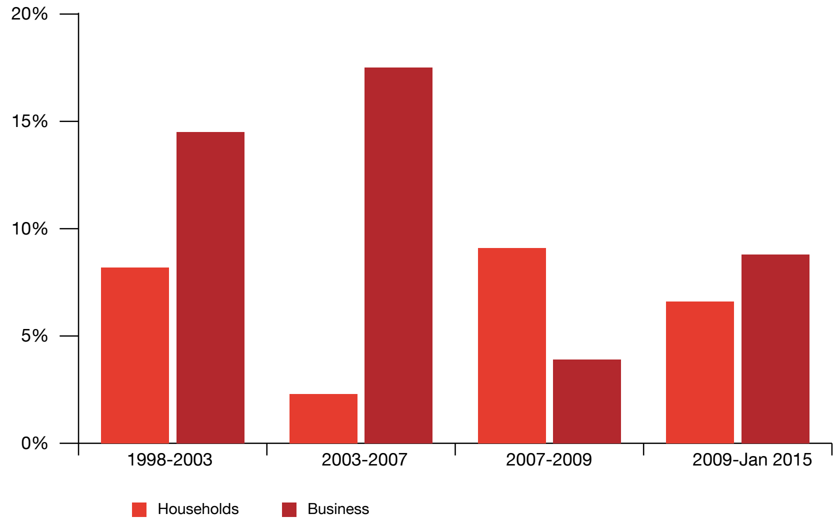
Despite a below-par GDP growth rate of only 1.5% in 2014, the financial sector recorded an exceptional performance, as illustrated by the following:

- Total bank assets surpassed the R4 trillion level for the first time, recording an increase over 2014 of more than 9%;
- Both long-term and short-term insurers posted record new highs for premium income received; and
- In the latest Global Competitiveness Report published by the World Economic Forum, South Africa retained a top-ten ranking for the indicator relating to soundness of banks.

Two of the key drivers behind the stellar performance of the financial and business services sector are employment growth and a renewed appetite for credit by businesses. An interesting feature of credit extension to the private sector over the past 16 years has been the divergent trend between businesses and households during different stages of the business cycle.

Negative output growth in the largest primary and secondary sectors of the economy stands in sharp contrast to sustained growth in all of the tertiary sectors, most notably transport, storage and communication.

Figure 2.1 Average annual growth rates in credit extension – households and businesses



Source: SARB, PwC analysis

Between 1998 and 2003, it became clear that South Africa was experiencing a sustained economic growth cycle. Business confidence was also buoyed by the country's first two democratic elections, which were classified as free and fair, confirming an inherently stable socio-political dispensation.

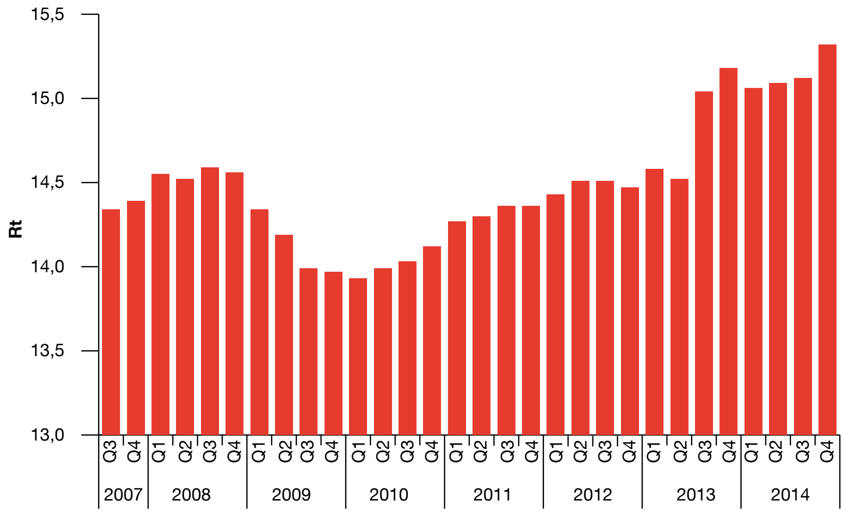
The result manifested itself in strong capital formation growth, leading to a healthy growth rate in credit extended to private business enterprises.

Muted household credit growth over this period was reversed after the first decade of democracy, averaging more than 20% per annum between 2003 and 2007. Credit extension to businesses also remained strong during this period, when the South African economy recorded real GDP growth rates of more than 5% per annum, on average.

Then came the recession and a decrease in capacity utilisation, especially in manufacturing, decimated the demand for credit in the private business sector.

Since 2009, however, credit extension to businesses has recovered to average annual growth of just below 10%, once again outperforming households.

Figure 2.2 Total employment in South Africa – continued progress after the global recession



Source: Statistics SA

The other driver of the recovery of credit extension to the private sector is employment creation, which turned the corner early in 2010, following a predictable increase in unemployment during the 2008/09 recession.

Over the past two years, almost 800 000 new jobs (both formal and informal) have been created, of which three-quarters emanated from three sectors, namely construction, trade and catering, and government services. Government has been applauded for its policies to stimulate job creation in an economy that is being hamstrung by labour unrest, infrastructure deficiencies and sluggish growth in Europe. These policies include the youth wage subsidy, which has already created more than 200 000 jobs, and the Expanded Public Works Programme.

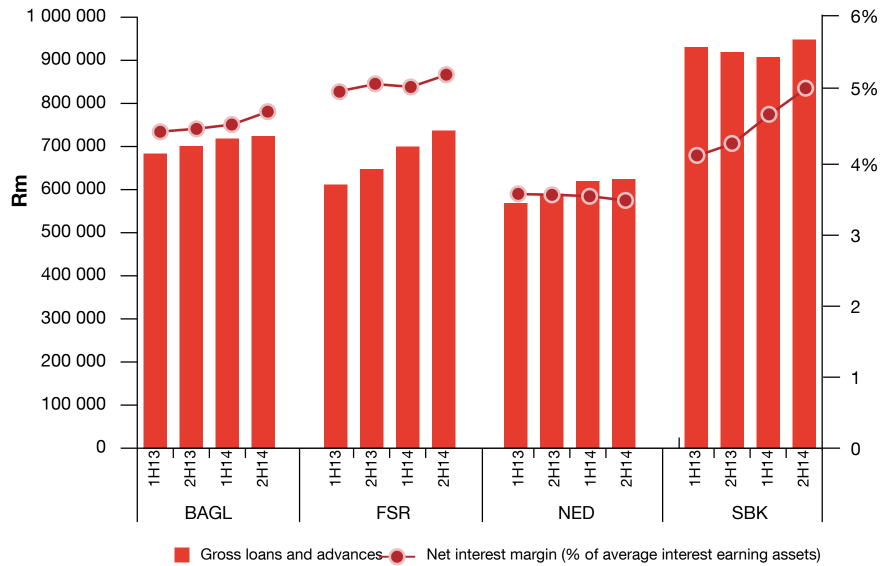
National Treasury is convinced that the economy will grow at more than 2% in 2015, a view that is shared by the International Monetary Fund. Hopefully, a modest improvement on the growth performance of 2014 will pave the way for a further improvement in 2016, possibly close to 3%.

3. Net interest income

Net interest margin (Rm)

	Combined			
	2H14	**1H14**	**2H13**	**1H13**
Gross loans and advances	3 033 571	2 945 912	2 859 262	2 795 257
Net interest margin (% of average interest earning assets)	4.64%	4.47%	4.37%	4.30%

Figure 3.1 Net interest margin and advances



Source: PwC analysis

Loans and advances growth continues, but at a moderate pace

Balance sheet mix continues to benefit NII, while the positive impact of endowment favourably influenced margins given the comparatively higher interest rate environment

However, the higher interest rate environment may potentially manifest in changes as the credit impairment cycle offsets the endowment impact on bank margins

Credit growth

Growth in loans and advances was 6.1% compared to 2H13 and 5.1% when compared to 1H14. A key driver of loan growth remains a strong contribution from corporate and wholesale advances compared to more moderate retail credit growth, consistent with the theme we have reported in our previous analyses.

Given the weak rand/dollar exchange rate, some of this growth would have been derived from the major banks' operations outside South Africa, where deals are typically written in USD, suggesting more moderate levels of growth on a constant-currency basis.

However, overall growth in net interest income is admirable when considering that lower-yielding corporate and wholesale advances grew faster than more margin-favourable retail advances.

Mortgage loans, which remain the largest credit portfolio of the major banks in absolute values relative to other portfolios, continue to show limited growth and have remained generally flat given the turn in the interest rate cycle and the economic headwinds facing the South African consumer. In addition, margins on mortgages are considerably lower when compared to other lending portfolios. This, together with the higher interest rate environment, generally uncertain outlook for the residential property market and capital intensive nature of these advances, results in a subdued outlook for mortgage lending growth over the short term.

We have also seen a continuation in the trend of strong growth in the card books which traditionally earn higher margin to compensate for increased expectations on credit impairments.

Customer deposits

Total deposits of the major banks grew 7.0% against 2H13, but grew by 4.7% when compared to 1H14.

Consistent with trends seen in previous periods, growth in deposits continue to be driven by corporate and retail deposits, which have longer tenor expectations than wholesale and institutional deposits. However, strong growth has also been seen in government deposits, which are generally subject to a range of factors that make forward-looking projections difficult.

This trend is supported by industry data, which reflects that growth in the deposits for 2H14 has materialised through corporate, government and municipality deposits, while growth in sought-after retail deposits appears to be slowing. This trend highlights the importance of maintaining strong corporate and retail transactional banking franchises as these less-capital intensive businesses maintain customer relationships and act as the primary platform for cross-sell opportunities. In the lead up to the implementation of the Net Stable Funding Ratio in 2018 the reversal of the trend of strong growth in Retail deposits in the last period is something to be monitored given the benefit to this new prudential requirement through having a large retail deposit portfolio.

Hedge portfolios

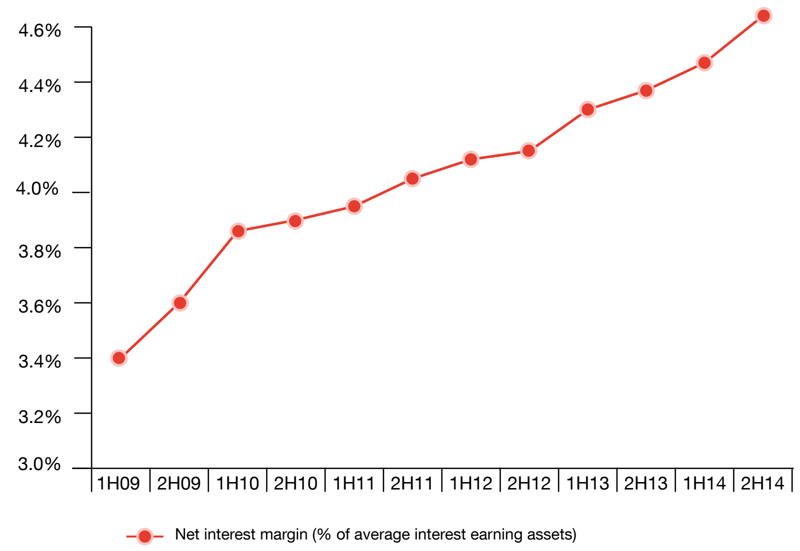
The effectiveness of hedge portfolios, designed to limit the impact of interest rate volatility, depends on the timing of the hedges, positioning against the interest rate cycle and the size of the risk hedged.

Higher South African interest rates seen in 2014 have had a positive endowment impact on margins. However, judging by the banks that disclose this information, the hedging activities have had a varied impact on margins.

Net interest margin

While the primary drivers of interest margin remain consistent with the themes reported previously, we continue to note improvements from balance sheet mix being counteracted by competitive pricing strategies. Although margins from the banks' operations outside South Africa are generally higher than those derived from domestic balance sheet activities, competition, the rate environment, macroeconomic uncertainty and regulatory change is expected to make maintaining margins at these levels difficult. As the interest cycle turns, there may be a normalisation of the trend where the net interest margin has been on a constant upward trajectory as set out in Figure 3.2.

Figure 3.2 Combined net interest margin



Source: PwC analysis

4. Non-interest revenue

NIR continues to be primarily driven by fee and commission income, which represents 71% of the total for 2H14

NIR grew 6.6% in 2H14 when compared to 2H13, and 8.5% when compared to 1H14

NIR has continued on its upward growth trajectory, although the level of growth has slowed compared to recent periods. NIR grew 6.6 % in 2H14 compared to 2H13, which is down from the highs of 9.8% experienced a year before. NIR continues to be dominated by fee and commission income, which represents 71% of the total for 2H14, consistent with the contribution as at 2H13.

An interesting development has been the significant increase in the contribution from the major banks' operations in the rest of Africa to growth in the NIR line. Although absolute contributions remain relatively small, the growth in these markets bears testimony to the successful implementation of strategies to find revenue growth outside South Africa, as it becomes increasingly more challenging to unlock growth domestically. This growth was achieved across all components of NIR, being net fee and commission income, insurance and bancassurance income, with an especially strong contribution from trading operations observed in the current period.

Net fee and commission income

Net fee and commission income grew by 6.2% when compared to 2H13, which represents a continuation of the growth trajectory seen in previous periods. Once again, this represents a remarkable outcome given the low-to-zero inflationary increases on bank charges, and highlights the considerable effort made by the banks to increase their customer bases and absolute transaction volumes. We have also seen a continuation in the trend of strong growth in credit card income, although this growth is expected to abate somewhat with the introduction of revised card interchange fees in March 2015.

Management focus has been on diversifying the net fee and commission income revenue streams across various geographical regions in Africa. This is expected to be one of the factors that will distinguish the winners in this area. An interesting development has been increased regulatory intervention recently observed in the rest of Africa on the appropriateness of fees charged to customers, as the 'treating customers fairly' ethos, which has been prevalent in South Africa for a number of years, gains traction in other territories.

Knowledge-based fee income, largely associated with investment banking advisory activities, has also continued to show resillience despite tough trading conditions.

Fair value income

Fair value income continued on the volatile trend seen in previous periods and was 7.3% up on 1H14, but flat on 2H13.

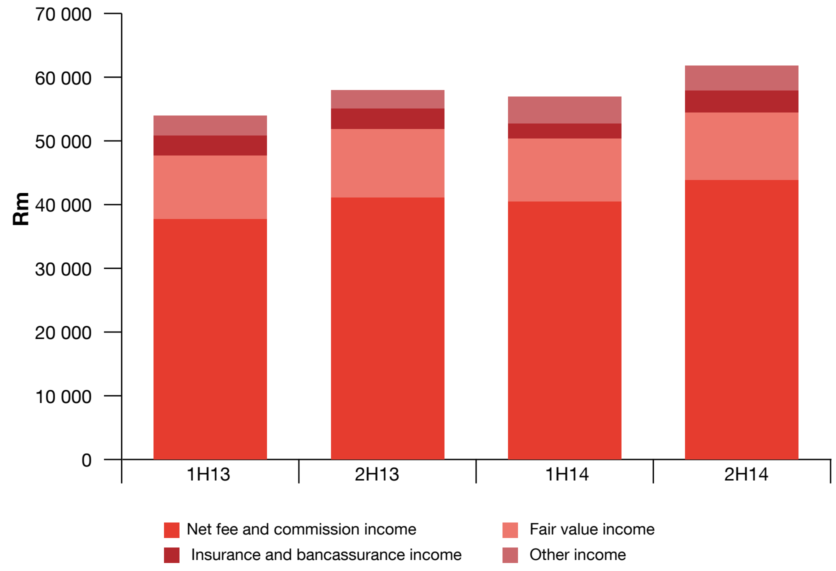
The trading environments remained challenging due to increased competition, compressed margins and lower volumes. As noted above, the contribution from trading operations in the rest of Africa has been a positive development, as the banks capitalise on the surge in cross-border trading activities and associated hedging considerations. It will be interesting to see how the drop in commodity prices and currency devaluations impact on the trading activities and associated trading revenue in 2015.

The fair value income of some banks were also favourably impacted by private equity realisations, while others recorded unfavourable revaluations on these investments.

Insurance and bancassurance income

Insurance and bancassurance income followed an upward trend and were buoyed by strong equity markets and the non-reoccurrence of weather-related claims which influenced net revenues from these activities in 1H14. Overall, this line item grew by 42.4% on 1H14 and 7.1% on 2H13.

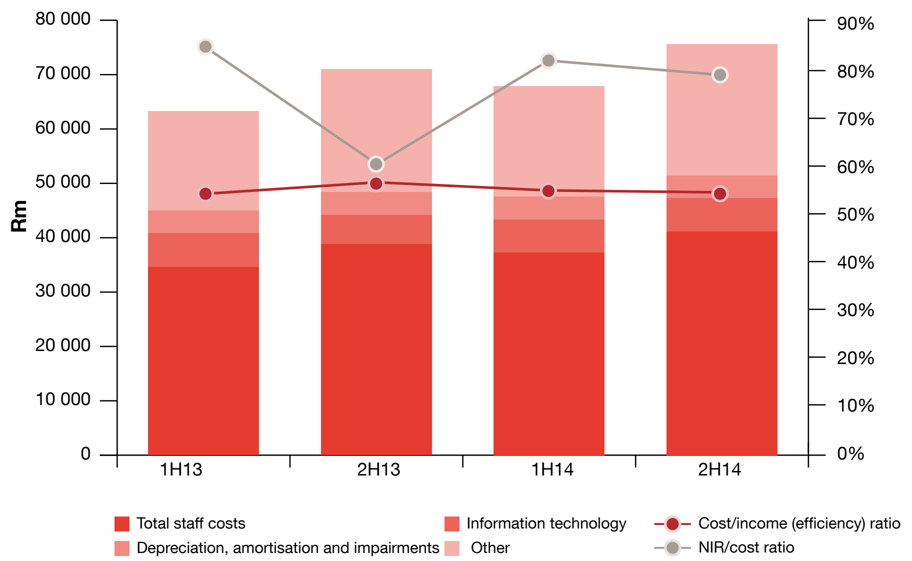
Figure 4.1 Non-interest revenue



Source: PwC analysis

5. Efficiency

Figure 5.1 Operating expenditure



Source: PwC analysis

Combined total operating expenses increased 6.8% on 2H13, while total operating income increased 10%. Consequently, the combined cost-to-income ratio improved to 54.5 % in 2H14 (2H13: 56.6%)

Cost containment strategies, which have been in place for a number of years, continue to be an important strategic lever as achieving robust revenue growth remains challenging

Sizeable investments in information technology and adapting the retail banking franchises and physical branch networks towards the 'branch of the future'

Exchange rate volatility and the weak rand remain a drag on the expense base

The major banks have once again successfully delivered on their cost management strategies with the combined cost-to-income ratio improving to 54.5% in 2H14 from 56.6 % in 2H13. This ratio has continued on its downward trend from the highs of 59% in 2H11, as banks intensify their efforts to manage costs effectively and improve revenue performance.

In the short term we expect further pressure on this ratio as the major banks invest now for the future. A few areas where increased costs may manifest are:

- Initiatives to rightsize branch networks and consolidate branches, coupled with increased costs to build out a branch network that is fit for the future.
- Initiatives to invest in the rest of Africa where significant investment is currently being made in infrastructure/IT systems. The general inflationary environment outside South Africa is generally higher compared to that of South Africa. The average rand/dollar rate weakened from R10.06 in 2H13 to R10.98 in 2H14, which places additional pressure on the cost line for imported IT services.
- The major banks have commented that they are making significant investments in IT systems to cater to increased regulatory requirements and heightened customer expectations of seamless transactional banking and treasury solutions. Increased amortisation charges as these systems come online could also negatively impact the cost line.

Salary costs continue to be the most significant contributor to the cost line at around 54% and have remained stable for the last couple of periods. These salary costs reflect annual salary increases as well as increased short- and long-term incentive awards associated with the banks' improved operating performances, as reflected in the 37% growth of the Banks Index over the last two years. Offsetting growth in variable salary costs, tight headcount management continues to be a priority for management teams. This, however, continues to be balanced with the need for ongoing investment in human resources and talent in the rest of Africa.

Maintaining cost-to-income ratios at the current levels is expected to become increasingly challenging in the medium term. The headwinds faced in the form of currency weakness and the need to transform the branch networks and IT platforms will continue to place pressure on costs. In the long run, these transformational initiatives are, however, expected to be critical business enablers and a strategic imperative.

6. Asset quality

Asset quality (Rm)

	Combined			
	2H14	1H14	2H13	1H13
Gross loans and advances	3 033 571	2 945 912	2 859 262	2 795 257
Non-performing loans	91 690	93 923	92 714	99 331
Impairments	-60 926	-62 015	-59 764	-58 277
Portfolio provisions	-21 602	-21 019	-19 418	-17 690
Specific provisions	-39 324	-40 996	-40 346	-40 587

Gross loans and advances

Combined loans and advances of the major banks grew by 3.0% in 2H14 compared to 1H14 and by 6.1% on a year-on-year basis. This reflects flat growth when compared against previous growth rates of 3.0% in the first half of 2014 against 2H13, but slower when compared to the 10.4% annual growth seen in December 2013.

The lacklustre levels of combined loan growth measured across the major banks continues to reflect the difficult and uncertain operating environment faced by households and corporates during 2014, as well as the impact of macroeconomic and structural economic weaknesses negatively affecting business confidence.

Corporate lending

Consistent with the trend we have observed previously and the outlook we put forward in our previous major banks analysis, growth in corporate lending continues to outpace retail lending and grew by 6.7% in the six months to 2H14 compared to marginal growth of 1.6% across all retail portfolios for the same period.

Key product drivers of growth in corporate and wholesale lending for the current period were strong demand for corporate overdrafts, term lending products and demand for credit from corporates in the rest of Africa. As a weaker rand prevailed throughout 2014, increasing the value of import transactions as well as corporate holdings of inventory, appetite for commercial trade finance products (including letters of credit and trade guarantees) continues to reflect healthy levels of growth and underpins other on-balance sheet corporate lending activity such as discounted letters of credit. In addition, continued activity related to renewable energy projects in which all of the major banks have participated has also assisted corporate deal flows.

Looking forward, various economic factors may impede corporate business activity and negatively influence corporate credit demand. A less than optimistic corporate outlook as a result of challenging economic conditions may constrain banks' ability to originate new corporate lending deals at the rate seen in previous years. In particular, the impact of the lower oil price is expected to have mixed implications for various sectors of the economy, with those on the supply side of the oil continuum likely to be negatively impacted as a result of a drop-off in expected revenues, while those on the demand side may benefit from lower unit and other input costs. Consequently, the outlook for corporate lending is less favourable than it was six months ago given the economic headwinds and levels of uncertainty prevalent in the macro and domestic economic landscape.

Retail mortgages

Industry data (see figure 6.3) suggests that the domestic residential property market grew in 2014 at a rate higher than consumer price inflation (CPI). As shown in the figure below, while retail mortgages continues to comprise among the most sizable of loan portfolios for our major banks given the focus placed in this product category in previous years during South African housing booms, the composition of retail mortgages as a percentage of total loan portfolios have been consistently decreasing in recent periods. At 2H14, retail mortgages comprised 29% of the total loan portfolio of the major banks, compared to 31% a year ago and 35% three years ago. While industry mortgages appear to still be reflecting positive growth, our analysis suggests that loan growth in this portfolio is likely originating from other players in the South African financial services industry, given that loan growth for the major banks continues to reflect the downward trend seen previously. Retail mortgages grew by only 0.9% in the six months to December 2014, and just 1.6% on an annualised basis.

Industry data for 2014 continues to show that accelerated capital repayments on mortgage advances – which have partly been contributing to the moderate growth in net mortgage advances over the past three years – slowed during 2014. As we have commented in our previous major banks analysis, the slowdown in the trend of early capital repayments on mortgages can be considered expected, given the upturn in the domestic interest rate cycle during 2014 prompting some caution on the part of South African consumers.

Looking ahead, market commentary suggests subdued consumer demand for retail mortgages is expected to continue as consumers are likely to be reluctant to enter into long term loan agreements given higher inflation expectations, the upward trending interest rate cycle, fragile levels of household debt as a percentage of disposable income while real-wage growth prospects within the South African economy is expected to remain muted. At the same time, with demand for retail mortgages expected to be challenging, the low levels of margin typically associated with mortgage lending and the still high stock of non-performing loans (NPLs) in absolute terms, incentives for the supply side are also constrained as banks will look to rather deploy capital in more strategic and potentially higher margin-earning lending areas.

Instalment sale credit, card debtors and other unsecured lending

Healthy growth in card debtors continued, with this product category showing growth of 5.7% for the six months to 2H14 and 13.2% on an annual basis. This was, however, partially offset by a slight slowdown in instalment sale credit and finance leases which grew by 5.3% for the six months to 2H14, and 10.8% against 2H13 (compared to 5.2% for the first six months of the year to 1H14 and 14.2% year-on-year growth seen between 2H13 and 2H12).

These loan categories are highly sensitive to even modest increases in the interest rate cycle, and therefore the growth trends seen in the current period are reflective of the higher rate environment experienced during 2014.

According to the National Association of Automobile Manufacturers of South Africa (NAAMSA), 2014 was noted to be a difficult year for the domestic automotive industry, with new vehicle sales being experiencing pressure despite attractive incentives and strong demand by the vehicle rental sector. While the purchase of new and used passenger vehicles increased over the period, the trend has moved from higher-margin new vehicle sales to lower-margin used vehicle sales. In some ways, the implications of the lower oil price – while serving as an attractive incentive for consumers to participate in the vehicle market – were offset by higher inflation experienced in other sectors and the relatively short-lived drop in fuel prices at the pumps as new fuel levies have been communicated by government and higher petrol prices being expected given the persistent rand/dollar weakness.

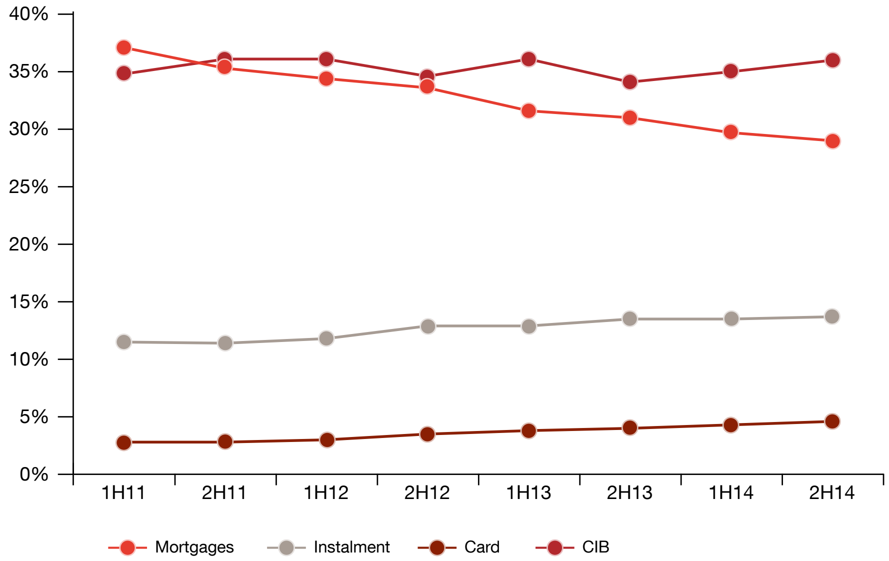
In the other loans and advances category, which includes unsecured and other personal lending, the combined portfolio of the major banks decreased by 3.3% in the six months to 2H14, while moderate growth of 2.7% was still seen when compared to December 2013. The trend in this product category clearly reflects the strategic decisions of the major banks to limit their exposure to unsecured lending portfolios.

Ongoing focus on balance sheet and product mix within the various lending categories, pricing and provisioning strategies continue to be expressed through the major banks' views that they remain appropriately provisioned and are pricing for the risk taken on in their unsecured lending portfolios.

We continue to expect that all of the major banks will exercise caution and closely monitor their unsecured lending portfolios while remaining focused on tightening lending decisions and credit scorecards in anticipation of expectations for higher interest rates and the resultant pressure that will place on household debt-service costs.

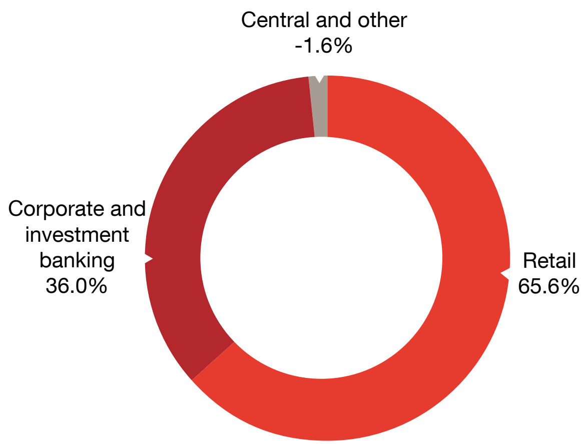
Looking ahead, as macroeconomic and domestic economic uncertainty persists, together with the prospect for higher interest rates and inflationary expectations, we continue to expect subdued household sentiment with regards to overall credit appetite. We expect that all of these factors, either individually or in combination, will continue to present challenges to growth in retail credit demand over the next six months. At the same time, as the minimum regulatory capital ratios continue to increase to 2019 over the Basel III implementation period, there will be pressure on bank margins, which will have an impact on loan pricing and which may, in turn, influence demand in the interest rate sensitive credit categories areas, like card and vehicle and asset finance.

Figure 6.1 Composition of loan portfolios (% of total book)



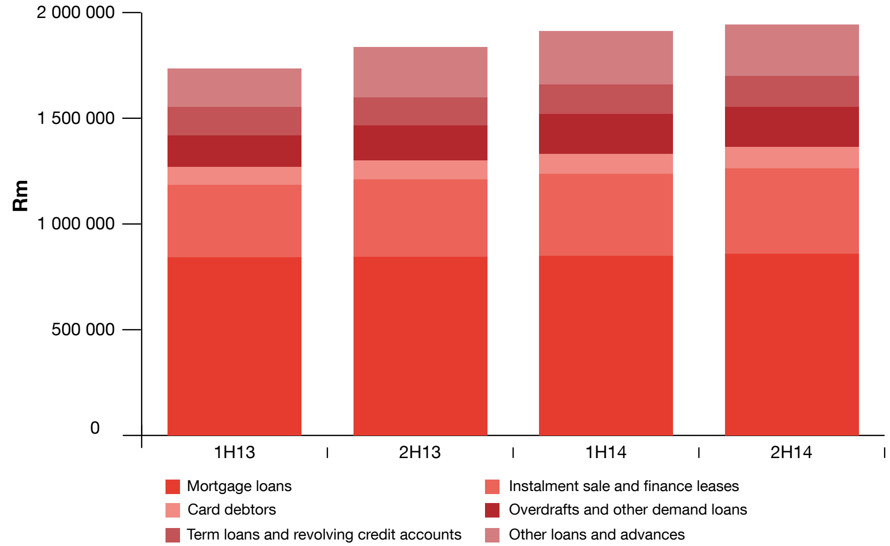
Source: PwC analysis

Figure 6.2 Combined loans and advances by product



Source: PwC analysis

Figure 6.3 Retail advances per product



Source: PwC analysis

Non-performing loans (NPLs)

The overall picture with regards to the combined NPLs of the major banks remains mixed, with the trend being markedly different across individual credit categories. On a year-on-year basis, the historical trend of declining NPLs continued, with the total NPL stock decreasing by 2.4% against 1H14 and 1.2% against 2H13 which is a reversal of the marginally increasing trend noted in 1H14.

Interestingly, the drivers in the current period contributing to the trends in combined NPLs are also reflective of unique factors and circumstances impacting specific banks. While retail card and corporate lending NPLs increased significantly across two specific banks, this was offset by strong declines in corporate commercial property lending and retail mortgage NPLs.

At 38.7% of total NPLs as at 2H14, retail mortgages continue to represent the largest component of NPLs, largely attributable to the underlying size of these portfolios which, given the long term tenor of these loans, were largely originated in previous years. A year ago this ratio was 44.2% with the decrease reflecting the considerable effort put in by banks to workout these NPLs. In contrast, NPLs associated with more recently originated corporate loans – which have seen resilient rates of growth in recent periods within the underlying portfolios of the major banks – follows retail mortgages as the next highest component to the total stock of combined NPLs amounting to 23.8% of total combined NPLs.

Coverage ratios

The major banks continue to report healthy levels of NPLs relative to the total size of their lending portfolios. At 2H14, total NPLs amounted to only 3.0% of total advances, compared to the 3.2% at both 1H14 and 2H13.

However, while the total of specifically impaired counterparties has fallen marginally, the major banks combined specific impairment coverage ratio (calculated as specific impairments divided by total NPLs) increased moderately to 68.4% at 2H14 compared to 68.2% at 1H14 and 66.3% at 2H13.

The increasing trend in the combined specific impairment coverage ratio continues to be driven by proactive provisioning decisions taken by the banks, specifically in anticipation of stress within the interest rate sensitive loan categories in their retail portfolios, combined with provisioning for uncertainties in their corporate lending portfolios particularly as a result of, direct or indirect, exposures in the economically volatile oil and gas sectors.

Looking ahead, we expect the major banks to continue to manage their loan portfolios with intensity as the forecasted economic environment presents numerous uncertainties that may directly influence their approaches with regards to maintaining adequate and early cover for future loan losses.

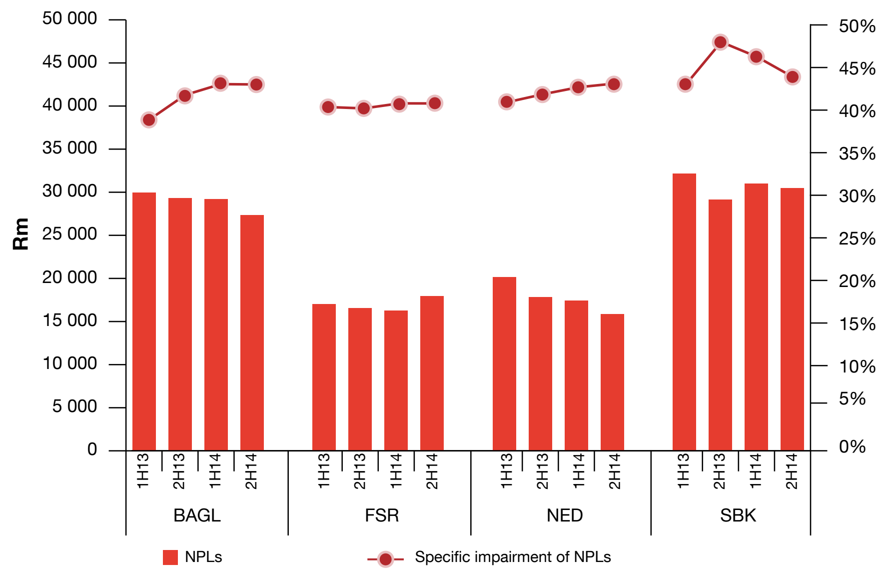
Income statement impairment charges

The relatively positive but linear trend in the combined credit loss ratio (calculated as income statement impairment charge divided by average gross advances) observed over prior periods continued, with the combined ratio falling to 0.84% at 2H14, compared to 1.12% at 1H13 and 0.92% at 2H13. The improvement in the combined credit loss ratio is directly attributable to focused efforts in the collections processes, the effectiveness of workout strategies and the proactive approach to post write-off recoveries on the part of the major banks during recent periods.

In absolute terms, total impairment charges of the major banks fell strongly by 13.6% for the six months to 2H14, but showed muted growth of 0.4% on a year-on-year basis, largely due to proactive increases in general provisions by some banks as a result of the economic uncertainties outlined above. However, from a retail perspective, portfolio impairments were driven by increasing levels of arrears in the instalment and card lending categories, coupled with the strong book growth seen in these portfolios commented on earlier.

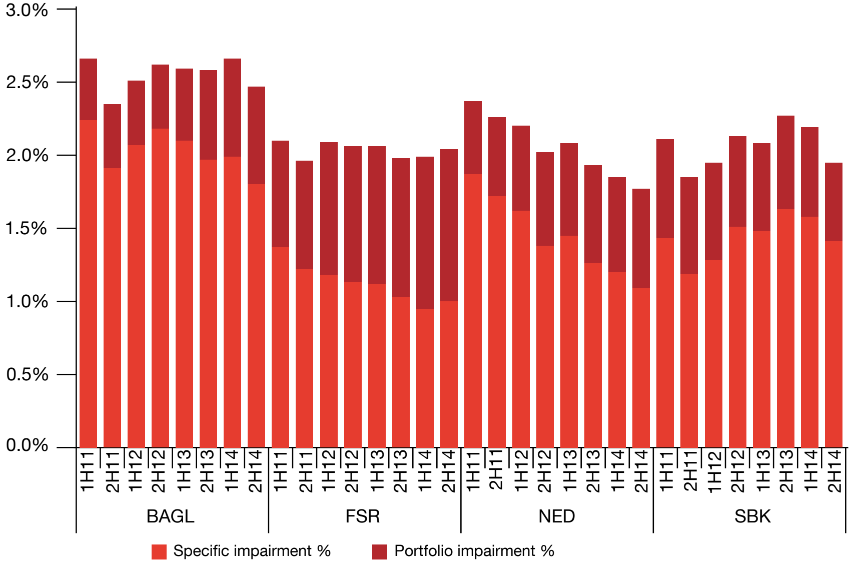
It remains difficult to forecast a specific trend in the combined impairment charge of the major banks as a range of domestic and macroeconomic factors will contribute to the banks' approach to credit origination across all loan categories. However, with all of the banks reporting credit loss ratios in the range of 0.75% to 0.87% for 2H14, it is clear that credit management will continue to be a headline area of focus for bank executive teams in the short to medium term given the degree of uncertain economic variables at present.

Figure 6.4 Non-performing loans and level of specific impairment



Source: PwC analysis

Figure 6.5 Specific and portfolio impairment levels



Source: PwC analysis

7. Capital and funding

Capital and funding (Rm)

	Combined/Average			
	2H14	1H14	2H13	1H13
Common Equity Tier 1	294 724	294 752	285 841	204 937
Total Tier 1	321 360	313 220	307 044	282 020
Tier 2	54 855	53 120	55 594	54 103
Total qualifying capital and reserve funds	376 215	366 340	362 638	336 123
Total capital adequacy ratio	15.3%	15.4%	15.9%	15.8%
Risk-weighted assets	2 527 286	2 465 769	2 330 473	2 196 525
Deposits	3 197 387	3 053 880	2 986 913	2 906 221

The trend of slowing growth in the major banks' total qualifying capital observed in previous periods has continued. Total qualifying capital grew by just 2.7% compared to 2H14, and by 3.7% on a rolling six-month basis against 2H13.

However, the major banks continue to remain very well capitalised, with capital adequacy ratios still comfortably above regulatory minimums. The implication of higher risk-weighted assets and the slowing growth trend of qualifying capital resulted in a combined total capital adequacy ratio of 15.3% (compared to 15.4% at 1H14 and 15.9% at 2H13).

As the regulatory landscape continues to evolve and banks move along the Basel III implementation timeline, the implications continue to be seen in the combined risk-weighted assets numbers and capital adequacy ratios. Previously issued 'old-style' additional Tier I and Tier II capital instruments continue to be phased out in line with the Basel III transitional requirements. The combined total capital adequacy ratio of the major banks for the current review period amounts to 15.3%, which is largely flat compared to the 15.4% reported at 1H14 and marginally lower than the 15.9% seen at 2H13.

The total capital adequacy ratio of 15.3% continues to reflect solid capital buffers and the measured approach to capital management taken by the major banks over the years in anticipation of regulatory change. While resilient growth in organic earnings continues to generate capital for the banks, this has been offset by the sustained growth in risk-weighted assets (RWA) observed in the current period. The major banks' RWA grew by 8.4% compared to 2H13 and 2.5% compared to 1H14.

Moreover, as the major banks continue to place strategic focus on African expansion, their South African balance sheets will continue to be required to capitalise for the impact of different capital regimes across their operations outside South Africa, as many jurisdictions on the continent still mainly adopt more capital punitive standardised approaches to risk measures for regulatory capital purposes.

It is also positive to note that the banks' combined Common Equity Tier 1 (CET 1) capital ratio, the core measure of regulatory capital under Basel III, continues to remain resilient at 12.4% at 2H14 (12.5% at 1H14 and 12.7% at 2H13), comfortably above the regulatory minimum.

Looking ahead, minimum regulatory capital ratios will continue to rise through to 2019, with additional capital buffers including both the capital conservation, the Domestic Systemically Important Bank (D-SiB) requirement and possibly the countercyclical buffer – being phased in from 2016 in line with the Basel III implementation timeline. The regulatory landscape for banks will remain top of mind for the banking industry and will continue to influence overall bank strategy, balance sheet positioning and capital planning decisions.

While the major banks' total capital levels are expected to remain strong, we anticipate that some levels of pressure to their capital buffers will be seen as the minimum regulatory capital requirements increase over the period towards the end-state Basel III requirements in 2019. All of the banks fully acknowledge the importance of aligning capital planning and strategic decision-making with these increasing requirements. This is evident in the capital market activity seen during the current review period as the banks look to replace old-style capital instruments with Basel III-compliant instruments. During 2014, the Basel Committee on Banking Supervision (BCBS) has issued multiple consultative documents proposing significantly revised guidance dealing with a range of technical regulatory matters. We analyse these recent developments in the section below.

With the recent consultations issued by the Committee and the focus on enhancing the standardised approaches in measuring risk-weighted assets on the back of the BCBS' concerns over disparities between global banks in RWA due to different modelling practices, we have begun to track the RWA density ratio of the major South African banks. This is a useful measure of the banks' risk modelling behaviour in measuring credit risk under one of the Basel framework's advanced approaches.

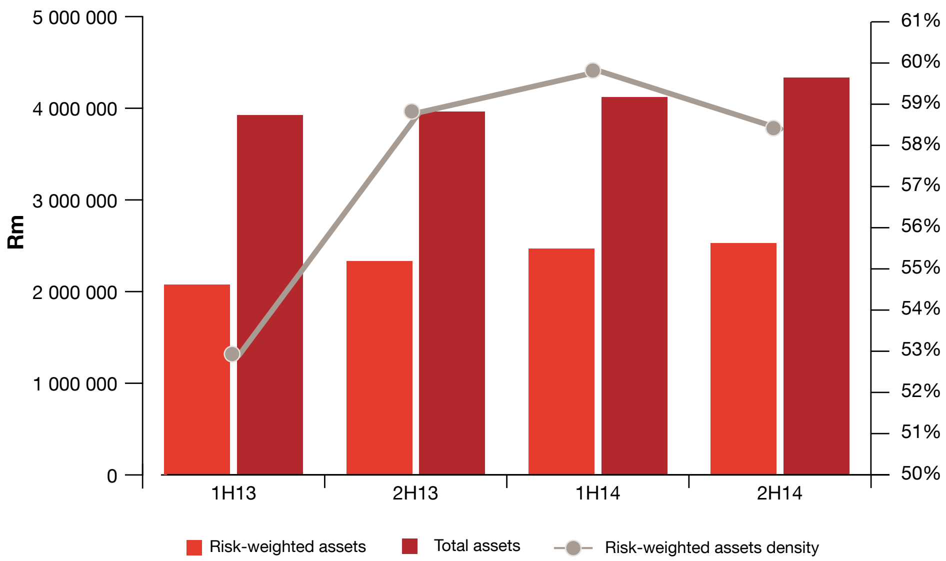
In South Africa, all of the major banks utilise an advanced approach for the measurement of the majority of their credit risk-weighted assets, and therefore modelling techniques are a key component in the determination of credit risk capital. However, where business units or operations outside South Africa do not have sufficiently granular data to utilise modelling, the major banks typically make use of the Standardised Approach to measure credit risk exposure for regulatory capital purposes.

At 2H14 this ratio (RWA divided by total assets) for the major banks shows a moderate reversal of the upward trend seen previously, reflecting a combined average of 58.4% (compared to 59.8% at 1H14 and 58.8% at 2H13). However, when compared to some of the large, internationally active banks, this ratio continues to reflect the relatively prudent approach adopted and assumptions applied by the major banks in modelling their risk exposures.

At the same time, it is also worth noting that many of the major bank's operations outside South Africa continue to make use of standardised approaches to measuring credit risk due to the significant data quality challenges. This is useful as the standardised approach limits the use of judgement in determining credit risk RWA and will result in higher RWA compared to model-based methods.

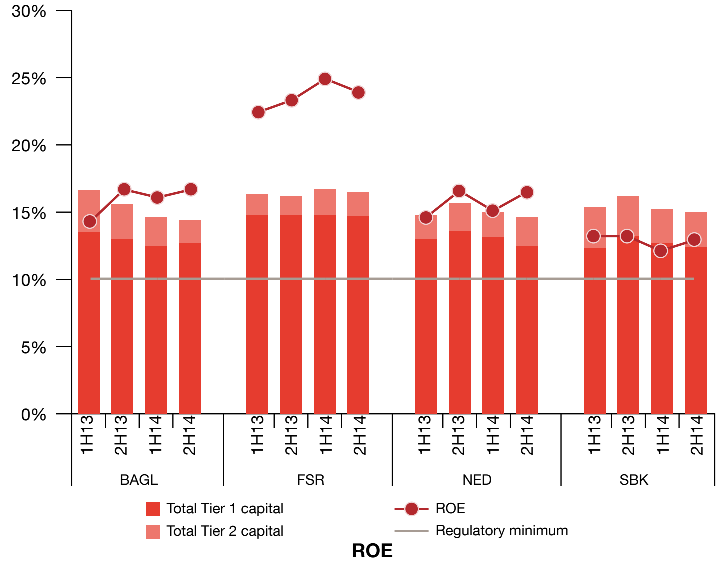
As the banks look to grow their operations across the continent, it will be interesting to observe their responses to dealing with data quality and other challenges in certain markets, which necessitate the use of more capital-intensive standardised approaches to the measurement of credit risk, particularly as we move along the Basel III implementation timeline to increase minimum capital requirements. At the same time, it will be interesting to see what impact other strategic and business initiatives to minimise RWA will have on a range of the banks' activities, including credit decisions.

Figure 7.1 Risk-weighted assets density



Source: PwC analysis

Figure 7.2 Regulatory capital ratios and ROEs



Source: PwC analysis

8. Forging a winning culture

Successful companies are marked out by the strength of their culture. How can you actively shape your culture and turn it to your competitive advantage?

"78%

of BCM CEOs acknowledge evolving talent demands and now look for a much broader range of skills when hiring than they did in the past."

PwC 18th Annual Global CEO Survey
Key findings in the banking and capital markets industry

Time for a new take on cultural change

The first question an analyst is likely to ask a CEO is: *'What is your strategy for the future?'* A better question would be: *'Do you have the right culture to succeed?'* From sharper customer centricity to more assured control over risk, a winning culture can deliver decisive competitive advantages. It's going to be especially important in fostering the innovation and willingness to embrace change needed to compete in a financial services (FS) marketplace being transformed by digital technology, fast-shifting customer expectations and an influx of new entrants.

Culture is certainly top of mind in the boardroom. But this is largely a response to regulatory pressure rather than a competitive focus. Regulators in many parts of the world want FS organisations to tackle what they see as a dysfunctional culture, which has had its most extreme manifestation in recent scandals such as the LIBOR and Forex manipulations. Yet, after several years of determined effort to reshape attitudes and behaviour, many boards have been left wondering why the culture within their organisation hasn't really changed.

While they've sought to impose a new tone at the top and adjusted compensation policies, how confident are they that their businesses aren't at risk of more damaging lapses? It's telling that the proportion of FS industry leaders who believe that lack of trust is a threat to growth has continued to rise. Looking specifically at risk culture, a global PwC survey of 500 banks found that their executives rated their risk culture as C+ on average, when at least A- would have been expected given the investment and effort to date.

Could the focus on cultural change as primarily a compliance requirement be destined to fail by positioning it as a bureaucratic distraction within the business? Might this approach even cause detriment by impeding agility and enterprise within FS organisations and innovation, investment and growth in the wider economy?

The role of culture in the future of FS

What we mean by culture

We define culture as 'the assumptions or beliefs common in an organisation that allow you to predict how your people will behave and what they will achieve'.

Have you tried to change the culture within your business? What have you wanted to achieve and why? How much difference has this made? It's clearly important to be able to demonstrate to your regulator that you're seeking to enforce appropriate and sustainable behaviours. Indeed, this pressure continues to intensify. But if your employees see the need to reshape culture as being primarily driven by regulation, then any changes are likely to be skin deep at best. If your culture is viewed as a 'problem' to be fixed, then it's likely to be treated as a compliance rather than competitive opportunity, with functions like internal audit taking the lead rather than the board and the broader business. You can't change a culture overnight, but the judgments and behaviours that have the biggest influence on customer and commercial outcomes can be adjusted relatively quickly.

As the nature of FS and what customers expect from your business changes, your culture is set to play an ever more important role in your ability to sustain profitability and growth. Rather than simply responding to regulatory demands and fixing the failings of the past, the priority should be building for the future. A strong culture has become a key business imperative.

Culture drives strong performance

Culture is a crucial source of competitive advantage and differentiation in an FS sector facing major transformation. This includes strengthening reputation, innovation and customer centricity. Our analysis shows that a strong culture is more highly correlated with sustainable high performance than strategy, operating model, or product coverage.

Behaviour is proving difficult to change

FS organisations have invested heavily in cultivating a culture that promotes risk awareness and ethical behaviour. Yet, regulatory challenges and allegations of misconduct have persisted.

There can be no cultural change without business buy-in and alignment

If cultural change is simply driven by compliance considerations, it's difficult to gain buy-in within the organisation. Experience demonstrates that culture can only be changed if this is aligned with business objectives and what employees value. This alignment is the basis for a new take on cultural change.

Setting a baseline for tracking progress

Culture is often seen as too intangible to evaluate and track. But by assessing the levers that influence it and the behaviour and outcomes it generates, it's possible to develop a clear and quantifiable assessment. This assessment can provide a clear indication of whether employees understand what is expected, whether they're translating this into their day-to-day activities, and whether rewards and other reinforcing mechanisms appropriately support this. This assessment can then form the basis for clearly targeted interventions that go beyond vague talk of cultural change.

Setting a clear and realisable agenda for change

You can't change an entire culture and way of working overnight. But key judgments and behaviours can be shifted in a relatively short space of time, while helping to build momentum for broader change. So it's important to concentrate efforts on the few decision points and interactions that have the most telling impact ('moments that matter').

We believe that there are six questions your organisation will need to address to ensure it can unleash the full force of its culture:

- Does our organisation have a clear and compelling vision and set of values, and is what is expected as a result understood within the organisation?
- What elements of our culture do we want to reinforce and what would we like to change?
- To what extent is our leadership living up to our values and how is this demonstrated?
- To what extent is staff behaviour aligned with our vision, how is this monitored and how are breaches addressed?
- How clear and well-enforced are the accountability structures and reporting lines that govern the levers of our culture?
- How effective are rewards, performance management and other reinforcing mechanisms in supporting our desired culture and behaviour?

Conclusion – Is your culture competitive?

Reshaping your culture and the behaviour that underlies it might seem like a huge undertaking and there may therefore be a temptation to wait until other pressing priorities are out of the way. But targeted changes in behaviour can provide a useful catalyst for tackling the other challenges in areas ranging from market perception to sharpening customer understanding and a readiness to embrace change in a rapidly evolving market.

Creating a winning culture is a powerful way to enhance your reputation, build trust and secure sustainable long-term growth. Failure to address these issues could leave you with stuttering growth and at risk from lapses. In a period of change, culture could thereby be your greatest ally or your biggest enemy. How can you turn it into a force for good?

The publication can be viewed at *http://www.pwc.com/gx/en/financial-services/publications/forging-a-winning-culture.jhtml*

9. Hot off the press

Recent PwC financial services and related publications

http://www.pwc.co.uk/financial-services/publications/is-this-basel-iv.jhtml

Is this Basel IV?

Through 2014 the BCBS consulted on revisions to the standardised approach to credit, counterparty credit and operational risk. This is in addition to a consultation on standardised capital floors and a fundamental review of the trading book. Each consultation is significant in its own right, but considered as a whole they represent a substantial revision to the core of risk measurement. It's starting to feel like the Committee is working on replacing today's implementation projects with tomorrow's regulations, and we feel these consultations could be setting the foundations for Basel IV.

Responding to the strategic and operational challenges

This overview addresses the complex regulatory challenges that the financial services industry will face in the upcoming year and beyond.

In so doing, this report not only analyses the ongoing evolution of post-financial crisis regulation, but also places regulatory developments into the broader context of political, commercial and technological change. It strives to provide a useful overview of the major regulatory developments of the past year, as well as a roadmap for what firms can expect in the near future.

Stress tests – keeping up with the rising bar

http://www.pwc.co.uk/financial-services/publications/stress-tests-keeping-up-with-the-rising-bar.jhtml

The stress tests carried out by the European Banking Authority (EBA) and the Bank of England (BoE) Prudential Regulation Authority (PRA) in 2014 placed much tougher operational, logistical and governance demands on organisations than in the past, bringing the expectations closer to the high bar set by the US Federal Reserve.

The bar is set to rise further as new and tougher scenarios are added and assessment of qualitative capability becomes more deliberate and pointed. This is also likely to become a regular process, reinforcing the need for efficient and repeatable stress test capabilities.

In this report, we identify the areas that proved most challenging and those that are likely to pose the greatest difficulties in the future. We also outline how organisations can integrate stress test processes with the rest of the business.

Fit for $50 oil in Africa – will the boom go bust?

http://www.pwc.co.za/en/publications/fit-for-50-oil-in-africa.jhtml

PwC SA's 'Fit for $50 oil in Africa' analysis explores the risks, opportunities and challenges associated with reduced oil prices, unique operating environments and global demand.

Africa has seen substantial successes in the exploration for hydrocarbons over the last decade, including the entry of new country players. In 2013 alone, six of the top 10 global discoveries by size were made in Africa – including some of the largest discoveries in the last decade in East Africa. Oil revenues make up a large portion of the GDP for many African countries. The key to surviving the ups and downs of the cyclical oil & gas market is to learn how to adapt quickly. Oil & gas explorers must rethink their capital expenditure on exploration activity across the African continent in the wake of the significant drop in the global oil price.

Future shape of banking – time for reformation of banking and banks?

http://www.pwc.com/gx/en/financial-services/publications/future-shape-banking.jhtml

This publication outlines four key areas banks need to address in order to remain relevant, as we argue that the future of banking will look very different to what we see today, and that while the need for banking services remains – traditional banks need to sharpen their strategic focus and regulators and regulation will also need to adapt…adding up to a paradigm shift in the banking landscape.

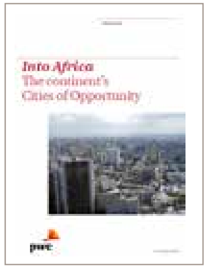
Retail Banking 2020 – Evolution or Revolution?

http://www.pwc.com/gx/en/banking-capital-markets/banking-2020/

Powerful forces are reshaping the banking industry, creating an imperative for change.

Banks need to choose what posture they want to adopt – to lead the change, to follow fast, or to manage for the present.

Into Africa – The continent's Cities of Opportunity



http://www.pwc.com/gx/en/issues/strategy/emerging-markets/africa/publications/into-africa.jhtml

Based on the methodology, research, and analytical framework of our global Cities of Opportunity series – the seventh edition of which will be released next year – Into Africa concentrates on 20 of the cities in Africa that we judge to be among the most dynamic and focused on the future. The report ranks the 20 cities on 29 variables in five categories: infrastructure, human capital, economics, society and demographics.

The report has been jointly developed by a multi-territory team from PwC Africa, PwC France and PwC UK working with the global Cities of Opportunity team.

10. Key banking statistics

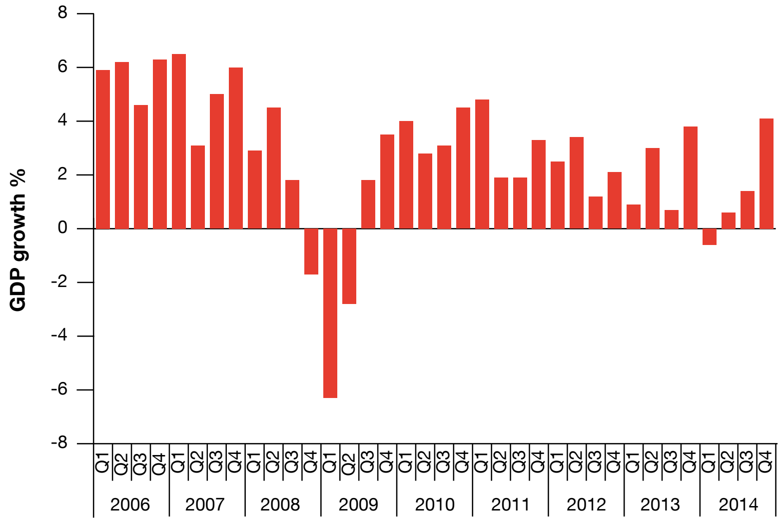
Key banking statistics: 2H14

Rm	BAGL				FSR				NED				SBK				Combined				Growth	
	2H14	1H14	2H13	1H13	2H14	1H14	2H13	1H13	2H14	1H14	2H13	1H13	2H14	1H14	2H13	1H13	2H14	1H14	2H13	1H13	2H14 vs 1H14	2H14 vs 2H13
Balance sheet																						
Total assets	991 414	977 803	959 599	948 013	980 176	946 609	894 431	869 669	809 313	783 792	749 594	714 330	155 0261	1 414 243	1 358 467	1 394 024	4 331 164	4 122 447	3 962 091	3 926 036	5.1%	9.3%
Gross loans and advances	724 681	718 683	701 357	683 516	736 523	699 826	648 254	611 611	624 116	619 686	590 828	569 208	948 251	907 717	918 823	930 922	3 033 571	2 945 912	2 859 262	2 795 257	3.0%	6.1%
Total deposits	677 863	662 323	657 075	620 926	801 698	768 234	727 032	697 005	653 450	631 663	602 952	578 807	106 4376	991 660	999 854	1 009 483	3 197 387	3 053 880	2 986 913	2 906 221	4.7%	7.0%
Risk-weighted assets	619 705	595 053	560 865	457 480	598 698	572 446	535 410	519 960	440 696	422 165	392 926	386 804	868 187	876 105	841 272	851 545	2 527 286	2 465 769	2 330 473	2 215 789	2.5%	8.4%
Asset quality & provisioning																						
Non-performing loans	27 367	29 225	29 300	29 960	17 970	16 281	16 564	17 001	15 846	17 409	17 455	20 176	30 507	31 008	29 395	32 194	91 690	93 923	92 714	99 331	-2.4%	-1.1%
Impairments	-16 130	-16 787	-16 049	-14 341	-14 994	-13 900	-12 811	-12 636	-11 095	-11 476	-11 456	-11 859	-18 707	-19 852	-19 448	-19 441	-60 926	-62 015	-59 764	-58 277	-1.8%	1.9%
Collective provisions	-4 359	-4 206	-3 811	-2 692	-7 665	-7 259	-6 152	-5 775	-4 263	-4 046	-3 986	-3 605	-5 315	-5 508	-5 469	-5 618	-21 602	-21 019	-19 418	-17 690	2.8%	11.2%
Individually assessed provisions	-11 771	-12 581	-12 238	-11 649	-7 329	-6 641	-6 659	-6 861	-6 832	-7 430	-7 470	-8 254	-13 392	-14 344	-13 979	-13 823	-39 324	-40 996	-40 346	-40 587	-4.1%	-2.5%
Non-performing loans (% of advances)	3.8%	4.1%	4.2%	4.4%	2.44%	2.33%	2.56%	2.78%	2.5%	2.8%	3.0%	3.5%	3.2%	3.4%	3.2%	3.5%	3.0%	3.2%	3.2%	3.5%		
Impairment charge (% of average advances)	0.86%	1.18%	1.05%	1.35%	0.86%	1.35%	0.77%	1.07%	0.75%	0.83%	0.81%	1.31%	0.87%	1.13%	1.04%	1.17%	0.8%	1.1%	0.9%	1.2%		
Impairment coverage ratio	58.9%	57.4%	54.8%	47.9%	83.44%	85.38%	77.34%	74.33%	70.0%	65.9%	65.6%	58.8%	61.3%	64.0%	66.2%	60.4%	68.4%	68.2%	66.0%	60.3%		
Implied loss given default	43.0%	43.0%	41.8%	38.9%	40.78%	40.79%	40.20%	40.36%	43.1%	42.7%	42.8%	40.9%	43.9%	46.3%	47.6%	42.9%	42.7%	43.2%	43.1%	40.8%		
Profit & loss analysis																						
Net interest income	18 404	17 197	16 656	15695	19 048	16 965	16 397	14 458	11 698	1 1263	10 911	10 309	23 590	21 666	20 313	18 912	72 740	67 091	64 277	59 374	8.4%	13.2%
Non-interest income	14 037	13 487	14 387	12668	16 114	15 853	14 839	14 007	10 832	9 480	9 826	9 535	20 829	18 155	18 943	17 726	61 812	56 975	57 995	53 936	8.5%	6.6%
Total operating income	32 441	30 684	31 043	28363	35 162	32 818	31 236	28 465	22 530	20 743	20 737	19 844	44 419	39 821	39 256	36 638	134 552	124 066	122 272	113 310	8.5%	10.0%
Total operating expenses	-19 380	-17 880	-18 311	-16142	-18 724	-17 046	-17 108	-14 708	-13 157	-12 012	-1 1965	-11055	-25 592	-23 026	-24 601	-21 833	-76 853	-69 964	-71 985	-63 738	9.8%	6.8%
Core earnings	13 061	12 804	12 732	12 221	16 438	15 772	14 128	13 757	9 373	8 731	8 772	8 789	18 827	16 795	14 655	14 805	57 699	54 102	50 287	49 572	6.6%	14.7%

Rm	BAGL				FSR				NED				SBK				Combined				Growth	
	2H14	1H14	2H13	1H13	2H14	1H14	2H13	1H13	2H14	1H14	2H13	1H13	2H14	1H14	2H13	1H13	2H14	1H14	2H13	1H13	2H14 vs 1H14	2H14 vs 2H13
Profit & loss analysis																						
Impairment charge	-2 722	-3 568	-3 151	-3 836	-3 086	-3 074	-2 445	-3 187	-2 173	-2 333	-2 240	-3 325	-4 057	-4 952	-4 149	-5 065	-12 038	-13 927	-11 985	-15 413	-13.6%	0.4%
Other income/ (expenses)	71	71	51	79	742	578	487	528	48	10	-19	-4	1 363	339	489	248	2 224	998	1 008	851	122.8%	120.6%
Discontinued operations	0	0	0	0	0	0	0	0	0	0	0	0	-2 713	-1 032	0	0	-2 713	-1 032	0	0	162.9%	100.0%
Income tax expenses	-2 859	-2 714	-2 772	-2 450	-3 274	-2 557	-2 891	-2 240	-1 841	-1 627	-1 603	-1 413	-3 344	-2 778	-4 149	-2 048	-11 318	-9 676	-11 415	-8 151	17.0%	-0.8%
Profit for the period	7 551	6 593	6 860	6 014	10 820	10 719	9 279	8 858	5 407	4 781	4 910	4 047	10 076	8 372	6 846	7 940	33 854	30 465	27 895	26 859	11.1%	21.4%
Attributable earnings	7 050	6 166	6 388	5 593	10 304	9 390	9 050	7 520	5 198	4 598	4 727	3910	8 639	7 294	7 619	7 245	31 191	27 448	27 784	24 268	13.6%	12.3%
Headline earnings from continuing operations	6 922	6 110	6 289	5 554	9 901	9 832	8 839	7 919	5 281	4599	4756	3914	7 880	7 285	7 758	7 225	29 984	27 826	27 642	24 612	7.8%	8.5%
Key data																						
Other operating income (% of total income)	43.3%	44.0%	46.3%	44.7%	45.8%	48.3%	47.5%	49.2%	48.1%	45.7%	47.4%	48.0%	46.9%	45.6%	48.3%	48.4%	46.0%	45.9%	47.4%	47.6%		
Net interest margin (% of total assets)	3.7%	3.5%	3.6%	3.8%	2.0%	3.6%	3.7%	3.3%	3.0%	3.0%	3.1%	3.3%	3.8%	3.7%	3.3%	3.1%	3.1%	3.5%	3.4%	3.4%		
Net interest margin (% of average interest earning advances)	4.74%	4.6%	4.5%	4.5%	5.3%	5.1%	5.1%	5.0%	3.49%	3.6%	3.6%	3.6%	5.05%	4.7%	4.3%	4.1%	4.6%	4.5%	4.4%	4.3%		
Standardised efficiency ratio	57.2%	56.4%	57.3%	55.2%	50.8%	50.7%	52.5%	50.1%	56.500%	56.5%	56.3%	54.2%	53.30%	55.9%	60.5%	57.3%	54.5%	54.9%	56.6%	54.2%		
Return on equity	16.7%	16.1%	16.7%	14.3%	24.0%	25.0%	23.4%	22.5%	16.5%	15.1%	16.6%	14.6%	12.9%	12.1%	13.2%	13.2%	17.5%	17.1%	17.5%	16.2%		
Total number of staff	41 644	42 114	42 356	33 897	39 508	38 989	38 026	37 231	30 499	30 061	29 513	28 889	42 642	42 211	42 221	48 730	154 293	153 375	152 116	148 747		
Capital ratios																						
CET 1	11.9%	11.8%	11.9%	0.0%	13.8%	13.9%	13.7%	13.8%	11.6%	12.1%	12.5%	11.8%	12.4%	12.2%	12.6%		12.4%	12.5%	12.7%	8.5%		
Tier 1	12.7%	12.5%	13.0%	13.5%	14.7%	14.8%	14.8%	14.8%	12.5%	13.1%	13.6%	13.0%	12.9%	12.7%	13.2%	12.3%	13.2%	13.3%	13.7%	13.4%		
Tier 2	1.7%	2.1%	2.6%	3.1%	1.8%	1.9%	1.4%	1.5%	2.1%	1.9%	2.1%	1.8%	2.6%	2.5%	3.0%	3.1%	2.1%	2.1%	2.3%	2.4%		
Total	14.4%	14.6%	15.6%	16.6%	16.5%	16.7%	16.2%	16.3%	14.6%	15.0%	15.7%	14.8%	15.5%	15.2%	16.2%	15.4%	15.3%	15.4%	15.9%	15.8%		

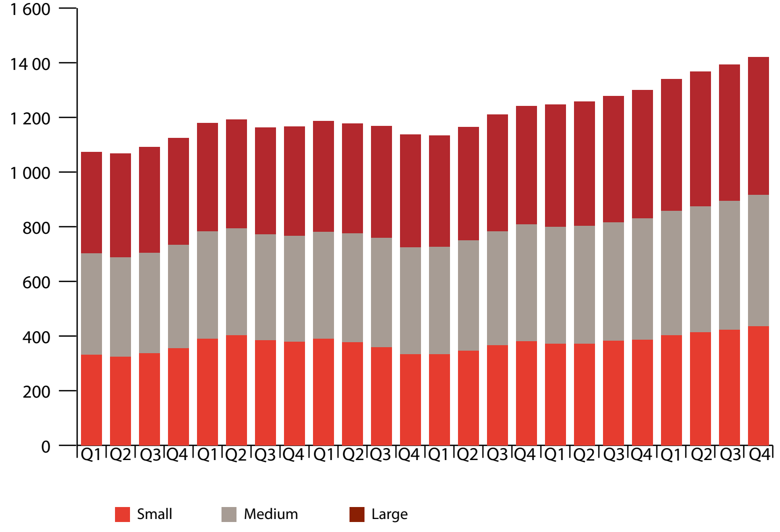
11. Industry data

GDP growth



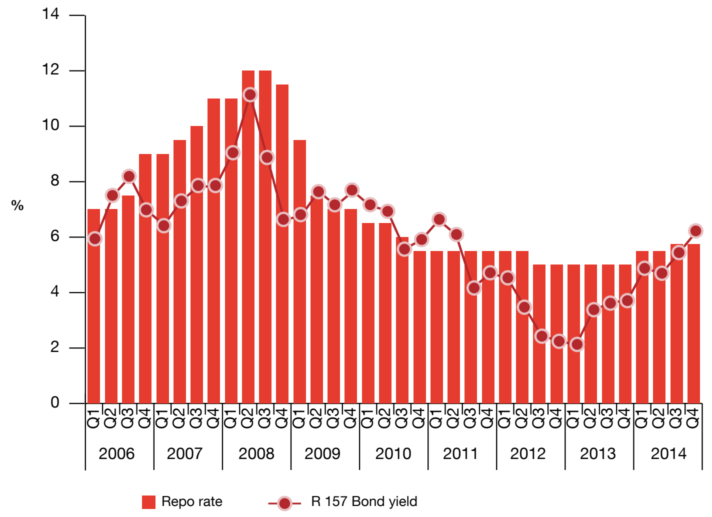
Source: Statistics SA

BAGL House Price Index



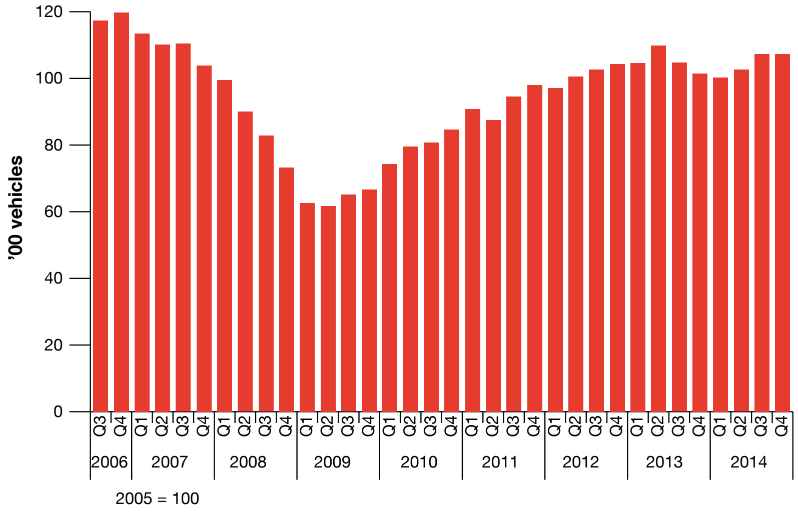
Source: BAGL

Interest rates



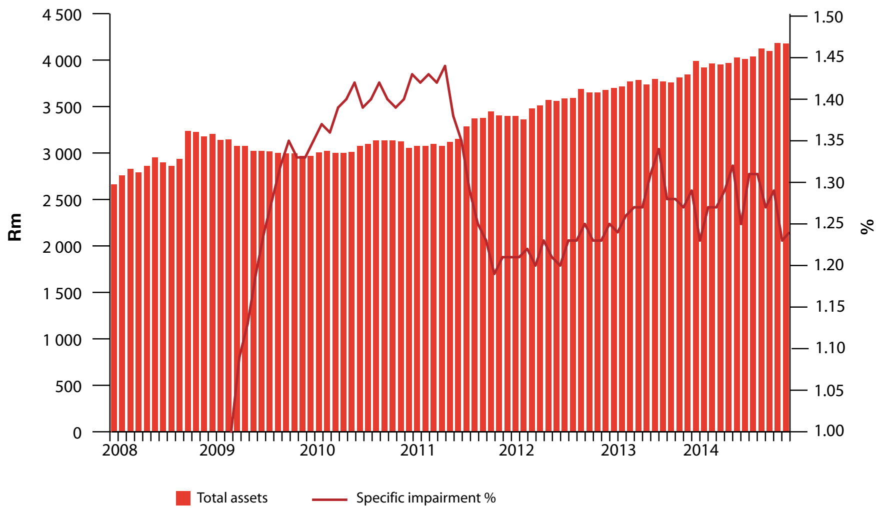
Source: SARB

New vehicles sold



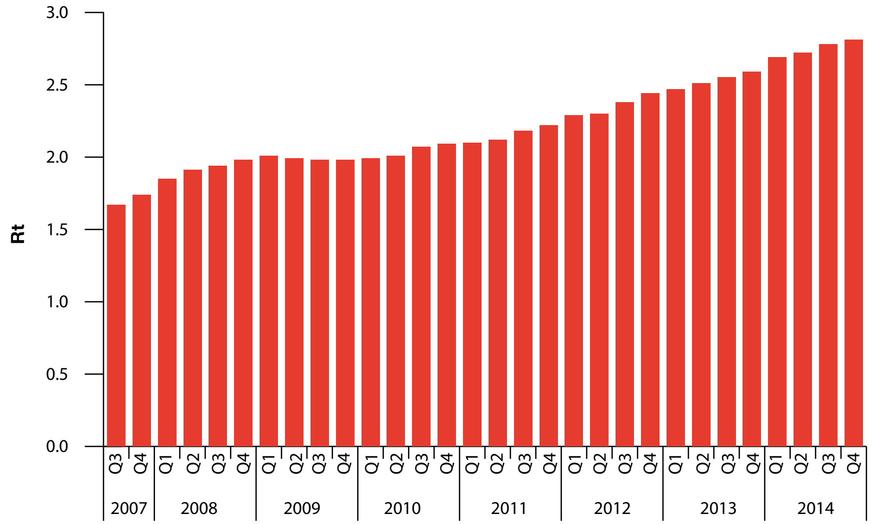
Source: SARB

Industry credit impairments



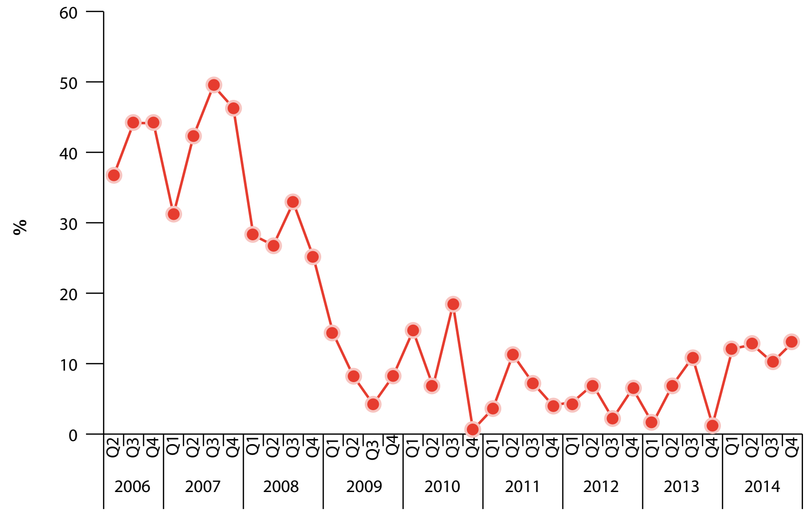
Source: SARB

Industry credit extension (Rt)



Source: SARB

Growth in mortgage advances



Source: SARB

12. Contacts

Johannes Grosskopf
Banking & Capital Markets Leader
PwC Africa
+27 11 797 4346
johannes.grosskopf@za.pwc.com

Stefan Beyers
Banking & Capital Markets Partner
PwC Africa
+27 11 797 4690
stefan.beyers@za.pwc.com

Contributors

- Louwrens van Velden
- Rivaan Roopnarain
- Hemal Kana
- Nitish Mudgal