Standing firm against headwinds

South Africa – Major banks analysis

PwC analysis of major banks' results for the reporting period ended 31 December 2016

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Costa Natsas
Banking & Capital Markets
Leader: South Africa
costa.natsas@pwc.com

Louwrens van Velden
Banking & Capital Markets
Associate Director
louwrens.van-velden@pwc.com

Rivaan Roopnarain
Banking & Capital Markets
Senior Manager
rivaan.roopnarain@pwc.com

*Annualised head-line earnings growth	8.4%	↑
**Return on equity	18.6% (2H15: 18.4%)	↑
**Common Equity Tier 1 ratio	13.1% (2H15: 12.7%)	↑
**Net interest margin	4.61% (2H15: 4.39%)	↑
**Credit loss ratio	0.8% (2H15: 0.82%)	↑
**Cost-to-income ratio	55.36% (2H15: 55.08%)	↓

*FY16 vs FY15 **As at 2H16

For two decades we've been taking the temperature of global CEOs through our Annual Global CEO Survey and asking business leaders about the trends shaping business and society. This year marked the 20th edition of the survey, which focused much of its analysis on how much the world has changed over this defining period. In last year's survey, many global business leaders foresaw a world divided by multiple beliefs and frameworks. 2016 revealed the tangible ways in which these differences play out.

In fact, 2016 offered landmark moments which will be studied long into the future; moments which have the potential to reshape the global economic, political and social status quo. When world leaders met in January at the 2017 World Economic Forum in Davos, they raised concerns about uncertain economic growth, over-regulation and skills shortages. Yet CEOs globally, on average, were optimistic about growth, and particularly confident in their company's 12-month revenue growth prospects.

Insights from our Global CEO Survey

Banking and Capital Market (BCM) CEOs are encouragingly optimistic about their prospects. 40% are very confident that they'll achieve revenue growth over the coming 12 months up from 31% last year.

Nearly half of BCM CEOs (48%) are very confident that their revenues will increase over the next three years.

Just over 33% of South African CEOs are very confident about their company's own growth in the next 12 months, 4% down on last year, and 5% below this year's global average (38%).

Only 19% of local CEOs expect global economic growth to improve in the next 12 months, 10% below the global average growth expectations.

As always, the economic, regulatory and operating environment we consider below sets the scene for analysing the major banks results.

External developments[1]

The macroeconomic context in 2016 painted a mixed picture. Sluggish growth in advanced economies continued, despite record low interest rates. Q3-16 GDP growth in the G7 countries averaged 1.4% on a year-on-year basis, while the Eurozone grew by 0.3% quarter-on-quarter – the same as in Q2.

Eurozone growth was slower than in the US and the UK, where the economies grew by 0.8% and 0.5% respectively in Q3. Despite weak overall Eurozone growth, the figure masks a strong performance in some peripheral countries. Spain and Cyprus, for example, are now among the fastest-growing economies in the region.

The European economic outlook is threatened by uncertainty as the region could be entering a period of intense political activity. While 2016 ended with the Italian referendum result in December, which triggered the resignation of the Prime Minister, the European political calendar will remain busy with Dutch elections in March, French presidential elections in April and German federal elections in September.

Geopolitical uncertainty over the 'European project' as a whole, coupled with a lack of clarity about what future trading relationships between the UK and the EU might look like, could dampen the region's growth prospects over the short term.

Our global economic research expects the Eurozone to continue growing at trend rates of around 1.5% per annum in 2017, and the US to grow by around 2% – the fastest in the G7 – driven by continued job creation and strong household consumption.

Our expectation is for the US to continue to drive global growth, with the possibility to surprise on the upside depending on the form and scale of the new administration's policies to pursue fiscal objectives, including how plans to boost infrastructure spending pan out.

Emerging markets' economic performance in 2016 has again been relatively disappointing, with the IMF expecting growth of only around 4%, considerably below the 2000-2015 average of 5.8%. Our research suggests various contributing factors to this slowdown: adverse global conditions, concerns over the sustainability of Chinese growth, particularly in light of its credit-driven nature, and emerging market susceptibility to the marked decline in commodity prices since 2014.

Domestically, economic growth in South Africa registered a disappointing 0.3% in 2016 on the back of a negative Q4-16 GDP figure. The RMB/BER Business Confidence Index and the FNB/BER Consumer Confidence Index both dipped in the same quarter to reveal South African businesses and consumers remain under pressure.

National Credit Regulator data[2] shows the number of South African consumers classified in good standing decreased by 11 000 to 14.4m consumers at end September 2016, while those consumers with impaired credit records increased by 178 000 to 9.85mn from 9.67mn in Q2-16.

Despite the economic turbulence in which the year ended, the rand showed resilience following modest recent increases in some commodity prices improving the terms of trade. However, at the most recent Monetary Policy Meeting (MPC) in January, the MPC noted that the short-term inflation outlook had deteriorated, with food price inflation elevating to 12% in December 2016, despite improved rainfall in previous drought-stricken regions. The MPC unanimously decided to keep the repurchase rate unchanged at 7% per annum – retaining its view that we may be approaching the end of the rate hiking cycle in South Africa.

[1] PwC Global Economy Watch, December 2016 and January 2017

[2] National Credit Regulator, Credit Bureau Monitor: September 2016 – https://goo.gl/F6GBUw

Stakeholder expectations

Prudential

The regulatory reform agenda in recent years has proceeded relentlessly towards 'fixing the fault lines' revealed by the crisis. With the end of the Basel III transition period in 2019 on the horizon, it might be hopeful to wonder if this is the year when the pace of regulatory change begins to slow. These hopes may be short-lived.

The Basel Committee is close to finalising remaining elements of the prudential regime, in spite of noting in January and again in March that more time is needed to finalise work on outstanding components. As this process unfolds, it will be interesting to see to what extent political transitions and some desires for regionally-balanced requirements influence the global regulatory landscape.

A key area of contention in finalising the package of rules (which some have branded as 'Basel IV' given their scale) relates to the calibration of output floors – which will impose a 'hard limit' to the modelling benefit banks can derive from using internal models to measure risk.

Depending on the final design of these rules – including those relating to new approaches for standardised measurements of credit and operational risks – banks could find themselves navigating further binding constraints on capital resources and balance sheets. Expectations are for this set of rules to land in certainty this year, with many banks eager to analyse the impacts on business models, product mix and capital allocation in order to appropriately adjust strategy.

In the meantime, planning will be underway for the significant transformation of the regulatory market risk framework – the Fundamental Review of the Trading Book (FRTB). The FRTB rules were finalised at a global level in January 2016 and are expected to be transposed into national legislation by January 2019, for banks to report under by end 2019.

FRTB's impact will be felt well beyond risk functions and trading desks – with front-office, finance and IT teams all heavily affected. Among other changes, the rules will limit diversification and offsetting benefits that currently exist across individual asset classes (such as interest rate and equities products) and trading desks – potentially limiting revenues earned from trading flows between desks. Additionally, the rules electrify the fence between banking and trading-book boundaries through a more prescriptive trading-book definition.

Treasury teams that currently hedge banking-book activities, and offset banking hedging positions with their trading businesses may find themselves holding additional capital on these positions under FRTB requirements assuming these positions can no longer be netted as in the past.

The higher capital requirements which FRTB threatens could mean a rise in the costs of the major banks' market-making activities. Broadly, the new rules will require various operating-model decisions to be made, along with a number of systems and data issues that will need to be thought through prior to implementation.

From a liquidity perspective, the major banks would have welcomed the discretion applied by the South African Reserve Bank (SARB) in Q3-16 regarding the treatment of certain short-term deposits for the Net Stable Funding Ratio (NSFR). In moving towards the effective date of 1 January 2018 for the NSFR, areas of focus for the major banks will likely shift away from making major changes to funding structures, towards concluding on significant interpretational and operational matters within the NSFR framework as they seek full compliance.

Accounting

The major banks sharply focused on IFRS 9 implementation programmes in 2016 – ironing out accounting policy judgements and updating modelling capabilities – in anticipation of the evolutionary accounting standard's implementation from January 2018.

While the banks prepare for IFRS 9 parallel-runs in 2017, gears will need to shift from transition-readiness to making sure their systems of governance and internal control over all areas of the standard are fit for purpose, beyond just expected credit loss (ECL) provisioning.

Many observers will also be keen to understand what impact the standard will have on regulatory capital levels, although this may be less of a concern for the South African major banks given their robust capital positions.

To mitigate some of this concern for banks globally, in October 2016 the Basel Committee consulted on several transitional options to provide relief for the day-one IFRS 9 impact on regulatory capital, with final guidance expected during 2017.

Conduct

Market conduct has been a hot topic on the global banking stage for some time and 2016 saw a continued rise in regulatory pressure in this area. From concerns over anti-money laundering (AML) controls to landmark settlements by systemically important banks over securities mis-selling, 2016 made clear that regulators are acutely attuned to conduct and compliance risks.

Consistent with international trends, we continue to expect rising supervisory interest in conduct risk in South Africa as the Twin Peaks regulatory architecture is embedded – especially as banks' business models and risk profiles evolve in response to economic, regulatory and technological change.

The Protection of Personal Information (POPI) Act was signed into law in 2013. In September 2016, the Information Regulator was appointed, who will be tasked with monitoring compliance with, and enforcement of, the provisions of the POPI Act. Banks are well underway with establishing programmes to implement the requirements of the Act.

Reputation

The recent announcement by the Competition Commission of South Africa – that it has referred a case of price fixing and market allocation in the trading of foreign currency pairs involving the rand for prosecution to the Competition Tribunal – triggered a wave of media interest. All stakeholders will follow this issue closely in the next months as more information becomes available.

Internal responses

Globally and domestically, the industry continues to respond to multiple strategic headwinds. Rapidly developing financial and regulatory technology (fintech and regtech), competition from non-traditional players, advances in big data, cloud computing, artificial intelligence and ongoing innovation of core banking activities – like payments and settlements processing – all offer the prospect of significant opportunity, and major disruption.

Within these dynamics, the major banks will continue to find themselves exceptionally busy. Projects on the to-do list continue to include focus on target operating models in areas ranging from compliance to risk and finance functions.

Key operational priorities include implementation of emerging technology to evolve or replace legacy systems, a sharp focus on cyber and IT resilience, and digitising front and back-office operations – all while ensuring electronic channels keep pace with customer expectations.

As banks think through the array of changes around them, recent history provides a reference for charting the course. Our global research suggests that the most critical factor constraining advanced territory banks was not external at all: it was their own strategies.

When those banks took steps to become coherent, they began to not only recover, but thrive. A study[3] conducted by our strategy consulting group, Strategy&, analysed the performance of 17 major European and American banks during and after the crisis. We found a strong correlation between strategic coherence (the degree of alignment between strategy, capabilities and portfolio of products and services), financial performance and recovery.

These insights offer important lessons for banks in today's rapidly-changing environment. For all the headlines that depict an industry facing relentless disruption and uncertainty, the reality is that there is a lot banks do know and can plan for. Overall bank strategy matters, perhaps more than ever.

[3] 'Banking's Biggest Hurdle: Its Own Strategy', Strategy&, January 2017 – https://goo.gl/dx6vCL

Outlook

Political events in 2016 provided lessons in forecasting risk when measuring unknown outcomes. As these events unfolded, business and society were confronted by deep ideological questions: for example, how to close divides in skills, jobs and income inequality, or how to leverage a world and workforce more connected than it has ever been?

Many will spend 2017 reflecting on these and other questions, while it becomes increasingly clear that the risk outlook now includes dynamic and emerging risks far more difficult to predict with precision.

In advanced economies, policymakers ended 2016 focusing on fiscal levers in a bid to stimulate growth – with Canada, Japan and the UK all announcing or extending fiscal plans. How these play out in practical policy terms will be important for global growth.

On foreign policy, market analysts will be monitoring US-Russian relations closely, which could have spillover effects in Eastern Europe, the Middle East and potentially East Asia – all important emerging market trading partners.

Commodity prices – oil in particular – ended the year in slightly higher territory compared with the sharp declines of recent periods on the back of an OPEC agreement to prevent the oil market drowning in oversupply. The sustainability of the agreement, and commodity prices broadly, will be key for both government budgets and corporate balance sheets in many emerging markets.

Our global research suggests that with commodity prices still set to remain well below 2014 levels, and Chinese growth projected to keep falling gradually over time, emerging market growth is expected to remain subdued.

The domestic growth outlook is also expected to remain subdued, with the SARB noting a marginal downward revision to its 2017 forecast to 1.1%, while the 2018 forecast remains unchanged at 1.6%.

While expectations that South Africa may be approaching the end of the rate-hiking cycle potentially holds welcome news for business and consumer debt-service costs, the rate cycle remains dependent on the longer-term inflation outlook and broader macro conditions.

Despite a gloomy short-term forecast globally and domestically, our recently refreshed global economic thinking – The World in 2050 – highlights the importance of taking a longer-term view of global economic prospects that looks beyond the short-term ups and downs of the economic and political cycle.

In our view, leading banks will be those that are considered and disciplined in thinking through and setting strategy with the right balance of flexibility and patience – ensuring that responding to short-term pressures does not come at the expense of, or distract from, longer-term value creation. They will be those with a healthy scepticism for conventional wisdom; those that look at 'change', 'transformation' and 'disruption' and can tell the difference between which aspects of their future represent something to be predicted, versus something to be achieved.

Results overview

2

Headline earnings

Within an eventful and turbulent operating environment, the major banks posted a credible set of results, with resilient earnings growth of 11% against 2H15, 8.9% against 1H16 and 8.4% on an annualised basis (FY16 vs FY15). Earnings growth continues to be underpinned by solid operating drivers and well-diversified product sets across franchises. It reflects the major banks' efforts to deliver on their strategic ambitions.

A key theme we have been tracking over recent periods and now clearly evident in the combined results is the sizeable contribution of the major banks' African operations outside the domestic market. While relative rand appreciation during the period offset some growth in the banks' continental operations outside South Africa, these operations accounted for approximately 13.5% of combined headline earnings at 2H16 (15.7% at 2H15).

Uncertainty related to the macroeconomic environment in the rest of Africa given low commodity prices, foreign exchange volatility and political uncertainty weighed down on the banks' African operations outside South Africa.

Credit growth

The tight credit environment that prevailed over 2H16 is reflective of ongoing stresses facing South African consumers, while business confidence levels remained subdued. Gross loans and advances grew by a lacklustre 0.7% against 1H16 and a moderate 2.1% against FY15. Consistent with our previous observations and expectation for 2017, combined credit growth for the major banks remains driven by corporate rather than retail demand. We have also observed that the number of clients in debt counselling continued to increase in FY16.

Asset quality

Total non-performing loans (NPLs) continues to present a mixed picture, reflecting a 2.8% decline against 1H16 but increasing 4.5% against 2H15. As the trend driver, corporate NPLs showed a marked decline of 17.7% against 1H16, while retail NPLs (which still make up the vast majority of NPL stocks) grew 2.5% against 2H15, largely driven by the 'other retail loans' category.

Overall, NPL and workout strategies that the major banks continue to focus on have kept the NPL-to-total gross loans ratio at a steady 3% at 2H16 (3.1% at 1H16) – well below the 4% level last seen at 2H12, and comfortably below the elevated NPL levels seen in some international territories. Corporate NPLs worked out largely related to the mining and oil & gas sectors.

Net interest income (NII)

The positive endowment impact resulting from the higher interest rates that prevailed over 2H16 continued to benefit the major banks' NII, with the combined figure growing 9.9% against 2H15 (2.2% against 1H16) and by a healthy 12.8% on an annualised basis. The major banks' combined NII margin improved by 22bps to 4.61% at 2H16 compared to 4.39% at 2H15, reflecting an ongoing focus on appropriately pricing for risk.

Non-interest revenue (NIR)

This was driven by resilient net fee and commission income growth of 4.6% against 2H15, and strong trading revenues. The major banks' combined NIR showed broadly muted growth of 0.9% for 2H16 (contracting 1.9% against 1H16). Annualised growth in NIR was 5.4% (FY16 vs FY15). We observed continued strong growth in the relative proportion of non-interest revenue earned outside of South Africa.

Efficiency

Ongoing focus on cost management remains a theme across the major banks' results, reflected in moderate growth on the operating expenses line of 6.1% and 1.4% against 2H15 and 1H16 respectively. This was driven by double-digit growth in IT expenses as the banks continue to enhance IT resilience, upgrade legacy systems and enhance data requirements to ensure regulatory compliance.

On an annualised basis, operating expenses grew 9.2% and in some ways reflects the heightened inflationary environment that persisted over 2016. The combined cost-to-income ratio deteriorated marginally by 28bps to 54.36% against 2H15.

Return on equity

On the back of resilient earnings, combined ROE grew by 18bps and 98bps against 2H15 and 1H16 respectively to a healthy 18.6% at 2H16. At the same time, the combined economic spread (ROE less reported cost of equity) improved to 4.1% from 3.6% at 1H16 (4.9% at 2H15) – a level well above many international counterparts.

The decline in the major banks' combined economic spread* compared to 2H15 reflects increases in the cost of funding given the challenging operating climate and political events over the period that threatened the risk of a sovereign downgrade, which was eventually avoided for the time being.

Additionally, prudential liquidity changes would have contributed to funding demand, increasing funding costs. However, as a more risk-reflective view of performance, the positive economic spread continues to reflect favourably on the financial health of the major banks.

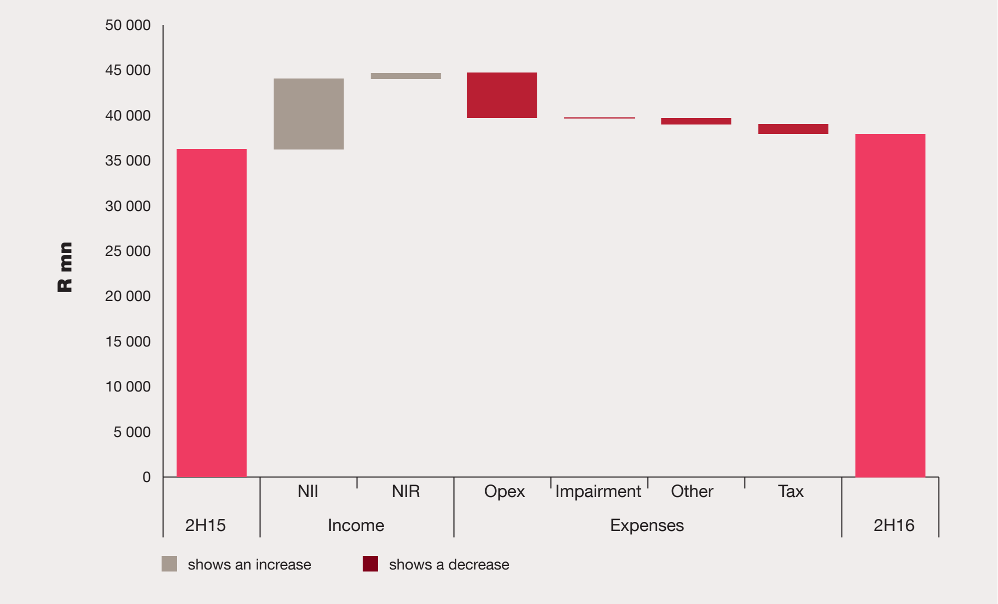
Combined results (Rm)

	FY16	FY15	2H16	1H16	2H15	1H15	FY16 v FY15	2H16 v 2H15	2H16 v 1H16
Net interest income	171 471	151 987	86 668	84 803	78 834	73 153	12.8%	9.9%	2.2%
Non-interest revenue	132 602	125 846	65 662	66 940	65 046	60 800	5.4%	0.9%	-1.9%
Total operating income	**304 073**	**277 833**	**152 330**	**151 743**	**143 880**	**133 953**	**9.4%**	**5.9%**	**0.4%**
Total operating expenses	-173 028	-158 442	-87 135	-85 893	-82 154	-76 288	9.2%	6.1%	1.4%
Core earnings	**131 045**	**119 391**	**65 195**	**65 850**	**61 726**	**57 665**	**9.8%**	**5.6%**	**-1.0%**
Impairment charge	-30 593	-26 926	-13 356	-17 237	-13 336	-13 590	13.6%	0.1%	-22.5%
Other income/ (expenses)	-1 195	1 256	-1 378	183	-453	1 709	> -100%	> 100%	> -100%
Discontinued operations	-	2 741	-	-	-261	3 002	-100.0%	-100.0%	-
Income tax expenses	-24 143	-22 200	-12 513	-11 630	-11 432	-10 768	8.8%	9.5%	7.6%
Profit for the period	**75 114**	**74 262**	**37 948**	**37 166**	**36 244**	**38 018**	**1.1%**	**4.7%**	**2.1%**
Attributable earnings	70 071	68 220	34 194	34 468	32 502	35 718	2.7%	5.2%	-0.8%
Headline earnings	72 354	66 736	36 254	34 640	33 973	32 763	8.4%	11.0%	8.9%
Return on equity	17.9%	18.1%	18.6%	17.6%	18.4%	18.3%	-0.2%	0.2%	1.0%

Source: PwC analysis

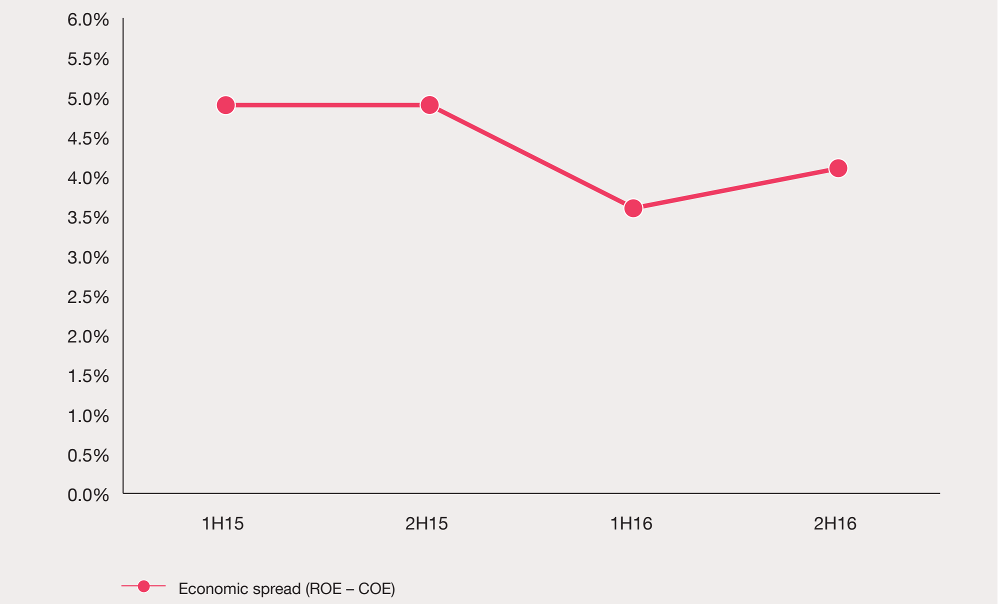
**Refer to Figure 2.2*

Figure 2.1 Key drivers of combined profit and loss



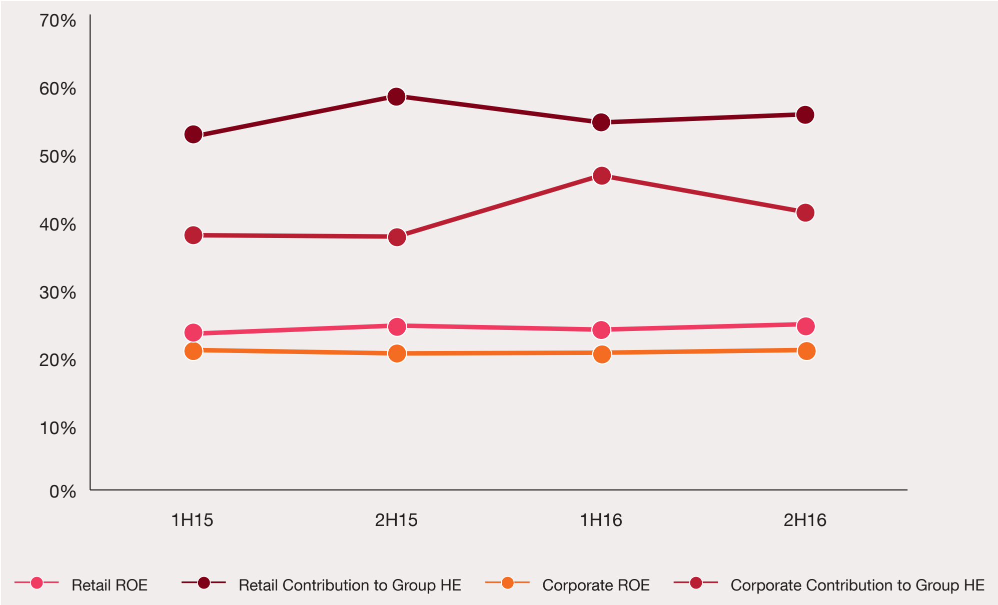
Source: PwC analysis

Figure 2.2 Economic spread performance (ROE – cost of equity)

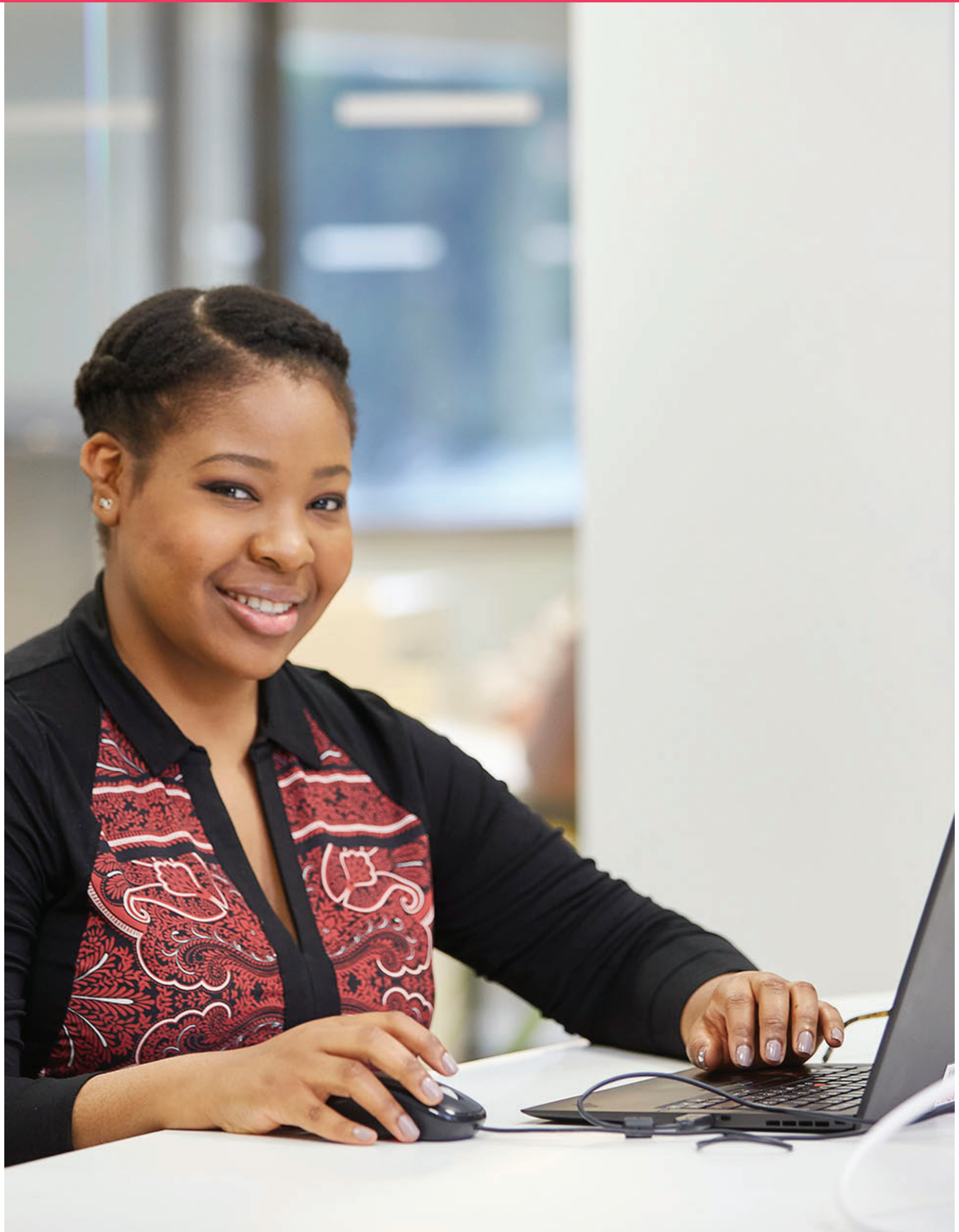


Source: PwC analysis

Figure 2.3 Segmental ROE and contribution to group headline earnings



Source: PwC analysis



Balance sheet dynamics

3

Credit growth

Gross loans and advances

The overall composition of the major banks' combined loan portfolios remained largely unchanged at FY16 when compared to FY15, as depicted in figure 3.1. In many ways this reflects the banks' strategic decisions to maintain the shape of their balance sheets and portfolio structures given heightened levels of economic uncertainty and forecast risk.

Combined loans and advances grew 0.7% and 2.1% against 1H16 and FY15 respectively. Aggregate credit demand, across retail and wholesale portfolios, continues to be constrained by economic factors ranging from slow economic growth in the South African market, increasing pressure on household incomes and subdued levels of business confidence – all amplified by the heightened rate environment that persisted over the period.

In constant currency terms, some banks have commented on an increase in US-dollar-denominated credit appetite coming from their African operations outside South Africa. This growth, however, was offset by a stronger rand.

Corporate lending

Corporate lending grew 3.8% at FY16 when compared to FY15 and 1.1% against 1H16. Consistent with our previous observations, growth in the corporate sector continues to outpace retail lending in aggregate terms, and remains largely driven by robust commercial property activity.

Based on SARB industry data, both financial and non-financial companies increased their reliance on bank funding during Q3, with the utility sectors showing a healthy demand for bank intermediated funding in the second half of the year.

We also observed that the banks have tightly managed their exposures to sectors experiencing stress, including the agriculture, mining and oil & gas sectors.

Retail mortgages

Mortgage portfolios continue to show sluggish levels of growth in the domestic retail sector with combined residential mortgage advances growing 1.7% in FY16 compared to FY15, and growing by 0.7% against 1H16.

This trend – one we have persistently observed – continues to reflect a slowing in consumer credit appetite for residential mortgages given pressure on household balance sheets, on the one hand, and potentially amplified by strategic supply-side decisions on the part of the major banks to direct lending activity to other asset classes. As a result, this has increased pressure on capital and interest repayments as well as the ability for households to settle contractual payments early on their mortgages.

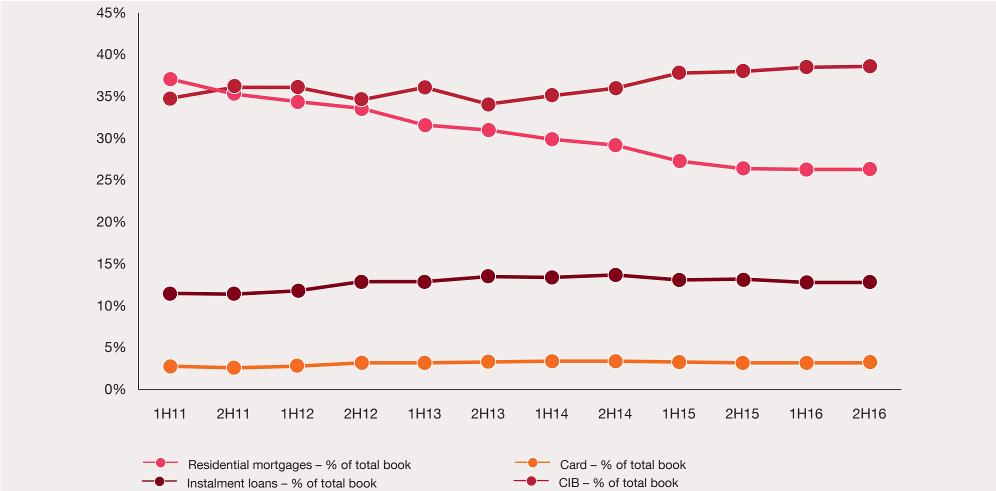
Instalment sale credit, card debtors and other unsecured lending

Growth in the credit card, instalment sale and other retail loan categories reflected a relatively mixed trend at 2H16.

While the combined card portfolios of the major banks showed growth against FY15 of 1.2%, and a contraction of 0.2% against 1H16, instalment sale and other retail demand loans reported growth of 0.4% and 2.6% respectively against 1H16.

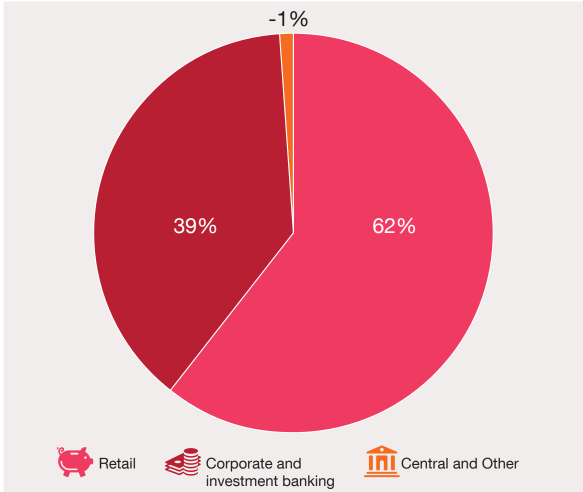
SARB industry data at Q3 provides some insight into the dynamics impacting the instalment sale loan portfolio, noting that used vehicle sales remained broadly flat during the period. We also note a decline in retail unsecured lending of 0.8% against 1H16 and 3.6% when compared to FY15 – a function of potentially reduced risk-appetite levels and stringent origination criteria given the domestic economic landscape. Additionally, new affordability criteria and unsecured lending rate caps proposed by the Department of Trade and Industry in 2016 may be contributing to the slowdown in retail unsecured lending.

Figure 3.1 Composition of loan portfolios



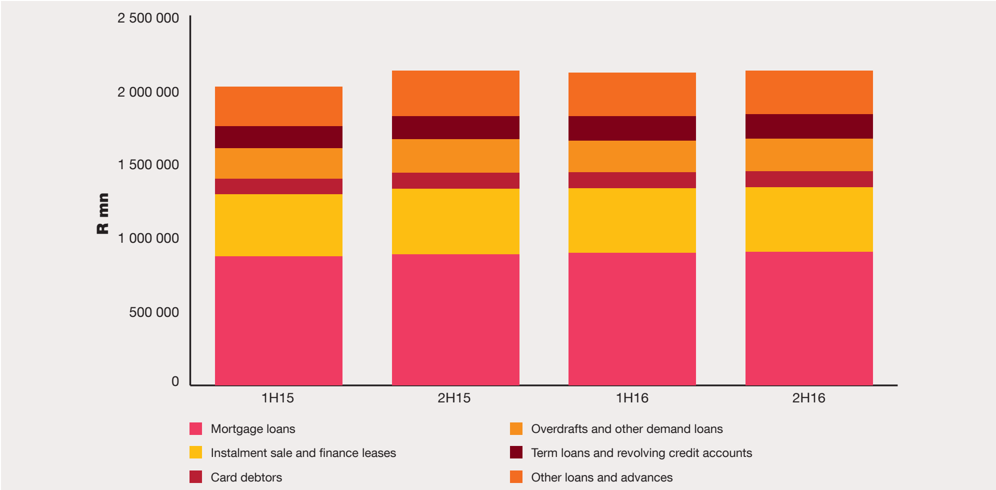
Source: PwC analysis

Figure 3.2 Combined loans and advances by sector as at 2H16



Source: PwC analysis

Figure 3.3 Retail advances per product



Source: PwC analysis

Capital and funding

Capital resources and requirements

Robust capital positions of the major banks is a theme that has continued over 2016, with the combined core Tier 1 ratio increasing 60bps from 12.5% at FY15 to 13.1% at FY16.

Organic capital generation on the back of resilient earnings growth continues to be a key driver underpinning this increase, supported by proactive management of risk-weighted assets (RWAs) which decreased 0.6% at FY16 compared to FY15. In part, this is as a result of low loan growth and ongoing RWA optimisation initiatives.

The total capital adequacy ratio of the major banks strengthened from 15.2% at FY15 to 16% at FY16, well above the South African regulatory minimum of 9.75% (excluding bank-specific capital add-ons and the Basel III buffers currently being phased in).

Liquidity and funding

Deposit growth over 2016 came in at 2.6% against FY15, reflecting in part the historically low savings rate in South Africa and the increasingly competitive nature of the domestic transactional banking beyond the four major banks included in our market analysis.

At FY16, the combined loans-to-deposit ratio of the major banks remained healthy at 94.7%, moderately lower than the 96.2% reported at FY15.

The banks also commented favourably on the SARB's decision in Q3 to amend the Net Stable Funding Ratio (NSFR) framework – which comes into effect from January 2018 – for the South African market by applying discretion over the regulatory treatment of short-term funding received from financial corporates (excluding banks).

The SARB has proposed a 35% available stable funding factor for institutional funding less than six months in tenor, compared to 0% proposed by the Basel Committee. As the prudential liquidity regime remains a focus area of the banks, and in particular compliance with the NSFR, they continue to engage with the SARB on the remaining areas of clarification and to explore solutions to ensure that the framework aligns with local conditions. The major banks were compliant with minimum standards required to comply with the Basel III's longer term prudential liquidity ratio, the NSFR as at 31 December 2016.

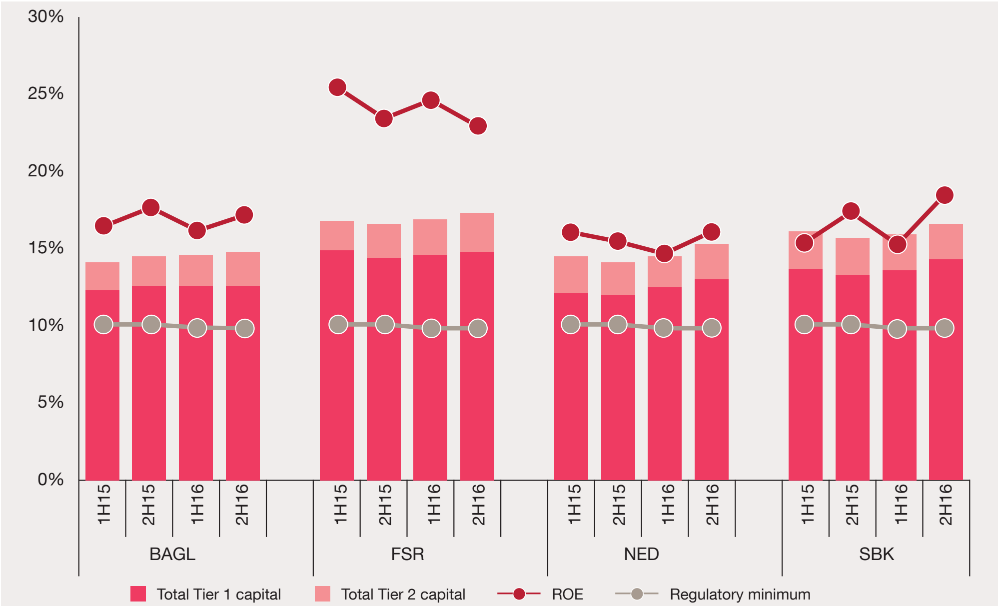
Long-term funding spreads continue to remain elevated and still appear to be reflecting a high liquidity premium. In order to meet the LCR requirements, liquidity demand by banks increased in direct response to the regulation which prompted a rise in the market cost of liquidity.

At 31 December 2016, the major banks' average LCR ratios exceeded the 70% minimum phased-in Basel III LCR requirement.

Due to the competition in the market to attract customer deposits to help meet liquidity requirements, this has resulted in increased rates being paid to customers to attract deposits. Focus continues by banks to grow their share of household and commercial deposits given the structural features of the domestic banking sector, which is reliant on a large proportion of institutional funding in the system. Banks noted growth in negotiable certificates of deposit and other structured deposits that tend to reduce the proportion of more expensive foreign currency funding.

There were noticeable efforts to maximise use of the domestic wholesale deposit market, given strategies to reduce foreign currency liabilities, which tend to be a more expensive source of funding.

Figure 3.4 Regulatory capital ratios and ROEs



Source: PwC analysis

The evolving regulatory landscape

At the global level, the Basel Committee continues to make progress towards finalisation of the Basel III reforms, even though it appears to be taking longer than expected. While it remains to be seen how political transitions influence final outcomes, it is clear that key features of these reforms include revisions to the standardised RWA framework, the leverage ratio framework and the capital output floor.

As outlined in our strategic overview earlier, while there remains uncertainty as to the design and calibration of the final revisions, a lot is known in terms of regulatory changes which banks should already be planning for. Key among these include the far-reaching FRTB market risk framework, the Standardised Approach for Counterparty Credit Risk (SA-CCR) and the evolution of the Pillar 3 disclosure framework – each of which will require substantial investments of time, energy and budget to achieve compliance.

Asset quality

4

Combined NPLs decreased 2.8% against 1H16, but increased 4.5% against FY15. Impairment charges grew 13.6% against FY15 on an annualised basis.

Non-performing loans (NPLs)

NPLs continue to reflect a mixed picture across the individual banks. On a combined basis, total NPLs increased 4.5% as at FY16 when compared to FY15.

However, total NPLs decreased 2.8% when compared to 1H16. Retail NPLs continue to make up the majority of NPL stocks, comprising 78% of total NPLs at 2H16 (74% at 1H16). The decrease in combined NPLs is driven by corporate portfolios on the back of successful restructurings and ongoing portfolio management, aided by the appreciation of the rand in respect of distressed exposures in certain African markets outside South Africa. Corporate NPLs worked out largely related to the mining and oil & gas sectors.

Across retail and wholesale portfolios, the major banks continue to adopt prudent credit origination approaches amid relatively volatile market conditions as well uncertainties in the macroeconomic environment. These prudent measures and a proactive focus on credit quality appear to have reflected in the overall decline in total NPLs over 2H16.

We have also observed that the number and value of clients in debt counselling continued to increase in FY16. Debt counselling clients are over-indebted consumers who have affordable repayment plans with credit providers. The banks have started to dedicate teams to deal with the operational and business-related matters relating to this portfolio, while continuing to monitor provisioning assumptions used in calculating impairments relative to this portfolio.

Coverage ratios and income statement impairments

Consistent with our previous analyses, the major banks continue to maintain healthy credit coverage ratios. The specific impairment coverage ratio increased 28bps at 2H16 compared to 1H16, from 40.8% to 41.08%, while total coverage ratios also strengthened from 67% at 1H16 to 67.6% at 2H16.

An interesting observation is that NPLs as a percentage of gross advances has remained in the 3%-4% range since 2H12, significantly lower than other major European banks, for example, where NPL reduction has proven challenging. At 2H16, this ratio remained broadly flat at 3% of gross loans and advances (3.2% and 3% at 1H16 and 2H15 respectively).

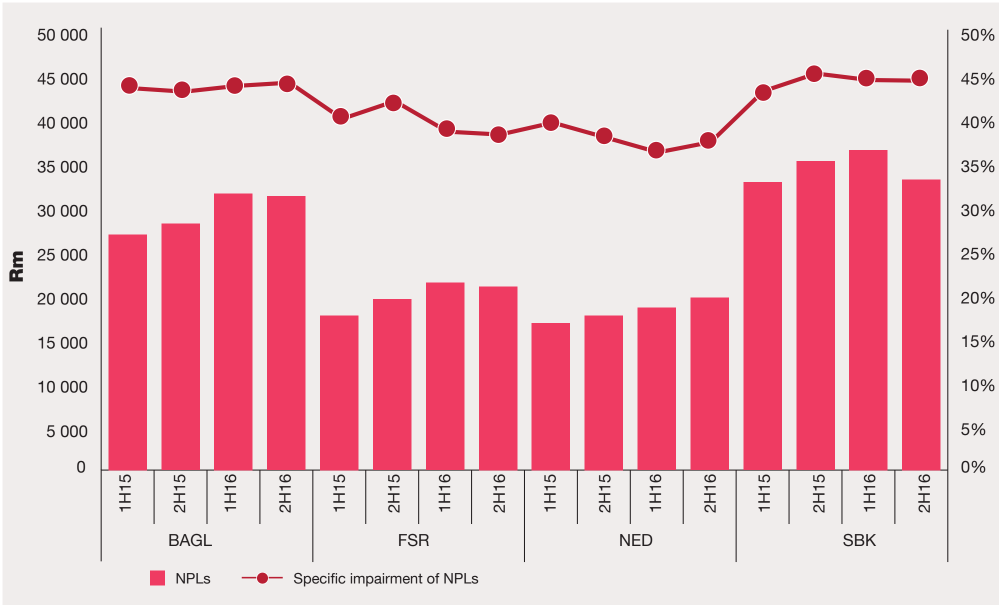
From an income statement perspective, the combined impairment charge on an annualised basis grew 13.6% against FY15. The combined impairment charge was relatively flat against 2H15 growing by only 0.1%, but showed a 22.5% decline against 1H16. The combined credit loss ratio decreased by 24bps and 2bps from 1.04% in 1H16 and 0.82% at 2H15 to 0.8% in 2H16.

The major banks' focus on stringent origination strategies continues to result in better quality balance sheets and well-managed levels of NPLs. At the same time, proactive provisioning practices have, to some extent, seen earlier write-offs in previous periods. Overall, the major banks increased their portfolio impairments at 2H16 to take into account the impact of macroeconomic conditions.

We also observed an increase in impairment provisions related to exposures held in the rest of Africa with increased use of overlay provisions. This reflects the deteriorating macroeconomic environment given low commodity prices, foreign exchange volatility and political uncertainty that many African countries remain exposed to. Specific countries currently experiencing heightened economic stress include: Nigeria, Kenya, Mozambique, Botswana, Angola and Zambia.

The level of impairments, coverage ratios and NPLs, will remain focus areas over the short to medium term, particularly in light of heightened levels of forecast risk and overall macroeconomic volatility. It will be interesting to see how the major banks' provisioning strategies, and coverage ratios in particular, evolve given implementation of IFRS 9 – and the new expected credit loss (ECL) model it brings – on 1 January 2018.

Figure 4.1 Impairment coverage ratios



Source: PwC analysis

Net interest income

5

Net interest income remains a key revenue driver contributing to earnings growth of the major banks, and grew by a robust 12.8% at FY16 compared to FY15.

The combined net interest margin grew by a healthy 22bps to 4.61% at 2H16.

What's driving the numbers?

Endowment and economic impact

Consistent with our previous observations, the major banks benefitted relatively substantially from the higher interest rate environment that prevailed over 2016. This translated into healthy net interest income growth as variable-rate assets repriced faster than non-rate sensitive liability and equity funding. With the SARB noting that we may be reaching the end of the rate-hiking cycle, it will be interesting to see how, and to what extent, the positive trajectory of the banks' net interest income can be sustained.

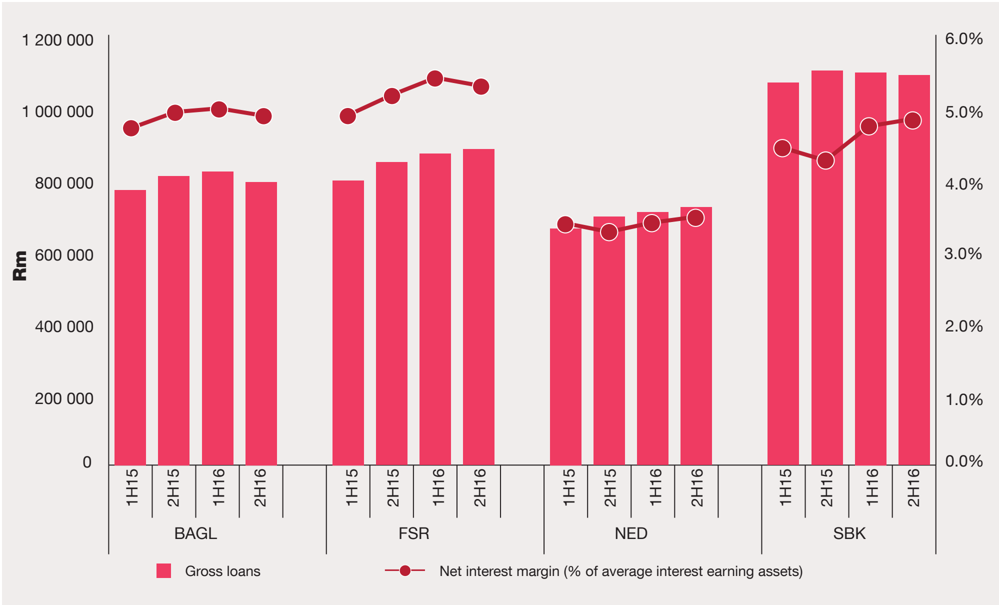
Regulatory requirements, higher funding costs and balance sheet mix

The major banks continue to focus on appropriate, risk-reflective loan pricing and ensuring that their overall asset mix remains optimal relative to individual strategic ambitions. In particular, corporate and investment banking lending portfolios – including those originated in continental markets outside South Africa – served to boost net interest income growth.

However, given persistent uncertainty over the potential for a sovereign credit rating downgrade during 2016, the associated implications of higher funding costs appears to have played a part in offsetting net interest margin growth for some banks.

Additionally, with the LCR now firmly embedded into the prudential regulatory regime in South Africa, the banks continue to accumulate stocks of low-yielding, high-quality liquid assets (HQLAs) for the purposes of the LCR – a factor that also served to offset net interest margin growth. The banks also commented on the adverse impact the National Credit Act (NCA) verification requirements and caps on rates – particularly in unsecured lending portfolios – had on their margins. Meanwhile, regulatory changes in Kenya where caps on lending rates and floors on deposits were introduced further adversely impacted bank margins.

Figure 5.1 Net interest margin and gross loans



Source: PwC Analysis

Non-interest revenue

6

Non-interest revenue (NIR) continues to be primarily supported by growth in fee and commission income, which represents 73% of total NIR revenue for 2H16

Combined NIR annualised growth was 5.4% in FY16 when compared to FY15

Combined NIR grew 0.9% in 2H16 against 2H15, but decreased 1.9% against 1H16, reflecting a muted growth trajectory

What's driving the numbers?

Net fee and commission income

Net fee and commission income grew 4.6% compared to 2H15, which represents a continuation of the strong growth trajectory previously recorded. The banks have commented that this is attributable to net growth in customer numbers, better transaction volumes on electronic channels and sub-inflation increases in the prices of selected products.

We see this growth as a remarkable achievement given headwinds experienced in the form of lower interchange fees and the generally subdued macroeconomic environment across the continent. The majority of banks also commented that they have seen muted growth in card-acquiring volumes.

Management teams continue to diversify the net fee and commission income revenue streams across various geographical regions in Africa, given the relatively mature state of the banking market in South Africa and muted opportunities for significant further growth in the domestic market.

Banks continue to focus on growth in annuity revenue in the rest of Africa, particularly through focusing on less capital-intensive activities. Knowledge-based fee income, largely associated with investment banking advisory activities, has continued to show resilience despite tough trading conditions. Current economic uncertainty could, however, impact banks in the near term as financing decisions, listings and takeovers may be delayed.

Fair-value income

Fair-value income continued to follow the volatile pattern observed in previous reporting periods, declining by 9% on 2H15, with a similar decline of 10% against 1H16. Trade flows generally benefited from increased demand for hedging and risk management products in light of the levels of market volatility prevalent over the current period.

At the same time, the trading environment remained challenging due to increased competition and compressed margins. Given the currency volatility noted in 2H16, the banks' fair-value income benefited from this tailwind, notwithstanding the pressure placed on other financial statement line items (such as foreign currency translation reserves) as a result of the currency volatility experienced.

The growing contribution of trading operations in the rest of Africa has been a positive development for some of the major banks as they capitalise on the increase in cross-border trading activity.

Insurance and bancassurance income

Revenue related to insurance and bancassurance activities increased by 25.5% compared to 2H15 supported by higher levels of assets under management in wealth businesses.

However, some headwinds were faced during the reporting period, including softer global equity markets, a moderation in the growth of life and short-term insurance premiums on the back of slower economic growth and higher weather-related claims. At the same time, increased investments are being planned to meet regulatory obligations expected in the near term in relation to insurance-type products.

Efficiency

7

The combined cost-to-income ratio deteriorated marginally to 55.4% as at 2H16 (2H15: 55.1%).

This is the 6th consecutive reporting period where the ratio remains in the 54%–56% range, illustrating the cost challenge facing the banks

What's driving the numbers?

The major banks continue to focus on structural cost programmes to realise efficiency gains that can be invested in growth initiatives. Interestingly, this is the sixth reporting period in which the cost-to-income ratio is in the 54% to 56% range, illustrating the challenge that banks are facing to further improve on it. As previously observed, we continue to expect pressure on the cost-to-income ratio as the major banks invest for future growth in a challenging economic climate.

Areas where increased costs continue to manifest include:

- Initiatives to right-size branch networks, coupled with increased costs to build out a branch network that is fit for the future and responsive to the changing needs of customers. The banks are looking critically at internal processes and levels of automation with the aim of simplifying processes and rationalising systems, where possible, in order to deliver an enhanced customer experience;
- Initiatives to invest in operations in the rest of Africa, where significant investments are currently being made in infrastructure/IT systems, within a generally higher inflationary environment;
- Significant investments in data capabilities in IT systems to meet increased regulatory requirements;
- Investments in digital solutions to respond to heightened customer expectations for seamless transactional banking; and
- Increased spending on cyber programmes in order to respond to the threat of cyber risk

We previously indicated that there will be increased amortisation charges as IT systems come online, which will negatively impact costs. Banks commented on this drag on performance in their current-period results.

Banks increased their spend in 2016 to prepare for their overall readiness for new regulation in the form of the Basel Committee's Principles for effective risk data aggregation and risk reporting (BCBS 239).

In South Africa, the SARB previously issued a Directive in 2015 advising domestic systemically important banks (D-SIBs) to comply with the requirements by 1 January 2017, while the implementation timelines for non-D-SIBs would be considered on a case-by-case basis.

The principles require greater linkage between risk and finance systems and seek to ensure the integrity of risk data nearly to the same extent as financial reporting data. There is heightened awareness of IT spend as the major banks race to embed digital platforms in competition with non-traditional players in the form of companies within industries outside financial services.

More than 55.5% of the major banks' total operating expenses as at 2H16 related to staff costs, which represents a slight decrease on the contribution of 55.7% at 2H15. We expect this staff cost trend to continue in the short term, as specialist and skilled resources are employed to assist the banks with the IT transformation described above and to help meet evolving regulatory and compliance requirements.

The major banks have to be commended on their cost containment strategies over the current period, which resulted in a relatively stable cost-to-income ratio. Over the coming period it will be interesting to see how banks respond to subdued global growth, an unstable local economic environment, a stronger currency and continuing levels of investment in IT-related costs to meet their future ambitions.

Hot off the press

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Key banking statistics

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	BAGL				FSR				NED				SBK				Combined				Growth (% and bps)	
	2H16	1H16	2H15	1H15	2H16	1H16	2H15	1H15	2H16	1H16	2H15	1H15	2H16	1H16	2H15	1H15	2H16	1H16	2H15	1H15	2H16 v 2H15	2H16 v 1H16
Balance sheet																						
Total assets	1 101 023	1 142 469	1 144 604	1 038 945	1 180 462	1 149 326	1 139 523	1 059 262	966 022	944 188	925 726	866 624	1 543 758	1 549 292	1 570 610	1 471 293	4 791 265	4 785 275	4 780 463	4 436 124	0.2%	0,1%
Gross loans and advances	789 814	818 303	806 410	767 395	880 742	867 982	844 691	793 964	719 226	704 871	693 043	659 848	1 087 421	1 095 230	1 099 797	1 066 107	3 477 203	3 486 386	3 443 941	3 287 314	1.0%	-0.3%
Total deposits	728 057	754 895	751 399	700 267	951 970	919 930	899 619	865 521	761 542	741 712	725 851	690 495	1 228 993	1 214 408	1 201 549	1 146 843	3 670 562	3 630 945	3 578 418	3 403 126	2.6%	1.1%
Risk-weighted assets	703 785	698 685	702 663	647 472	715 240	698 732	680 400	630 441	509 221	507 466	501 243	465 544	883 179	912 822	944 039	856 380	2 811 425	2 817 705	2 828 345	2 599 837	-0.6%	-0.2%
Asset quality & provisioning																						
Non-performing loans	31 097	31 409	27 980	26 758	20 851	21 282	19 409	17 551	19 553	18 437	17 559	16 695	33 406	36 344	35 128	32 681	104 907	107 472	100 076	93 685	4.8%	-2.4%
Impairments	-19 716	-19 431	-17 100	-16 448	-16 571	-16 577	-16 158	-14 793	-12 149	-11 539	-11 411	-11 004	-21 793	-23 796	-22 652	-20 241	-70 229	-71 343	-67 321	-62 486	4.3%	-1.6%
Collective provisions	-5 971	-5 666	-5 027	-4 790	-8 589	-8 359	-7 988	-7 760	-4 832	-4 856	-4 747	-4 386	-7 134	-7 623	-6 790	-6 114	-26 526	-26 504	-24 552	-23 050	8.0%	0.1%
Individually assessed provisions	-13 745	-13 765	-12 073	-11 658	-7 982	-8 218	-8 170	-7 033	-7 317	-6 683	-6 664	-6 618	-14 659	-16 173	-15 862	-14 127	-43 703	-44 839	-42 769	-39 436	2.2%	-2.5%
Non-performing loans (% of advances)	3.9%	3.8%	3.5%	3.5%	2.4%	2.5%	2.3%	2.2%	2.7%	2.6%	2.5%	2.5%	3.1%	3.3%	3.2%	3.1%	3.0%	3.1%	2.9%	2.8%	0.2%	0.0%
Impairment charge (% of average advances)	0.98%	1.48%	0.99%	1.11%	0.9%	0.95%	0.77%	0.68%	0.69%	0.67%	0.77%	0.77%	0.67%	1.05%	0.75%	0.99%	0.80%	1.04%	0.82%	0.89%	0.0%	-0.2%
Impairment coverage ratio	63.4%	61.9%	61.1%	61.5%	79.5%	77.9%	83.3%	84.3%	62.13%	62.6%	65.0%	65.9%	65.24%	65.5%	64.5%	61.9%	67.6%	67.0%	68.5%	68.4%	-0.9%	0.6%
Implied loss given default	44.2%	43.8%	43.1%	43.6%	38.3%	38.6%	42.1%	40.1%	37.42%	36.2%	38.0%	39.6%	43.88%	44.5%	45.2%	43.2%	40.9%	40.8%	42.1%	41.6%	-1.1%	0.1%
Profit & loss analysis																						
Net interest income	20 910	21 093	19 944	18 463	23 243	22 907	20 823	19 562	13 398	13 028	12 210	11 675	29 117	27 775	25 857	23 453	86 668	84 803	78 834	73 153	9.9%	2.2%
Non-interest income	14 976	15 415	14 831	13 960	17 663	18 080	16 909	16 595	12 146	11 357	11 298	10 450	20 877	22 088	22 008	19 795	65 662	66 940	65 046	60 800	0.9%	-1.9%
Total operating income	35 886	36 508	34 775	32 423	40 906	40 987	37 732	36 157	25 544	24 385	23 508	22 125	49 994	49 863	47 865	43 248	152 330	151 743	143 880	133 953	5.9%	0.4%
Total operating expenses	-21 317	-20 759	-20 336	-18 768	-21 819	-21 740	-20 130	-18 900	-15 141	-14 152	-13 987	-12 906	-28 858	-29 242	-27 701	-25 714	-87 135	-85 893	-82 154	-76 288	6.1%	1.4%
Core earnings	14 569	15 749	14 439	13 655	19 087	19 247	17 602	17 257	10 403	10 233	9 521	9 219	21 136	20 621	20 164	17 534	65 195	65 850	61 726	57 665	5.6%	-1.0%
Impairment charge	-3 554	-5 197	-3 370	-3 550	-3 741	-4 014	-3 145	-2 701	-2 343	-2 211	-2 482	-2 307	-3 718	-5 815	-4 339	-5 032	-13 356	-17 237	-13 336	-13 590	0.1%	-22.5%
Other income/(expenses)	60	55	58	71	469	640	813	757	-1 041	-427	294	436	-866	-85	-1 618	445	-1 378	183	-453	1 709	>100%	> -100%
Discontinued operations	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-261	3 002	-	-	-261	3 002	-100.0%	-100.0%
Income tax expenses	-2 838	-2 997	-2 992	-2 907	-3 495	-3 227	-3 557	-3 352	-2 011	-1 944	-1 699	-1 820	-4 169	-3 462	-3 184	-2 689	-12 513	-11 630	-11 432	-10 768	9.5%	7.6%
Profit for the period	8 237	7 610	8 135	7 269	12 320	12 646	11 713	11 961	5 008	5 651	5 634	5 528	12 383	11 259	10 762	13 260	37 948	37 166	36 244	38 018	4.7%	2.1%
Attributable earnings	7 689	7 019	7 561	6 770	10 480	12 083	10 480	11 319	4 690	5 442	5 393	5 328	11 335	9 924	9 068	12 301	34 194	34 468	32 502	35 718	5.2%	6.0%
Headline earnings from continuing operations	7 728	7 252	7 532	6 755	11 859	11 988	10 399	11 240	6 038	5 427	5 508	5 323	12 089	9 973	10 534	9 445	36 254	34 640	33 973	32 763	11.0%	8.9%
Key data																						
Other operating income (% of total income)	41.73%	42.22%	42.65%	43.06%	43.18%	44.11%	44.81%	45.90%	47.55%	46.57%	48.06%	47.23%	41.76%	44.30%	45.98%	45.77%	43.55%	44.30%	45.38%	45.49%	-1.8%	-0.7%
Net interest margin (% of total assets)	0.00%	0.00%	4.04%	3.96%	3.79%	0.00%	3.79%	3.79%	0.00%	0.00%	2.77%	2.79%	0.00%	0.00%	3.33%	3.44%	0.95%	0.00%	3.48%	3.49%	-2.5%	0.9%
Net interest margin (% of average interest earning advances)	4.87%	4.97%	4.92%	4.70%	5.29%	5.40%	5.16%	4.88%	3.45%	3.37%	3.24%	3.36%	4.82%	4.72%	4.24%	4.42%	4.61%	4.62%	4.39%	4.34%	0.2%	0.0%
Standardised efficiency ratio	57.00%	53.40%	56.10%	55.90%	51.94%	52.01%	51.10%	51.19%	56.70%	57.10%	56.40%	55.80%	55.80%	56.80%	56.70%	56.70%	55.36%	54.83%	55.08%	54.90%	0.3%	0.5%
Return on equity	17.1%	16.1%	17.6%	16.4%	22.9%	24.6%	23.4%	25.4%	16.0%	14.6%	15.4%	16.0%	18.4%	15.2%	17.3%	15.3%	18.6%	17.6%	18.4%	18.3%	0.2%	1.0%
Capital ratios																						
CET 1	12.1%	12.1%	11.9%	11.7%	14.1%	13.9%	13.7%	14.1%	12.1%	11.6%	11.3%	11.4%	13.9%	13.2%	12.9%	13.2%	13.1%	12.7%	12.5%	12.6%	0.6%	0.4%
Tier 1	12.6%	12.6%	12.6%	12.3%	14.8%	14.6%	14.4%	14.9%	13.0%	12.5%	12.0%	12.1%	14.3%	13.6%	13.3%	13.7%	13.7%	13.3%	13.1%	13.3%	0.6%	0.4%
Tier 2	2.2%	2.0%	1.9%	1.8%	2.5%	2.3%	2.2%	1.9%	2.3%	2.0%	2.1%	2.4%	2.3%	2.3%	2.4%	2.4%	2.3%	2.2%	2.2%	2.1%	0.2%	0.2%
Total	**14.8%**	**14.6%**	**14.5%**	**14.1%**	**17.3%**	**16.9%**	**16.6%**	**16.8%**	**15.3%**	**14.5%**	**14.1%**	**14.5%**	**16.6%**	**15.9%**	**15.7%**	**16.1%**	**16.0%**	**15.5%**	**15.2%**	**15.4%**	**0.8%**	**0.5%**

Contacts

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Johannes Grosskopf
Financial Services Industry Leader: Africa
PwC Africa
+27 11 797 4346
johannes.grosskopf@pwc.com
Connect on Linkedin

Costa Natsas
Banking & Capital Markets Leader: South Africa
PwC Africa
+27 11 797 4105
costa.nastas@pwc.com
Connect on Linkedin

Contributors

- Louwrens van Velden
- Rivaan Roopnarain
- Dale Stonebridge
- Hemal Kana
- Dirk Van Der Spuy