Striving for growth in a challenging environment

South Africa – Major banks analysis

April 2019

PwC analysis of major banks' results for the reporting period ended 31 December 2018

www.pwc.co.za/banking-analysis

Contents

This analysis presents the combined local currency results of Absa, FirstRand, Nedbank and Standard Bank. Investec and Capitec, the other major players in the South African banking market, have not been included due to their unique business mix and different reporting periods.

1 The big picture

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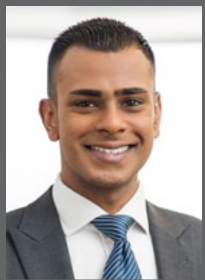

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Overall financial performance

Key metrics	2H18		1H18
ROE%, up 15bps	**18.9%**	↖	18.8%
Common Equity Tier 1 %, down 45bps	**12.3%**	↘	12.8%
Net interest margin %, remained flat	**4.36%**	↔	4.36%
Cost-to-income ratio, up 172bps	**56.8%**	↖	55.1%
Credit loss ratio, improved 7bps	**0.65%**	↖	0.72%

Source: PwC analysis

Growth	FY18 vs FY17	2H18 v 1H18
Combined headline earnings	8.7%	5.1%
Core earnings	4.2%	1.5%
Bad debts charge	-7.3%	-10.8%
Net interest income	5.6%	6.5%
Total operating income	5.9%	5.6%
Total operating expenses	7.2%	8.8%

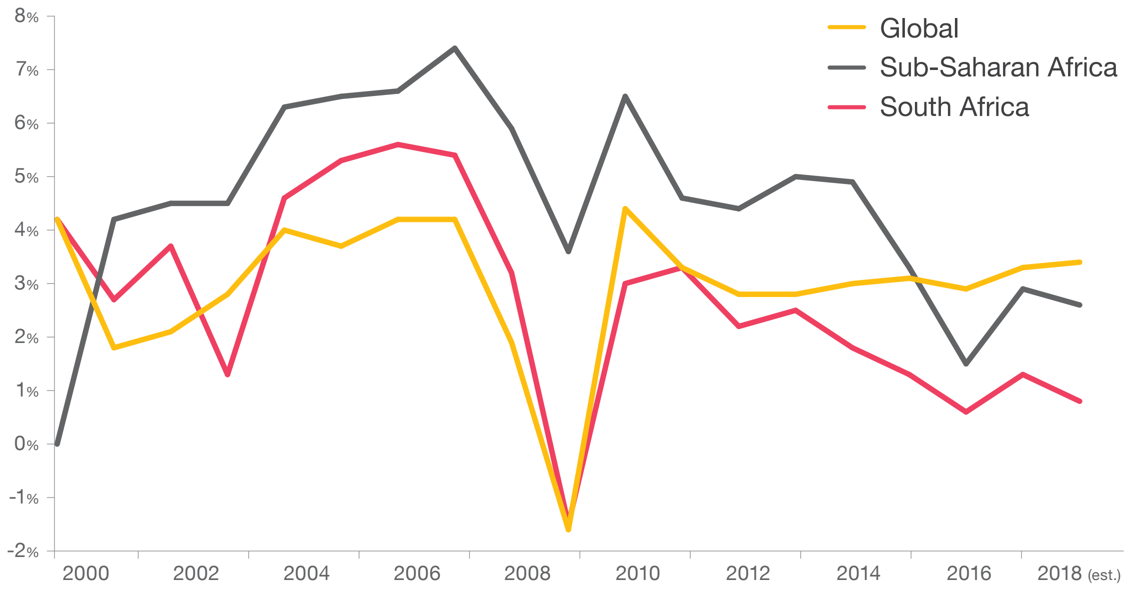
External developments

The major banks delivered resilient earnings growth and progressed many key strategic initiatives in 2018. This was achieved against the backdrop of a relatively supportive global economic environment over the first half of 2018, which was offset by a weak South African economy in technical recession during the same period, followed by a modest recovery over the second half. In addition to these challenging conditions, banks and their management teams also had to grapple with a range of strategic and regulatory imperatives.

Global economic growth in 2018 was driven by robust business and consumer activity in the US, supported by fiscal stimulus in that market, while the pace of growth elsewhere in the developed world generally slowed. As geopolitical concerns, protectionist fears and trade tensions escalated in 2018, global risk sentiment and trade volumes deteriorated. At the same time, China experienced a slowdown in growth from historical levels, which triggered adverse consequences for certain commodity prices and placed added export pressure on commodity-producing territories. The implications of this included, among others, reduced credit demand from already challenged mining and construction sectors.

Real GDP growth

Figure 1.1: Real GDP Growth



Source: Fitch Solutions, South African Reserve Bank

Domestically, the second half of 2018 saw the South African economy recover some of the weakness experienced in the first half, with modest annualised GDP growth of 0.8% recorded for the year. Despite modestly increased consumer spending in the second half, household income growth remained subdued, while business and consumer confidence continued to be depressed as a consequence of, among other factors, higher fuel prices, increased electricity and water tariffs and the effects of a higher VAT rate.

The 25 basis point interest rate cut in March was reversed in November as US fiscal tightening, the foreign exchange rate and oil price outlook threatened the SARB's inflation target. From a currency perspective, the rand reversed its strong position against major currencies in the first half of 2018, lessening the impact of foreign-exchange movements upon conversion of the bank's foreign operations to local currency results.

Capital expenditure on the part of corporate SA, state-owned enterprises (SOEs) and government slowed over the second half, reflecting continued policy uncertainty over a number of key issues. This uncertainty was amplified as a result of significant strategic, operational and financial pressures within some SOEs, which weighed on wholesale credit appetite in key sectors.

Positively, an increasingly relevant theme that we continue to observe in the major banks' results is the significant contribution from their operations in the wider African continent. Economic growth in sub-Saharan Africa came in at a resilient 2.9% in 2018, with recoveries experienced in key West African territories, including Nigeria and Cote d'Ivoire. Meanwhile, Uganda, Tanzania and Kenya recorded robust growth upwards of 5%, driven by a recovery in foreign investment and strong infrastructure spend. While inflation and currency devaluations stabilised in Angola towards the end of 2018, severe currency shortages and inflationary pressure in Zimbabwe heightened as 2018 drew to a close.

Internal responses

Overall, the major banks diversification strategies across franchises, regions and portfolios has been central to their ability to achieve growth amid difficult trading conditions. At the same time we expect the banks to be acutely focused on the continued evolution of their strategies in the context of heightened competition and the exciting digital journeys they are on – all of which focus on putting the customer at the heart of their business models.

The deep and rapid impact that technological progress is set to have on the global banking industry cannot be understated. Globally and domestically, banks are becoming more strategically focused and technologically advanced to respond to customer expectations, while deploying defensive strategies to protect market share against traditional competitors and new entrants. As such, the importance of product and channel innovation and developing new solutions that take advantage of this progress – in data, advanced analytics, digital and new delivery platforms – has never been more important.

Key trends that we expect to see the major banks continue to focus on in 2019 include:

- While most banks have initiatives aimed at targeting demographic-based or LSM clusters, we expect to see trends going beyond segment targeting, to developing highly-customised experiences for more granular subsets of customers based on common characteristics that leverage data-driven insights (for example common spend characteristics).
- A greater number of global regulators are embracing efforts towards 'open banking' – which requires institutions to securely share data with third parties based on customer consent – by democratising account and payment data through secure application programming interfaces (APIs). As this happens, customers stand to have greater freedom and control in how they interact with their financial service providers, leading to even greater innovation from non-traditional players and increased personalisation. This is arguably one of the most compelling prospects on the horizon as banks seek to leverage their skills, resources and trusted social status to strategically respond to this new competitive environment.

As The Banker described in an opinion earlier this year:

"With the arrival of open banking and the challenge of fintechs, banks need to up their game. Welcome to the idea of the self-driving bank account that uses artificial intelligence (AI) to predict when and in what format a customer will need funds; that takes care of routine financial transactions; that finds interest-earning opportunities for cash balances left idle for even the shortest time; and that adjusts loan rates to changing circumstances. In some scenarios, the self-driving account starts listening and talking, advising on investment opportunities, the cheapest airline seats, the best supermarket deals and so on." [1]

1 https://www.thebanker.com/Comment-Profiles/Editor-s-Blog/Will-self-driving-accounts-crash-and-burn

- These changes are not limited in their impact to retail banking. For corporate clients, they might entail using bank data to provide proactive insights to support strategic planning, or cash flow analysis that feeds into working capital and broader treasury management solutions.
- Beyond cost discipline, we expect to see relentless focus on optimising operational efficiencies, as banks continue to rationalise their IT architectures, standardise and simplify core banking operations and reduce operational complexity. Advancements in robotic process automation will have an increasing role to play in process optimisation.
- Meanwhile, a strong focus on further strengthening cyber risk monitoring and mitigation capabilities is likely to persist in 2019, as banks face a growing volume and sophistication of cyber threats against their systems and data.

Each of these represent exciting prospects for the industry as banks further incorporate the mindset and characteristics that may once have been the preserve of fintech start-ups. Naturally, with this bold new world of opportunity comes an evolving risk landscape, and banks will continue to focus on ensuring that their risk management capabilities and core risk disciplines keep pace. In this respect, we expect to see banks more keenly exploring the digitisation of risk functions and deploying technological innovations to improve, enhance and make risk management smarter, more resilient and responsive.

“Ultimately, leading banks will be those that harness technological and digital change to better anticipate and manage emerging risks within a rapidly evolving risk landscape.

The findings of PwC’s ***22nd Annual Global CEO Survey*** released in January highlights a number of key developments relating to banks’ strategic and digital transformations. In particular, nearly 80% of the 235 banking and capital markets CEOs who participated in the survey see skills shortages as a threat to their growth prospects (35% are ‘extremely concerned’ and 44% are ‘somewhat concerned’). Most believe that this skills gap is undermining their organisations’ ability to innovate effectively and provide a winning customer experience, prompting them to question: How do we put people back at the heart of a successful enterprise transformation?

It is clear from the results of the survey that there is a strong awareness that it is people – not systems – that drive innovation and help realise its full commercial potential. Consequently, we believe that it’s important for banks to progress a mature conversation within their organisations that deals frankly with how they are going to operate in the digital era, what roles might come under threat and how automation can augment rather than eliminate people’s work.

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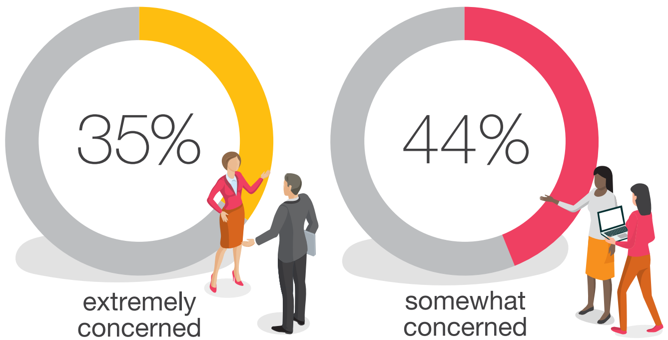


Stakeholder expectations

In 2018, we saw the first full reporting period under the new ***IFRS 9 Financial Instruments*** and ***IFRS 15 Revenue from Contracts with Customers*** accounting regimes, for which the major banks deployed large change programmes leading up to their implementation. While IFRS 15 has implications such as loyalty programme costs now being reported as a reduction in non-interest revenue (as opposed to being expensed), the overall impact of the standard on the banks' combined results was fairly muted. In contrast, we anticipate IFRS 9 impairment models to continue to be refined in areas such as the determination of write-off periods, application of forward-looking macroeconomic modelling methodologies and in the accumulation and refinement of data in certain portfolios

In December 2018, National Treasury released the draft Conduct of Financial Institutions (COFI) Bill, with expectations for it to be signed into law before the end of 2019. Following the establishment of a Twin Peaks regulatory architecture in South Africa in recent years – giving rise to separate market conduct and prudential regulators across the financial services industry – COFI takes a step towards conduct reform in financial services and sets out how entities must act, through a focus on outcomes provided to customers. COFI seeks to replace the conduct provisions of most existing financial sector laws in an effort to streamline the market conduct framework for all financial institutions. As the banks reflect on the provisions of the Bill, we expect that its effect will cause industry players to think differently about compliance in a way that puts customer outcomes at the centre of their thinking.

We also observe the major banks focusing on forthcoming prudential reforms and initiating programmes to critically analyse the package of regulation issued by the Basel Committee on Banking Supervision in December 2017 – collectively referred to as 'Basel IV' by the industry. While the aggregate impact of Basel IV on individual banks will be unique, we expect these changes, which will start to take effect between 2019 and 2022, to require large programmes of work to analyse effects on banks' risk-weighted assets and the downstream implications on capital demand, product pricing, data, systems infrastructure and, potentially, overall bank strategy.

Meanwhile, another regulatory development likely to progress during 2019 is the introduction of a financial conglomerate (FC) supervision framework in South Africa. In essence, an FC would comprise a group with multiple FS licences within its structure, under common control or dominant influence, including holding companies. The purpose of the framework is to capture risks not covered by the supervision of an individual licensed FS entity, address contagion risk and cross-sector regulatory arbitrage, and minimise the risk of failure of conglomerates.

To assist with the process of developing a framework for the regulation and supervision of designated FCs, the Prudential Authority of the SARB took a collaborative approach and established an FC Supervision Working Group represented by industry members and other stakeholders. Draft prudential standards were released in Q3-2018 for informal consultation, prior to a formal consultation in which the industry will have another chance to comment on the standards prior to their implementation (expected in 2019). The implications of the FC supervision framework will be varied, ranging from requirements to report prudential returns and assess capital adequacy at the conglomerate level, as well as supplemental governance requirements.

> **In the case of both conduct and prudential reforms, recent regulatory change programmes have shown that these changes have long lead times, and projects invariably have unforeseen tail risks. It will simply not be enough for banks to anecdotally conclude that they have the resources or capacity to absorb these changes as business-as-usual. Leading banks will be those who reach their conclusions on the basis of rigorous impact analyses, independent validations and robust checks and challenges.**

Competitive landscape

South African banking may herald 2019 as the ‘year of the customer’: a year in which the industry anticipates the launch of three retail banking operations – TymeDigital, Discovery Bank and Bank Zero – following the granting of new banking licences (a mutual banking licence in the case of Bank Zero) for the first time in more than a decade. At the same time, other major players including African Bank, Sasfin and Bidvest Bank have also recently highlighted their intent to focus on broader retail transactional banking offerings. In the business and corporate banking sectors, Capitec closed out 2018 with its deal to acquire a majority stake in Mercantile Bank, while Investec outlined ambitions to reinvigorate its corporate banking offering. Across the retail and wholesale banking sectors, the customer is poised to benefit from greater choice and increased competition in the domestic banking market.

The South African customer, both banked and unbanked, across the LSM scale, and clients spanning households, small businesses and corporates, are expected to be targeted through the business model and strategic choices that these new entrants intend to focus on. While the unique customer segments they target – at least initially – will be varied, the common characteristic that they all share is a distinct and laser-sharp focus on being truly ‘digital’ in their product and channel innovation strategies. This change in landscape will hopefully provide customers with easier access to digital banking, greater choice in choosing preferred providers and ultimately greater value – which could take the form of greater and different types of rewards, more competitive pricing and holistic financial services offerings.

2 Results overview

Headline earnings

Although there were unique performances between the individual banks, on a combined basis the four major banks posted full-year headline earnings of R82.75bn, which grew 8.7% year on year (against FY17) and 5.1% against 1H18.

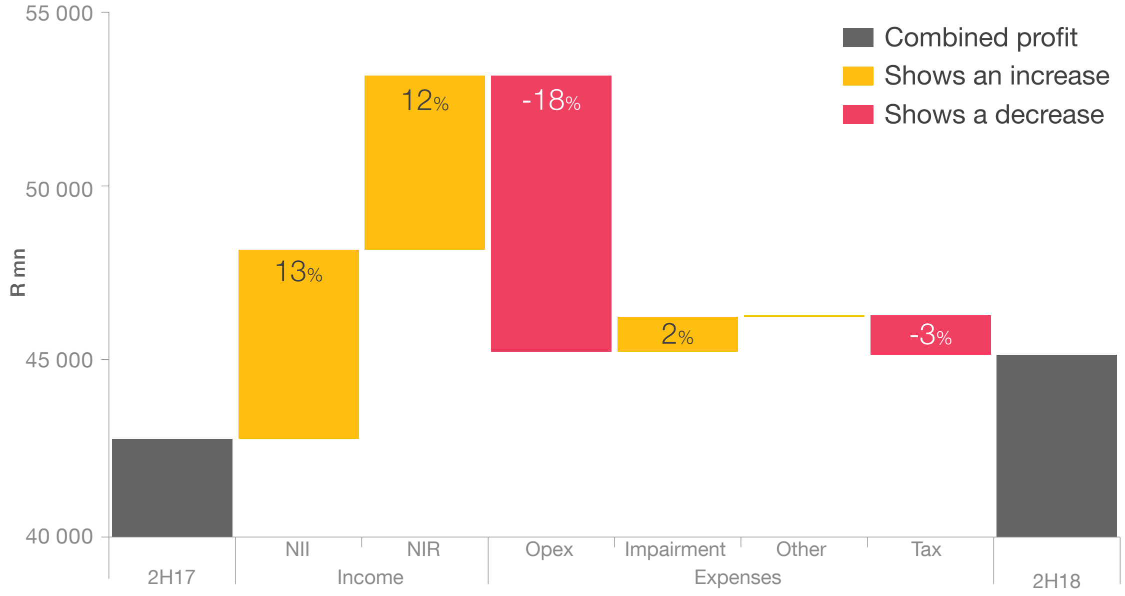
The contribution from the major banks' operations in key African markets outside South Africa continues to be notable – with the contribution to earnings from these territories now making up a significant proportion of overall group results, up to one-third of total earnings in some cases – in spite of the relatively stronger rand offsetting some of these gains.

On a combined basis the four major banks posted full-year headline earnings of

R82.75bn

R45.20bn at 2h18

Figure 2.1: Key drivers of combined profit and loss



Note: The percentages in the columns represent the increase/decrease against 2H17 profit and loss, not the growth rate.

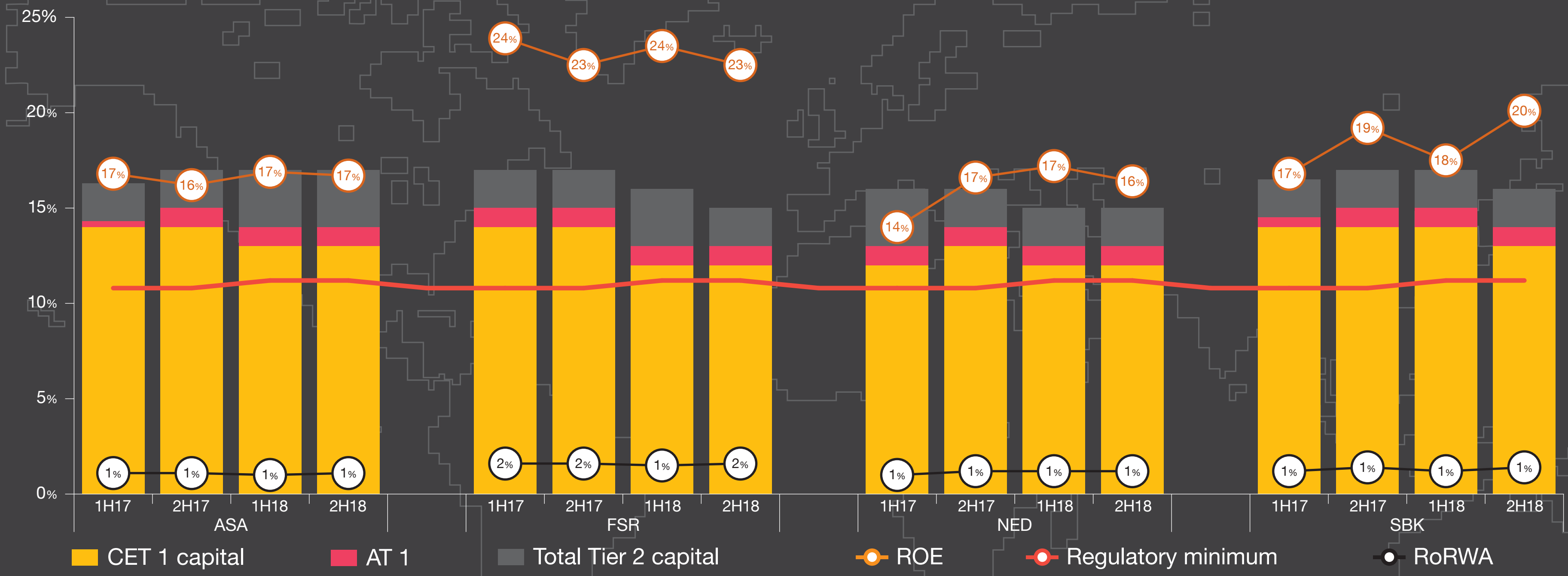
Source: PwC analysis

Return on equity

From a capital adequacy perspective, the major banks remain robustly capitalised, comfortably above regulatory minima across all capital tiers, while generating commendable returns. During the current period, combined ROE grew 10bps to 18.9% against 1H18 (18.8% at FY17).

Overall, the major banks' double-digit ROE levels remain significantly above those of their global peers and continues to benefit from diversified operations and geographic locations.

Figure 2.2: ROE vs regulatory capital



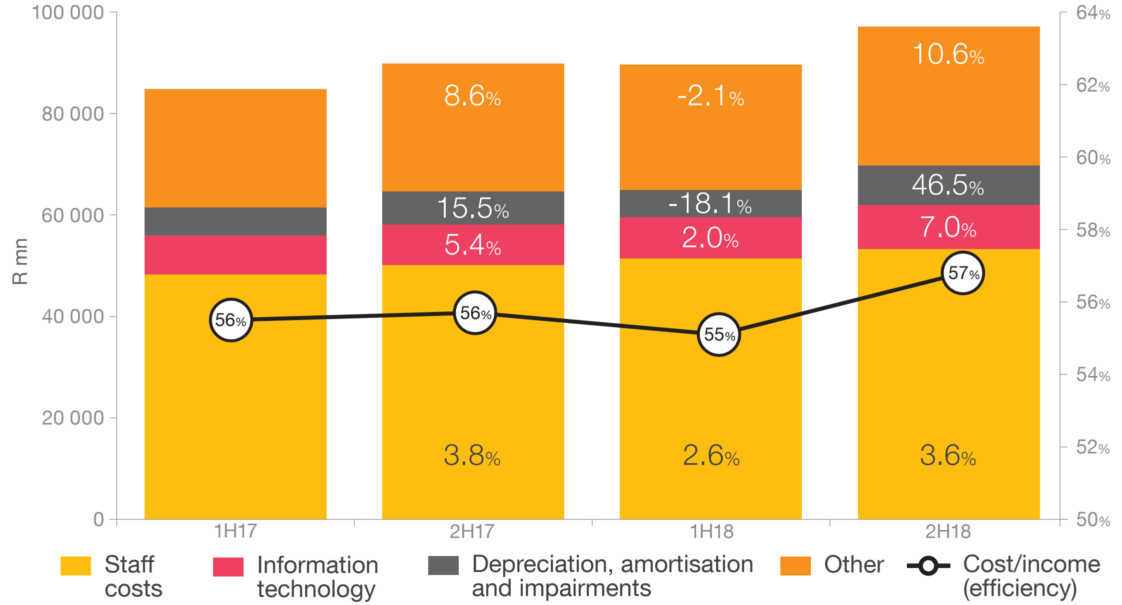
Source: PwC analysis

Efficiency

Cost management and a focus on optimisation initiatives remained top of the agenda of almost all bank management teams as they balanced investment with growth in 2018. In spite of this, the current period continued the theme of 'negative jaws' (as total costs grew faster than operating income), which we observed at both June 2018 and December 2017. At 2H18, the combined cost-to-income ratio was 56.8% (compared to 55.1% and 55.5% at 1H18 and FY17 respectively).

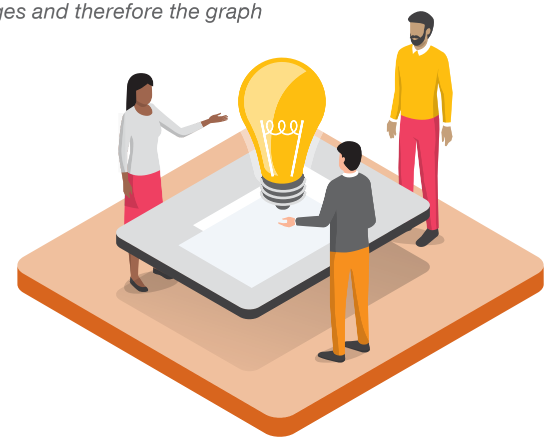
Consistent with our previous observations, staff costs comprise the majority of overall group costs, reflecting both the inflationary environment that persisted in 2018 as well as the demand for critical talent in response to increasing specialisation in the areas of risk, compliance and IT. At the same time, we continue to see increases in IT costs as the banks invest in their applications and systems infrastructure and further digitising their platforms.

Figure 2.3: Operating expenses and efficiency ratio



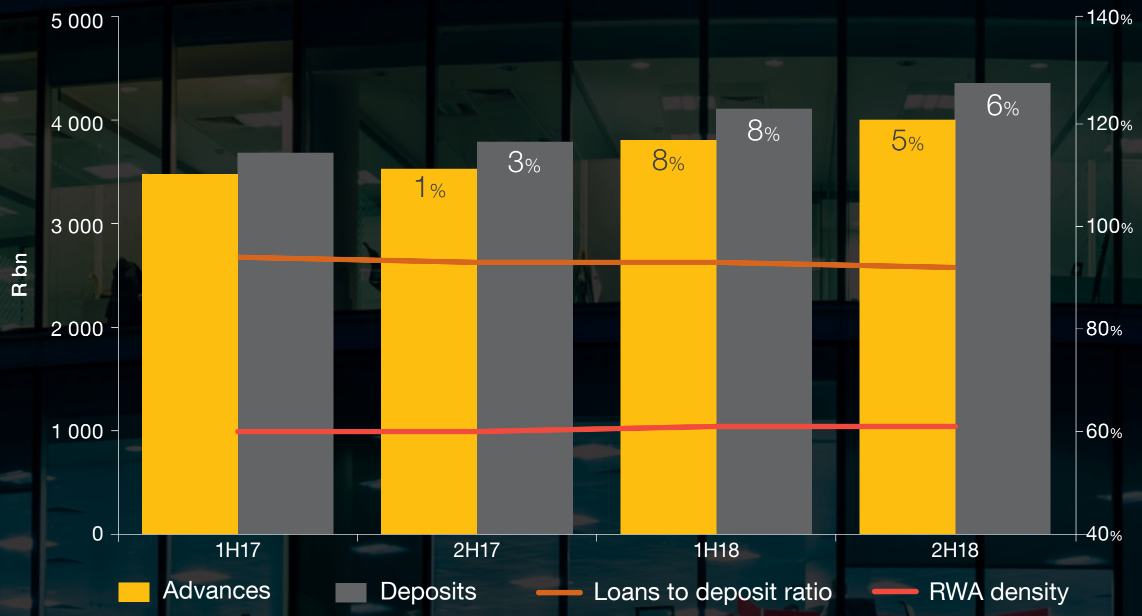
Note: Percentages in the columns reflect period-on-period changes in each expense category.
1H17 is the base year for the purpose of reflecting these period-on-period changes and therefore the graph does not reflect percentage changes in 1H17.

Source: PwC analysis



Credit growth and asset quality

Figure 2.4: Deposits and advance growth



Note: Percentages in the columns reflect period-on-period changes in advances and deposits. 1H17 is the base year for the purpose of reflecting these period-on-period changes and therefore the graph does not reflect percentage changes in 1H17.

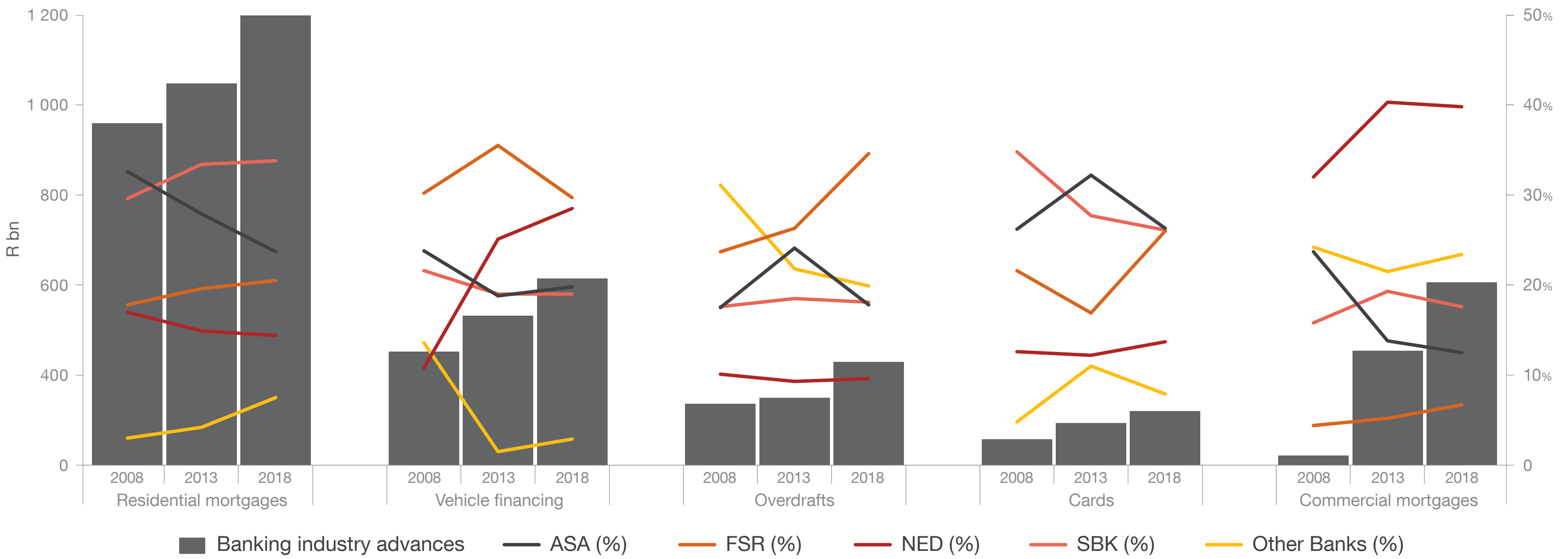
Source: PwC analysis

Balance sheets continue to grow in a challenging environment with the major banks' aggregate loan book registering growth of 5.1% against 1H18 (and 13.4% against FY17). Interestingly, the theme we had previously observed of corporate credit demand outpacing retail reversed in the current period for some banks, with retail outpacing corporate lending for the first time in in a number of reporting periods.

Some banks noted continuing challenges by corporate borrowers in the mining, construction and cement industries. On a positive note, the major banks noted improvements in the health of corporates in the oil & gas sectors – on the back of stable and rising oil prices.

We also note that some banks continue to grow certain products more aggressively than others, in line with their individual strategies and risk appetite.

Figure 2.5: Banking industry advances and market share



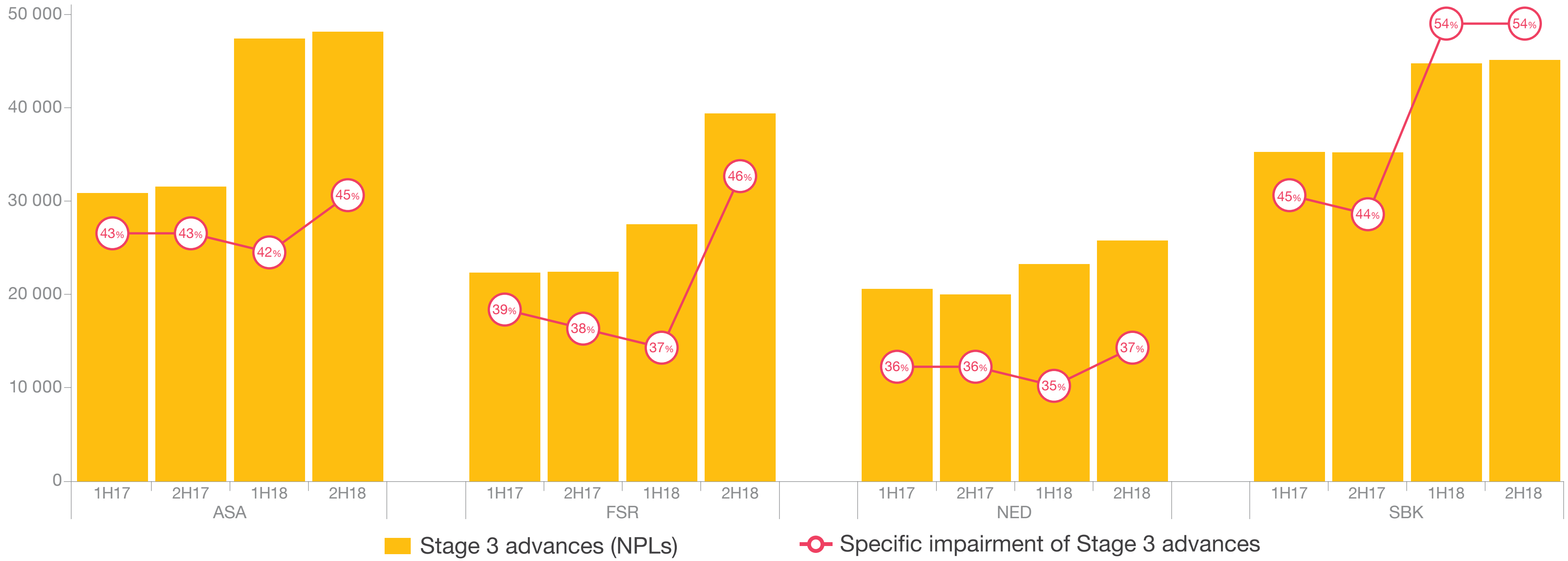
Source: PwC analysis and BA 900 regulatory returns

A relentless focus on credit quality is another theme that continued in the current period, with the major banks reporting a resilient combined credit loss ratio of 0.65% and a total impairment coverage ratio of 73.5% (compared to 0.72% and 65.8% respectively at 1H18).

Having been fully implemented in 2018, IFRS 9 was used by all banks in the classification, measurement and disclosure of financial assets at 31 December 2018. The implementation of IFRS 9 had a few noticeable impacts on the profit or loss measures (interest income and impairment charge) and the statement of financial position (non-performing loan balances) in the financial statements and key bank ratios at 31 December (interest margin ratio, non-performing loan ratio, impairment coverage ratio). These impacts are discussed at a high-level below. We note that previously reported impairment ratios in respect of performing and non-performing portfolios are not directly comparable under IFRS 9, and we unpack the effects of IFRS 9 in more detail in the section below (‘Unpacking the implications of IFRS 9 on the major bank results’).

Total non-performing loans comprised 3.9% of gross advances (3.7% and 3% at 1H18 and FY17 respectively), with the increase attributable mainly to changes brought about by the application of IFRS 9. Banks remain well covered for non-performing loans with high specific impairment coverage ratios. The increase in NPLs during the current period was mainly due to changes in the write-off rules relating to unsecured products. Given the extension of write-off periods under IFRS 9, NPLs remain on the books longer than previously (under IAS 39). In addition, debt counselling and certain restructured loans (although some may be performing) were reclassified to NPLs.

Figure 2.6: NPLs vs specific impairment coverage



Source: PwC analysis

Net interest income

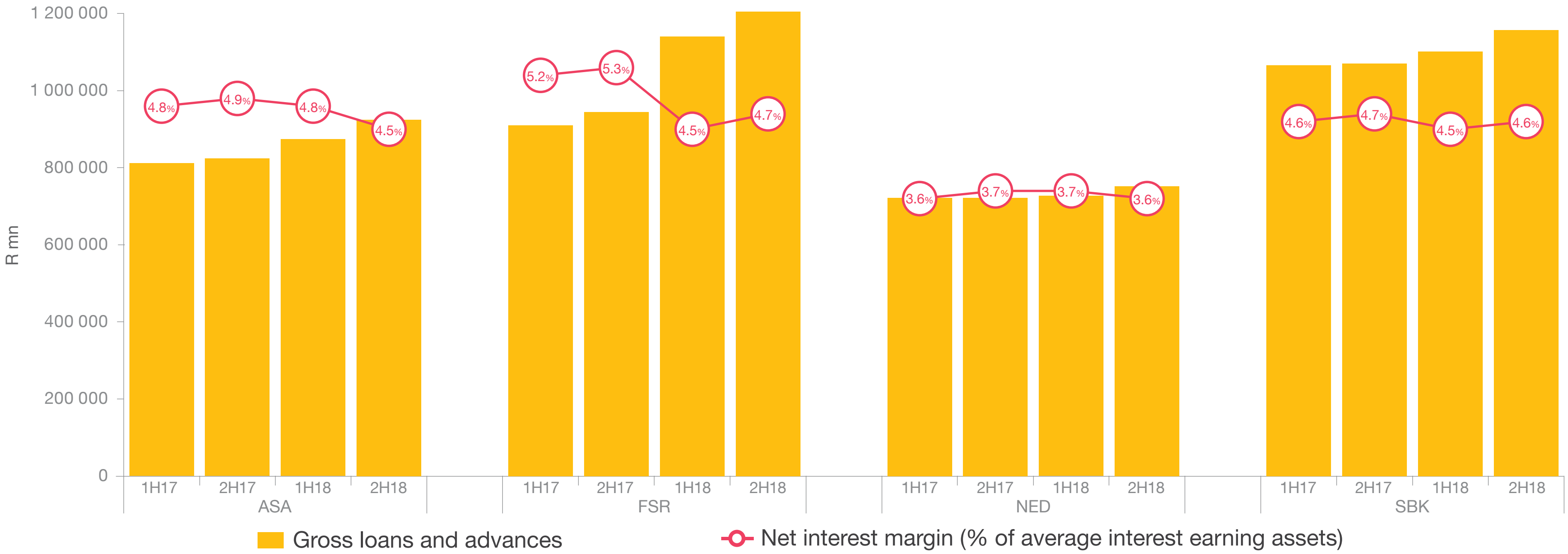
Margin growth factors

- Overall strong balance sheet growth
- 25 bps increase in repo rate in November 2018, positively impacted capital and deposit endowment
- Changes in asset and liquidity mix given credit environment and liquidity regulation. Strong growth in lower-margin deposit products, given increased competitive pressures
- Ongoing efforts to balance pricing in terms of risk, return and growth – in sharp focus given competitive environment

Margin growth constraints

- Higher funding costs driven by economic environment, uptick in UK base rates regulatory requirements and competitive pressure in funding markets
- Unsecured lending margins were negatively impacted by NCAA rate caps and removal of interest income on Stage 3 advances
- Slightly lower loans-to-deposit ratio impacted the net margin charged

Figure 2.7: Net interest margin



Source: PwC analysis

Non-interest revenue

Transactional volume growth supported by a sharp focus on digital strategies and richer mobile capabilities led to non-interest revenue growth of 4.6% against 1H18 (7.1% against FY17).

Margin growth factors	Margin growth constraints
• Robust fee and commission income growth, benefiting from strong electronic transaction volumes, and aided by migration of customers to electronic channels • Ongoing customer acquisition • Revenue supported by bancassurance • Loyalty programmes and bundled account packages continue to be refined • Overall market performance remained resilient despite the uncertain local macro environment. • Other gains and losses on financial instruments – driven by IFRS 9 • Strong rest-of-Africa growth in customer numbers and revenue	• Competitive pricing and competition for transactional banking/wallet share • Limited, below-inflation fee increases • Regulatory interventions have curtailed fee and commission growth • Knowledge-based and investment banking fees decreased, reflecting impact of muted deal volumes driven by lower corporate activity • Mixed results from trading revenue due to high levels of volatility in the market

Outlook

By most forecasts, global growth prospects and trade expectations for 2019 are marked by downside risks, which imply that the difficult banking environment seen in 2018 is set to continue – translating into modest credit and profit growth expectations for banks. Significant uncertainties pertaining to the finer details and market impact of how Brexit will manifest in the UK economy, coupled with expectations for the boost from fiscal stimulus to fade in the US, are expected to translate into a drag on global growth in 2019.

Regionally, while the outlook may be more positive given the recent economic performance of key African territories, a feeling of uncertainty was underscored in our recently-launched ***African Capital Markets Watch 2018*** report, which concluded that:

> **“A weakening economic outlook, significant geopolitical uncertainty and reputational challenges for new entrants brought on by recent listing failures will shape future capital markets sentiment. Accordingly, we can expect the low level of activity seen in African markets in 2018 to persist in 2019, despite the pipeline of announced and expected local and cross-border listings.”**

Locally, as 2019 presents an election year there is likely to be lower activity on the part of SA Inc. in terms of capital outlays and investment decisions as uncertainty prevails. At the same time, other key downside risks, which include the financial state of certain SOEs, a persistent threat of a Moody’s sovereign rating downgrade and the economic ramifications it could trigger, as well fiscal and policy concerns, are all likely to combine in muted 2019 economic forecasts. While each of these represent sentiments echoed by the banks in their own 2019 outlooks, there remains cautious optimism among most bank CEOs. The major banks remain sharply focused on their strategic initiatives (including continuing to build their diversified franchises and business models), retaining and attracting key skills, and driving greater cohesion and collaboration within management teams.

Table 2.1: Combined results

Income statement (R millions)	FY18	2H18	1H18	FY17	2H17	1H17	FY18 vs FY17
Net interest income	187 961	96 928	91 033	178 016	91 524	86 492	5.6%
Non-interest revenue	146 498	74 880	71 618	137 849	69 911	67 938	6.3%
Total income	**334 459**	**171 808**	**162 651**	**315 865**	**161 435**	**154 430**	**5.9%**
Operating expenses	-192 909	-100 511	-92 398	-179 999	-92 630	-87 369	7.2%
Core earnings	**141 550**	**71 297**	**70 253**	**135 866**	**68 805**	**67 061**	**4.2%**
Impairment charge	-26 037	-12 277	-13 760	-28 101	-13 266	-14 835	-7.3%
Other income / (expenses)	1 489	616	873	495	563	-68	200.8%
Income tax expenses	-27 797	-14 432	-13 365	-25 493	-13 304	-12 189	9.0%
Profit for the period	**89 205**	**45 204**	**44 001**	**82 767**	**42 798**	**39 969**	**7.8%**
Attributable earnings	91 060	49 462	41 598	76 632	39 706	36 926	18.8%
Headline earnings	82 750	42 401	40 349	76 154	40 161	35 993	8.7%

Balance sheet (R billions)	FY18	2H18	1H18	FY17	2H17	1H17	FY18 vs FY17
Gross loans and advances to customers	7 883	4 039	3 843	7 072	3 562	3 510	11.5%
Deposits from customers	8 541	4 394	4 147	7 545	3 827	3 718	13.2%
Risk-weighted assets	6 708	3 456	3 251	5 895	3 004	2 891	13.8%

Source: PwC analysis

Table 2.2: Combined segmental results (FY18)

	ROE	Headline earning growth	Net interest margin	Cost-to-income ratio	Credit loss ratio
Corporate & investment bank	18.9%	0.02%	2.3%	49.0%	0.2%
Retail & business bank	26.8%	10.3%	4.9%	58.7%	1.1%
Group	18.8%	8.70%	4.4%	55.9%	0.6%

Source: PwC analysis

3 Unpacking the implications of IFRS 9 on the major banks' results

Having been fully implemented in 2018, IFRS 9 was used by all banks in the classification, measurement and disclosure of financial assets at 31 December 2018.

The implementation of IFRS 9 had a few noticeable impacts on the profit or loss measures (interest income and impairment charge) and the statement of financial position (non-performing loan balances) in the financial statements and key bank ratios at 31 December (interest margin ratio, non-performing loan ratio, impairment coverage ratio). These impacts are discussed at a high-level below. We note that previously reported impairment ratios in respect of performing and non-performing portfolios are not directly comparable under IFRS 9.

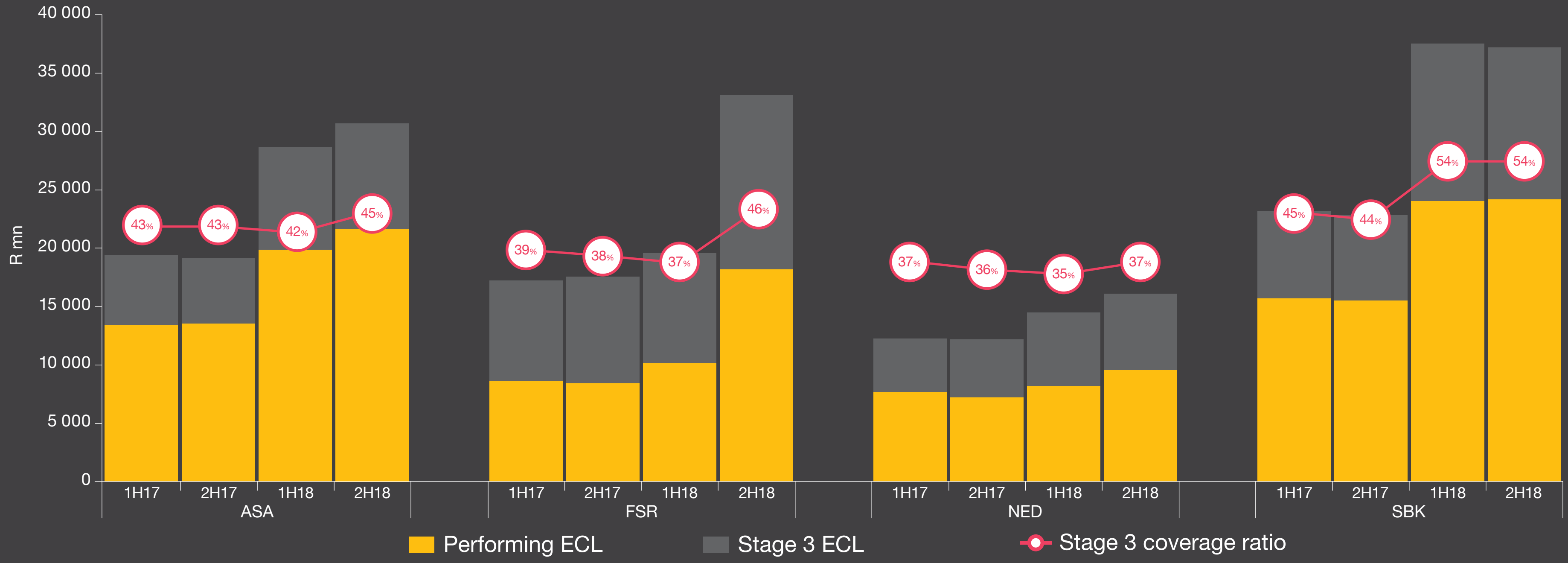
Total non-performing loans comprised 3.8% of gross advances (3.6% and 3% at 1H18 and FY17 respectively), with the increase attributable mainly to changes brought about by the application of the IFRS 9, including:

- Extensions in write off periods for non-performing loans due to further clarity provided under IFRS 9. This means non-performing loans stay on the balance sheet for longer before they are written off, thus inflating the levels of non-performing loans relative to the previous accounting treatment.
- Certain performing accounts which had a loss trigger (such as a forbearance event, or entered into debt counselling) were also reclassified by certain banks from the performing to the non-performing category.
- Some banks changed their 'cure rule' relating to non-performing loans. In the past, banks had varying requirements as to how many instalments needed to be made by a customer before a non-performing loan was treated as 'cured' or rehabilitated (this requirement varied between a minimum of six monthly instalments to a maximum of 12 monthly instalments). Under IFRS 9 credit policies at certain banks, customers will be required to make a minimum of 12 monthly instalments before they are treated as 'cured' and reclassified out of the non-performing category.

The implementation of IFRS 9 also impacted the impairment charge and had other disclosure effects, such as:

- The introduction of the expected loss impairment methodology (including the incorporation of macro forecasts) is expected to increase the impairment charge when compared to IAS 39 methodologies.
- IFRS 9 requirements also introduced different disclosures when compared to IAS 39. Under IAS 39, interest on defaulted loans was reflected as interest income in the statement of comprehensive income and then impaired (interest in suspense), as it was considered irrecoverable (net nil earnings impact). IFRS 9 amended this disclosure requirement and no longer presents interest income and the associated impairment charge of this interest income related to defaulted loans in the statement of comprehensive income. Given interest income and the impairment charge line items decrease, this impacts the comparability of certain metrics such as non-interest margin and impairment coverage ratios.
- We expect technical disclosure-related aspects of the standard to continue to be an area of focus in future periods.

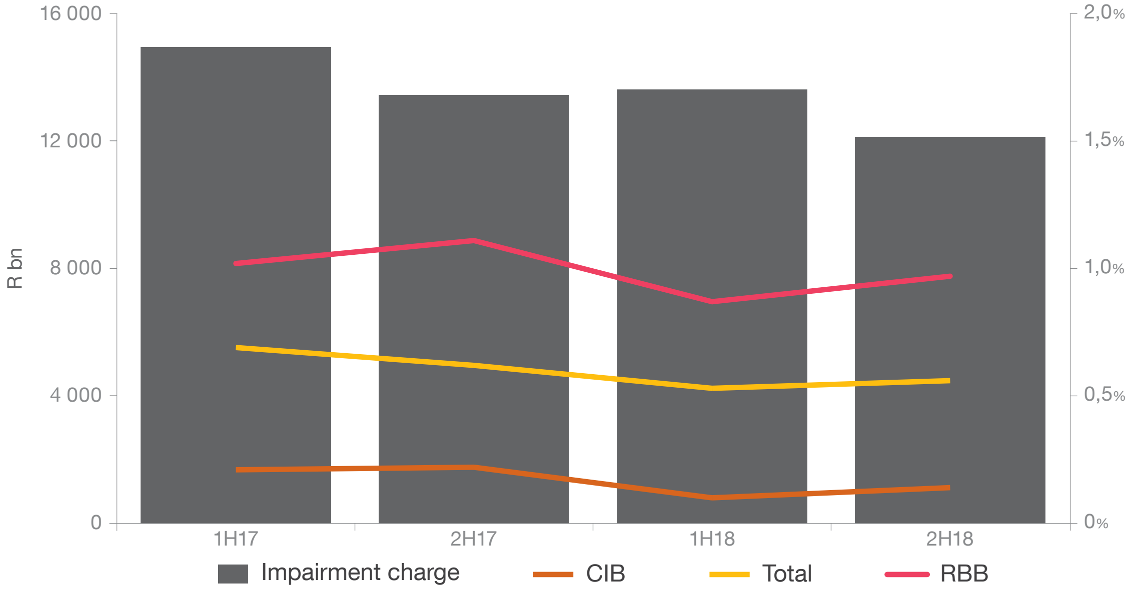
Figure 2.8: Balance sheet impairments and NPL coverage ratio



Source: PwC analysis

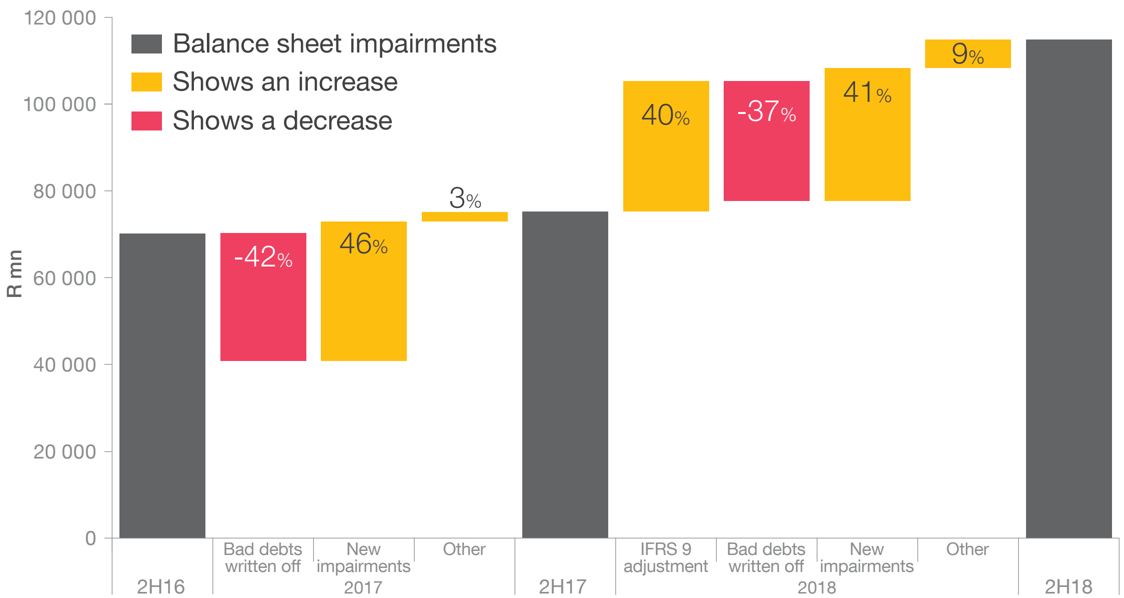
- Aggregate NPLs across the major banks generally increased YoY due largely to accounting changes under IFRS 9
- NPLs as a % of gross advances remains relatively low, at 3.8% (3.6% and 3% at 1H18 and FY17 respectively)
- NPL coverage ratios continue to reflect conservatism on the part of the major banks

Figure 2.9: Impairment charge and credit loss ratios



Source: PwC analysis

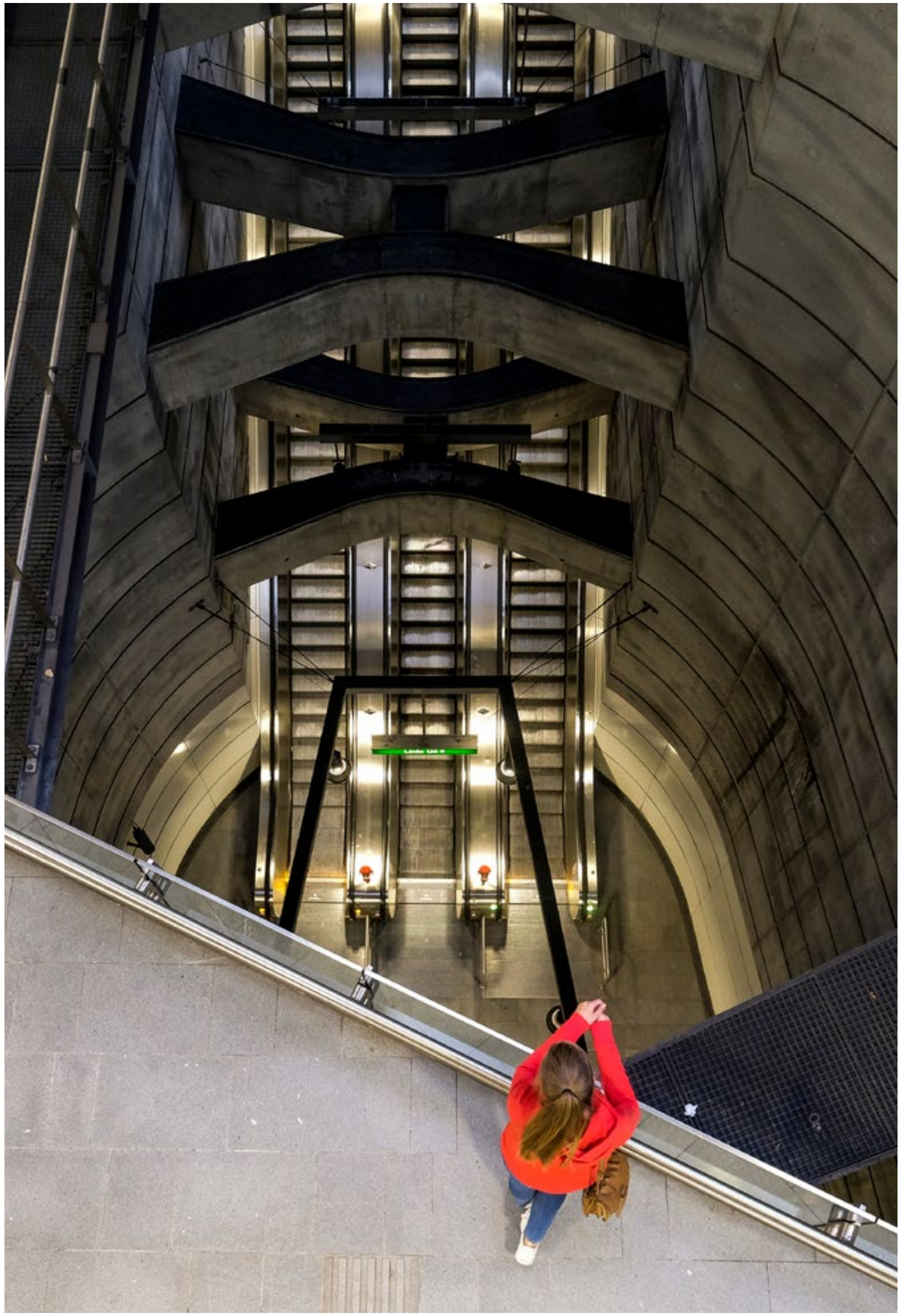
Figure 2.10: Balance sheet impairment reconciliation



Source: PwC analysis

Total balance sheet impairment provisions as at 2H18 grew 45.7% when compared to FY17. This significant increase is due to a change in methodology whereby a 40% increase is attributable to the implementation of the IFRS 9 accounting standard.

The Stage 3 specific impairment provision contributed to 62.8% of the total balance sheet impairment, compared to 62.2% in FY17.



4 Hot off the press

Recent PwC financial services and related publications

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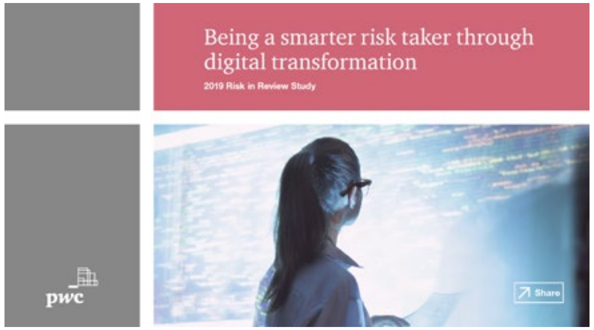
Banking & Capital Markets Trends 2019 – 22nd Annual Global CEO Survey

Putting people at the heart of successful enterprise transformation demands a new type of leadership – a 'tech-savvy humanist'. These leaders understand the potential of new technologies, how they knit together and how they align with strategic objectives, while recognising that successful banking and capital markets' organisations are run by people for people. There is also a recognition that the key question posed by automation and artificial intelligence (AI) isn't what jobs will be replaced, but rather how job descriptions will change, how to ensure your people make the most of the time that is freed up and knowing how to use the technology in customers' best interests.



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2019 Risk in Review Study – Being a smarter risk taker through digital transformation

Our 2019 *Risk in Review Study* reveals six behaviours that divide risk functions into those helping their organisations take smarter risks on their digital journeys – a group we call Dynamics – and those a step or more behind: the Actives and the Beginners. The groups tell us that risk management, internal audit and compliance professionals (or, collectively risk functions) – far from stalling digital initiatives – can help their organisations meet or beat their transformation goals. Certain risk functions are there now. For others, it's time to take action.

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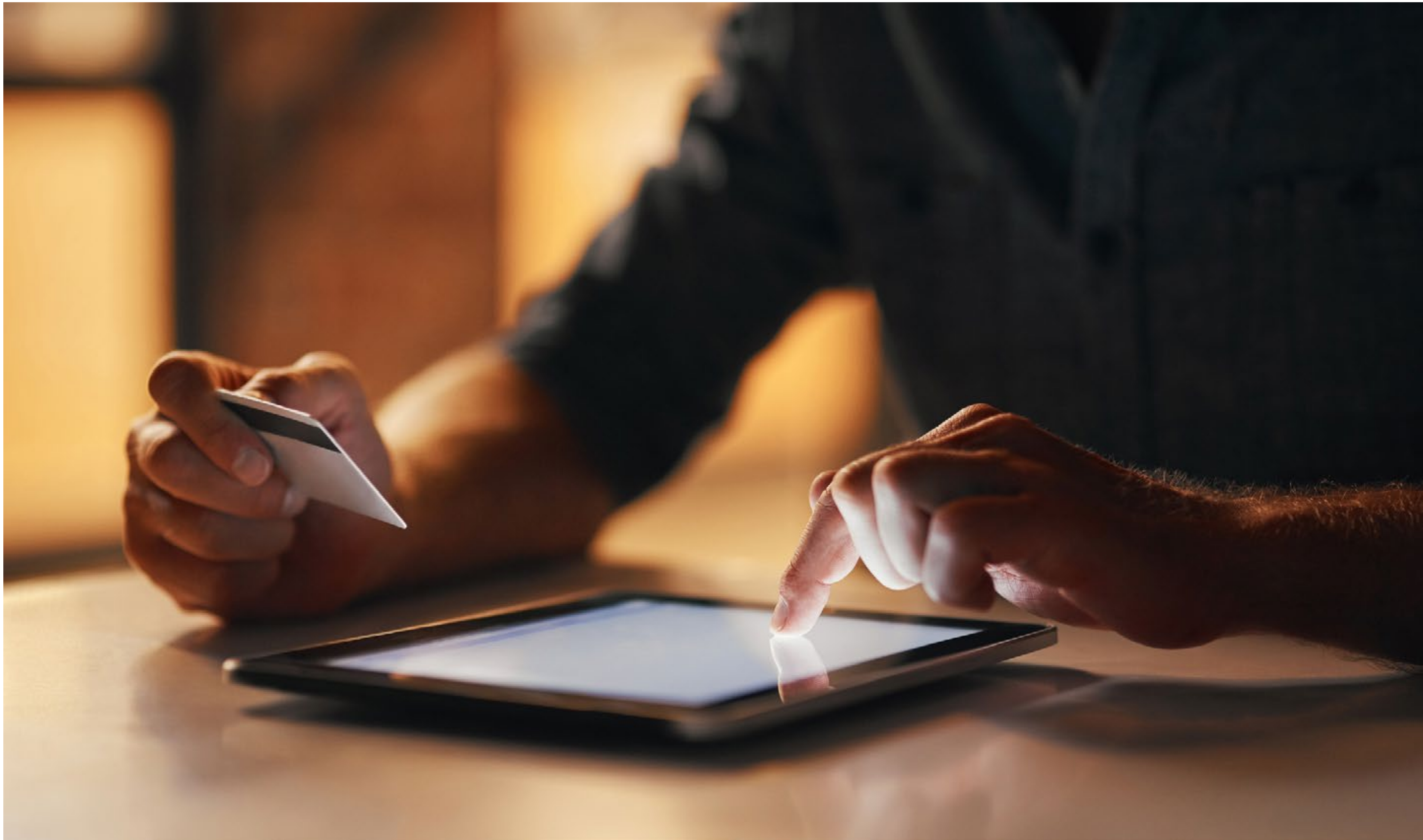
The productivity agenda: Moving beyond cost reduction in financial services

A variety of forces have put tremendous pressure on the financial services industry in recent years, leaving many institutions with unsustainable cost-to-income ratios. And several of these challenging trends – from new regulatory mandates to augmented capital requirements to aggressive fintech competitors – are strengthening. This paper presents the results of PwC's 2018 *Productivity in the Financial Services Sector Survey*, part of a series of thought leadership about important issues and opportunities facing the financial services industry and the ways in which senior executives at the most innovative and successful institutions are responding.

5 Key banking statistics



	ABSA				FSR				NED				SBK				Combined				Growth (% and bps)	
R' millions	2H18	1H18	2H17	1H17	2H18	1H18	2H17	1H17	2H18	1H18	2H17	1H17	2H18	1H18	2H17	1H17	2H18	1H18	2H17	1H17	2H18 v 2H17	2H18 v 1H18
Balance sheet																						
Total assets	1 285 552	1 234 643	1 165 979	1 137 876	1 589 462	1 532 310	1 291 724	1 217 745	1 043 912	1 019 015	983 314	965 830	1 704 335	1 617 569	1 597 968	1 532 004	5 623 261	5 403 537	5 038 985	4 853 455	11,6%	**4,1%**
Gross loans and advances	925 027	874 129	824 072	811 503	1 205 114	1 140 482	945 008	910 066	751 793	726 933	722 331	721 910	1 157 353	1 101 730	1 070 471	1 066 214	4 039 287	3 843 274	3 561 882	3 509 693	13,4%	**5,1%**
Total deposits	857 726	802 957	757 257	745 652	1 338 621	1 267 448	1 040 042	983 529	825 804	801 165	771 584	762 712	1 371 919	1 275 675	1 258 359	1 226 166	4 394 070	4 147 245	3 827 242	3 718 059	14,8%	**6,0%**
Risk-weighted assets	818 592	771 268	736 892	724 780	972 000	941 000	782 000	738 386	586 626	552 623	528 206	516 051	1 079 642	986 352	957 045	911 520	3 456 860	3 251 243	3 004 143	2 890 737	15,1%	**6,3%**
Loans-to-deposit ratio	107,8%	108,9%	108,8%	108,8%	90,0%	90,0%	90,9%	92,5%	91,0%	90,7%	93,6%	94,7%	84,4%	86,4%	85,1%	87,0%	91,9%	92,7%	93,1%	94,4%	-1,14	**-0,74**
Asset quality & provisioning																						
Non-performing loans	47 167	46 447	30 891	30 252	38 588	26 947	21 982	21 905	25 231	22 785	19 576	20 190	44 193	43 829	34 521	34 541	155 179	140 008	106 970	106 888	45,1%	**10,8%**
Impairments	-30 190	-28 191	-18 874	-19 067	-32 570	-19 255	-17 276	-16 960	-15 845	-14 265	-12 002	-12 046	-36 622	-36 945	-22 444	-22 816	-115 227	-98 656	-70 596	-70 889	63,2%	**16,8%**
Collective provisions	-8 907	-8 659	-5 559	-5 908	-14 696	-9 263	-9 011	-8 471	-6 476	-6 255	-4 921	-4 528	-12 821	-13 314	-7 174	-7 376	-42 900	-37 491	-26 665	-26 283	60,9%	**14,4%**
Individually assessed provisions	-21 283	-19 532	-13 315	-13 159	-17 874	-9 992	-8 265	-8 489	-9 369	-8 010	-7 081	-7 518	-23 801	-23 631	-15 270	-15 440	-72 327	-61 165	-43 931	-44 606	64,6%	**18,20%**
Non-performing loans (% of advances)	5,1%	5,3%	3,7%	3,7%	3,2%	2,4%	2,3%	2,4%	3,4%	3,1%	2,7%	2,8%	3,8%	4,0%	3,2%	3,2%	3,9%	3,7%	3,0%	3,0%	0,87	**0,17**
Impairment charge (% of average advances) – credit loss ratio	0,73%	0,83%	0,87%	0,96%	0,91%	0,81%	0,87%	0,96%	0,53%	0,53%	0,51%	0,47%	0,42%	0,70%	0,76%	0,96%	0,65%	0,72%	0,75%	0,84%	-0,11	**-0,07**
Impairment coverage ratio	64,01%	60,69%	61,1%	63,0%	84,40%	71,46%	78,6%	77,4%	62,80%	62,61%	61,3%	59,7%	82,87%	84,29%	65,0%	66,1%	73,52%	69,76%	66,50%	66,5%	7,02	**3,76**
Implied loss given default	45,12%	42,05%	43,1%	43,5%	46,32%	37,08%	37,6%	38,8%	37,13%	35,15%	36,2%	37,2%	53,86%	53,92%	44,2%	44,7%	45,61%	42,05%	40,28%	41,0%	5,33	**3,56**
Profit & loss analysis																						
Net interest income	22 237	21 188	21 528	20 791	29 406	26 689	24 565	23 383	14 813	14 006	14 076	13 548	30 472	29 150	31 355	28 770	96 928	91 033	91 524	86 492	5,9%	**6,5%**
Non-interest income	16 381	15 854	15 377	15 294	21 080	21 498	19 514	20 564	13 740	12 236	12 333	11 730	23 679	22 030	22 687	20 350	74 880	71 618	69 911	67 938	7,1%	**4,6%**
Total operating income	38 618	37 042	36 905	36 085	50 486	48 187	44 079	43 947	28 553	26 242	26 409	25 278	54 151	51 180	54 042	49 120	171 808	162 651	161 435	154 430	6,4%	**5,6%**
Total operating expenses	-23 752	-21 722	-22 446	-20 833	-27 524	-25 230	-23 511	-23 035	-17 342	-15 232	-15 970	-14 843	-31 893	-30 214	-30 703	-28 658	-100 511	-92 398	-92 630	-87 369	8,5%	**8,8%**
Core earnings	14 866	15 320	14 459	15 252	22 962	22 957	20 568	20 912	11 211	11 010	10 439	10 435	22 258	20 966	23 339	20 462	71 297	70 253	68 805	67 061	3,6%	**1,5%**
Impairment charge	-2 893	-3 431	-3 249	-3 773	-5 021	-4 515	-4 052	-4 313	-1 873	-1 815	-1 710	-1 594	-2 490	-3 999	-4 255	-5 155	-12 277	-13 760	-13 266	-14 835	-7,5%	**-10,8%**
Other income/(expenses)	123	56	91	79	481	426	488	572	211	153	22	-1 084	- 199	238	- 38	365	616	873	563	- 68	9,4%	**-29,4%**
Discontinued operations	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	-	**-**
Income tax expenses	-3 444	-3 322	-3 086	-3 204	-4 475	-3 971	-3 894	-3 456	-2 416	-2 346	-2 031	-2 178	-4 097	-3 726	-4 293	-3 351	-14 432	-13 365	-13 304	-12 189	8,5%	**8,0%**
Profit for the period	8 652	8 623	8 215	8 354	13 947	14 897	13 110	13 715	7 133	7 002	6 720	5 579	15 472	13 479	14 753	12 321	45 204	44 001	42 798	39 969	5,6%	**2,7%**
Attributable earnings	15 903	9 661	7 524	7 781	12 749	13 797	12 749	12 683	6 953	6 423	6 377	5 244	13 857	11 717	13 056	11 218	49 462	41 598	39 706	36 926	24,6%	**18,9%**
Headline earnings from continuing operations	8 085	8 043	7 821	7 802	13 344	13 936	12 573	11 903	6 799	6 696	6 516	5 271	14 173	11 674	13 251	11 017	42 401	40 349	40 161	35 993	5,6%	**5,1%**
Key data																						
Other operating income (% of total income)	42,42%	42,80%	41,67%	42,38%	41,75%	44,61%	44,27%	46,79%	48,12%	46,63%	46,70%	46,40%	43,73%	43,04%	41,98%	41,43%	44,01%	44,27%	43,65%	44,25%	0,35	**-0,27**
Net interest margin (% of total assets)	-4,11%	3,73%	4,11%	0,00%	3,99%	0,00%	0,00%	3,82%	0,00%	2,88%	2,83%	0,00%	-3,71%	3,74%	3,71%	0,00%	-0,96%	2,59%	2,66%	0,96%	-3,62	**-3,54**
Net interest margin (% of average interest-earning advances)	4,52%	4,76%	4,85%	4,81%	4,70%	4,52%	5,26%	5,24%	3,63%	3,67%	3,66%	3,58%	4,58%	4,50%	4,74%	4,60%	4,36%	4,36%	4,63%	4,56%	-0,27	**-0,01**
Standardised efficiency ratio – cost-to-income	59,20%	56,20%	57,90%	55,50%	52,40%	51,12%	52,25%	51,26%	58,60%	55,80%	57,90%	59,30%	56,90%	57,10%	54,90%	56,10%	56,78%	55,05%	55,74%	55,54%	1,04	**1,72**
Return on equity	16,7%	16,9%	16,2%	16,8%	22,5%	23,5%	22,5%	23,9%	16,4%	17,2%	16,6%	14,0%	20,1%	17,5%	19,2%	16,8%	18,9%	18,8%	18,6%	17,9%	0,30	**0,15**
Total number of staff	40 856	41 250	41 703	41 714	47 334	46 284	45 026	44 916	30 877	31 272	31 531	32 349	47 419	48 265	48 322	48 427	166 486	167 071	166 582	167 406	-0,1%	**-0,4%**
Capital ratios																						
CET 1	12,8%	13,3%	13,5%	13,7%	12,0%	11,5%	14,0%	14,3%	11,7%	12,4%	12,6%	12,3%	12,7%	13,8%	13,5%	13,7%	12,3%	12,8%	13,4%	13,5%	-1,10	**-0,45**
Tier 1	13,5%	13,9%	14,1%	14,0%	12,6%	12,1%	14,6%	14,9%	12,5%	13,2%	13,4%	13,2%	13,3%	14,4%	14,2%	14,2%	13,0%	13,4%	14,1%	14,1%	-1,10	**-0,43**
Tier 2	2,6%	2,8%	2,0%	2,1%	2,2%	2,6%	2,3%	2,2%	2,3%	2,4%	2,1%	2,5%	2,4%	1,8%	2,4%	2,0%	2,4%	2,4%	2,2%	2,2%	0,18	**-0,03**
Total	16,1%	16,7%	16,1%	16,1%	14,8%	14,7%	16,9%	17,1%	14,8%	15,6%	15,5%	15,7%	15,7%	16,2%	16,6%	16,2%	15,35%	15,80%	16,3%	16,3%	-0,92	**-0,45**
NSFR	110,1%	106,0%			112,0%	112,0%			114,0%	116,4%			118,6%	123,1%			113,7%	114,4%			-	**-0,70**
LCR	116,7%	108,6%			122,0%	115,0%			109,4%	106,9%			116,8%	121,3%			116,2%	113,0%			-3,21	**3,28**

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