In the eye of the storm

South Africa – Major Banks Analysis

PwC’s analysis of major banks’ results for the reporting period ended 30 June 2020

October 2020
PwC’s Major Banks Analysis presents the highlights of the combined local currency results of Absa, FirstRand, Nedbank and Standard Bank.

Other major players in the South African banking industry, including Investec and Capitec, are excluded from our analysis due to their different reporting periods and product mix. However, the analysis identifies common trends shaping the banking industry across all major players and builds on previous PwC analyses for a period of over a decade.

About this publication
- This analysis has been prepared from publicly-available information.
- The data, charts and figures included are based on the banks’ published results, which are available on the respective banks’ websites.
- Certain ratios have been recalculated to present comparable six-month results.
- Amounts and ratios for Standard Bank are based on ‘Banking activities’, as published in the results.

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.
Combined financial performance

**Figure 1.1** 1H20 Results summary, 1H20 vs 1H19

<table>
<thead>
<tr>
<th>Category</th>
<th>1H20</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net interest income</td>
<td>1.6%</td>
<td></td>
</tr>
<tr>
<td>Non interest revenue</td>
<td>2.5%</td>
<td></td>
</tr>
<tr>
<td>Cost-to-income ratio</td>
<td>55.1%</td>
<td></td>
</tr>
<tr>
<td>Net interest margin</td>
<td>392 bps</td>
<td>1H19: 432 bps</td>
</tr>
<tr>
<td>Credit loss ratio</td>
<td>232 bps</td>
<td>1H19: 78bps</td>
</tr>
<tr>
<td>Return on equity</td>
<td>5.4%</td>
<td>1H19: 18.5%</td>
</tr>
<tr>
<td>Common equity Tier 1 ratio</td>
<td>11.2%</td>
<td>1H19: 12.3%</td>
</tr>
<tr>
<td>Operating income</td>
<td>0.1%</td>
<td></td>
</tr>
<tr>
<td>Operating expenses</td>
<td>3.5%</td>
<td></td>
</tr>
<tr>
<td>Pre-provisioning operating profit</td>
<td>4.4%</td>
<td></td>
</tr>
<tr>
<td>Bad debts charge</td>
<td>226.2%</td>
<td></td>
</tr>
</tbody>
</table>

Headline earnings of R14.6bn declined 65.5% against 1H19

Source: PwC analysis
Overview and external environment

Since we began our SA Major Banks Analysis series almost a decade ago, we have never seen two reporting periods be so fundamentally different.

A rare commonality between the last six months of 2019 and the first of 2020 is that the South African economy ended 2019 and entered 2020 against the backdrop of weak domestic economic conditions and significant structural challenges.

These structural challenges and the tough economic climate extended the recessionary conditions in South Africa into Q1 2020 and by the time the first quarter concluded, a global crisis of unprecedented pace, scope and impact was underway with dire human, social and economic consequences.

That South Africa is delicately balanced — with deep socioeconomic issues and seemingly intractable structural and public sector challenges persisting against a low growth backdrop — is a well-worn narrative; one sharply exacerbated by the onset of the COVID-19 pandemic.

The major banks’ results for the period ended 30 June 2020 reflect these challenges, which were amplified by the effects of the pandemic and resultant containment measures.

While there is debate amongst risk professionals as to whether the COVID-19 pandemic reflects an unforeseeable cataclysm or a biological inevitability of unknown timing, there is no debate regarding the devastating economic scale resulting from the pandemic-induced economic shock globally, regionally and domestically.

South African GDP contracted by 16.4% in the second quarter year-on-year (Y0Y), representing a quarterly decline of a scale that dwarfs the annualised slowdown of 6.1% recorded in the first quarter of 2009 during the global financial crisis.

By the time the national lockdown was imposed on 27 March, the unemployment rate was 30.1%, a 17-year high, which has deteriorated further over the past months.

These deeply challenging operating conditions contributed to some of the weakest business and consumer confidence levels seen since records began, and played out on the major banks’ results in various forms as we summarise in Table 1.1.

Driven by heightened customer risk profiles and depressed outlooks across loan product classes, industry sectors and geographies, credit provisioning levels soared against expectations for rising volumes of distressed and non-performing loans. Sharply increased credit impairment charges translated into deep contractions in combined earnings and depressed return on equity (ROE) for the major banks.
Table 1.1  External environment and operating conditions

<table>
<thead>
<tr>
<th>External environment</th>
</tr>
</thead>
<tbody>
<tr>
<td>2020 began with slowest level of economic activity since the global financial crisis of 2007–8</td>
</tr>
<tr>
<td>• Q4-19 ended with a second technical recession in less than two years</td>
</tr>
<tr>
<td>• SA economy and operating conditions already under significant challenge prior to the onset of COVID-19</td>
</tr>
<tr>
<td>• Ongoing financial, operational and structural constraints</td>
</tr>
<tr>
<td>Unemployment at 17-year high before lockdown</td>
</tr>
<tr>
<td>• 30.1% unemployment rate prior to lockdown</td>
</tr>
<tr>
<td>• Household and business confidence levels lower than ever before</td>
</tr>
<tr>
<td>• Full-year unemployment expected to be significantly elevated</td>
</tr>
<tr>
<td>SA GDP contracted 51% in Q2-20</td>
</tr>
<tr>
<td>• Deepest nominal GDP contraction in South Africa in more than seven decades</td>
</tr>
<tr>
<td>• Growing concern over sovereign debt sustainability</td>
</tr>
<tr>
<td>• First ever IMF loan taken out</td>
</tr>
<tr>
<td>• 2020 annual GDP decline expected to take years to recover</td>
</tr>
</tbody>
</table>

Both globally and regionally, GDP growth over Q1-20 was broadly worse than expected with high-frequency indicators pointing to a more severe Q2-20 contraction

<table>
<thead>
<tr>
<th>Operating conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Factor</td>
</tr>
<tr>
<td>Declining interest rate environment</td>
</tr>
<tr>
<td>Low private-sector credit appetite</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Sustained low GDP growth</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Relatively higher private-sector liquidity</td>
</tr>
</tbody>
</table>
The economic impact of COVID-19

Christie Viljoen
Economist, Strategy &
PwC South Africa

South Africa

The South African economy fell into a recession during Q4-19 as a result of various structural constraints. However, the impact of electricity load shedding had an outsized impact on economic activity, investment spending, as well as business and consumer confidence. Load shedding is estimated to have cost the domestic economy between R58bn and R119bn in lost output during 2019.

Slower growth among key trading partners like China also weighed on the South African economy. Overall, the South African economy expanded by only 0.2% in 2019, compared to a population growth rate of 1.4%. The finance, real estate and business services industry sectors grew by a healthier 2.3% during the year — banking and financial services have been among the most resilient sectors in the recent past.

Economic weakness continued during Q1-20 in the period before the national lockdown, with the South African economy expanding by only 0.1% YOY. Agriculture and several services sectors were able to register more meaningful growth during the period: the finance, real estate and business services industry, for example, was 3.1% larger during Q1-20 relative to Q1-19. In turn, the industrial sector — in particular mining, manufacturing, utilities and construction — continued the negative trend seen at the close of 2019. A pandemic-induced slowdown in global trade and investment was one of the key factors adversely affecting the South African economy during Q1-20.

Similar to other jurisdictions, South Africa entered Q2-20 under strict lockdown conditions intended to combat the spread of COVID-19. With only essential services able to operate during April, and restrictions on most other industries during May and June, the South African economy contracted 16.4% quarter-on-quarter, 17.1% YOY and 51% on an annualised basis during Q2-20, entering the deepest recession on record.

All industries except agriculture and government services were smaller YOY due to the lockdown, with mining, manufacturing and construction around a third smaller compared to Q2-19. The finance, real estate and business services industry contracted 6.6% YOY during the period, the smallest contraction among the sectors.

Overall, PwC expects the South African economy to shrink by 10.4% in 2020. This takes into account economic data for the first half of the year, a continued easing in lockdown restrictions during the remainder of the year, the positive impact of fiscal and monetary stimulus in reducing the recession, as well as the adverse impact of load shedding on the recovery in economic activity. We believe the worst of the lockdown effects took place in the second quarter and the second half of the year will see a start in the economic recovery. However, by the close of the year, the recession is expected to result in a net loss of 1.6 million formal and informal sector jobs.

Following the 2020 recession, the South African economy is expected to grow by up to 5% in 2021 — off a very weak base, with growth in economic activity next year being compared with a lockdown-hit 2020. Expectations are for minimal restrictions on business activity by the start of next year. The recovery could be aided by the implementation of several key structural reforms to the economy, including the governance of electricity generation and distribution. This could address the issue of load shedding which is expected to be a disruptive factor for at least the next 18 months.

Figure 1.2 South Africa: Slow growth followed by a deep recession in Q2-20 (%)
Sub-Saharan Africa

Economies in sub-Saharan Africa have been hard hit by the global economic recession in 2020. While the total number of COVID-19 infections in the region is considered low by global standards, and domestic lockdown restrictions have in many cases been less severe than in northern hemisphere countries, trade-dependent African countries had to cope with severe disruptions in international supply chains. Many of their largest export buyers and import suppliers were hard hit by the pandemic. High-frequency data indicates that the biggest negative impact was felt during Q2-20, and that improvements in international trade, as well as the easing of lockdown restrictions at home, aided the start of a recovery for the continent’s largest economies during Q3-20. Overall, the sub-Saharan African economy is expected to contract by 3.5% in 2020.

Following the 2020 recession, PwC forecasts the sub-Saharan African economy to grow by 3.0% in 2021. This bounce-back growth will be lower than seen in many other regions globally, partly as a result of the shallower contraction forecast for 2020. An additional factor contributing to a moderate rebound is the smaller policy packages deployed by African countries compared to advanced and many emerging market economies. Furthermore, structural changes to the global tourism market could see some of the region’s largest economies — including South Africa and Kenya — experience significantly fewer international arrivals.
Analysis of the banks results – key themes arising from the reporting period

• The major banks entered the crisis with resilient balance sheets, sound capital and liquidity levels and strong franchises. These foundations helped anchor them as they swiftly turned attention to ensuring the safety of their workforces, maintaining cost discipline, operational and balance sheet resilience, and providing colleague, community and customer support.

• Driven by heightened customer risks and the depressed economic outlook across loan product classes, industry sectors and geographies, credit provisioning levels soared against expectations for rising volumes of distressed and non-performing loans. Sharply increased credit impairment charges translated into deep contractions in headline earnings and depressed ROE.

• While different banking segments and products reacted with different levels of sensitivity to the crisis, the major banks remained open for business and focused on operational stability — positioning themselves for a recovery of unknown timing and shape and maintaining an eye towards strategising the longer-term impacts on their businesses and operating models.

• Robust increase in digital transactional volumes were insufficient to offset the significant lockdown-related decline in trading activity, negatively impacting revenues.

• Supported by robust technology architecture and years of strategic focus on customer centricity, innovation and channel development, the banks turned to online channels to facilitate customer experiences as lockdowns rapidly accelerated digitisation of banking services. These ranged from collection capabilities and transactional channels to enabling new product sales.

• Underpinned by a focus on operational excellence, innovation efforts and partnerships with niche fintech players continued and were accelerated in a climate characterised by new ways of working. These efforts ranged across diverse aspects including artificial intelligence, robotic process automation, cloud computing and application programming interfaces, among others.

• Tight cost control and intense management of discretionary spend was an important focus area over the period in response to lower revenue growth and significant operating uncertainty.

• The major banks recognise that their business models will need to continue to be refined. This will include a redesign of distribution structures with a focus on reskilling teams to further enable delivery of the digital customer experience of the future.

• Regulatory capital and liquidity ratios reflected continued resilience and were maintained well above required levels, aided by a consistent track record of prudential discipline, risk management and balance sheet strength.

• Evolution of the risk landscape began long before the pandemic with the emergence of cyber risks, vendor risks, climate and sustainability risks, among others, increasingly ranking alongside primary risk types. These emerging risks took on renewed prominence as crisis conditions emboldened malign actors in areas ranging from data theft to exploiting operational vulnerabilities.
Regulatory developments

Consistent with actions taken by central banks and banking regulators globally, the South African Reserve Bank and its Prudential Authority (PA) acted decisively at the start of the lockdown period to provide a package of regulatory and supervisory relief measures to South African banks, in a manner ensuring South Africa’s continued compliance with internationally agreed frameworks.

On the monetary policy front, the repo rate has been cut by 300 basis points in the course of the year in an effort to ease financial conditions and improve the resilience of households and businesses in the face of the pandemic. In the latest Monetary Policy Committee meeting during September 2020, the repo rate was maintained at 3.5%, the lowest rate in nearly 50 years.

From a regulatory and supervisory perspective, the PA took various supportive actions over the period. These included a temporary reduction in the minimum capital requirement and liquidity coverage ratio requirement, and definitional relief to ‘distressed restructures’ to ensure that initiatives such as payment holidays and other debt relief provided by banks did not result in unintended consequences such as higher capital requirements.

Guidance was also provided by the PA emphasising the need for capital preservation to support the real economy and absorb losses. It therefore recommended that no distributions of dividends on ordinary shares or payment of cash bonuses to executive officers and material risk takers should take place in 2020.

Additionally, the PA and other regulators provided operational relief through extending filing timelines for, inter alia, annual financial statements, regulatory submissions and assurance reports.

More broadly, the financial press was met with news in mid-September from the International Consortium of Investigative Journalists, together with other media partners in 88 countries, with findings and analysis of suspicious activity reports and other documents from the United States Treasury Department intelligence unit, the Financial Crimes Enforcement Network (FinCEN), collectively dubbed the FinCEN Files. The findings again raise attention to potential anti-money laundering transgressions by large international banks and may trigger a fresh round of regulatory and market focus in this area.

Outlook

As many contemplate how the pandemic will play out, some commentators observe that any attempt to predict when and how economies – and bank profitability – might return to pre-crisis levels is less an exercise in forecasting, and more one of conjecture.

Due to the lack of precedent both in terms of the extent of the recession in 2020 and the scale of any partial rebound in 2021, estimation uncertainty and forecast risk remains significantly heightened. Expanding forecast time horizons amplifies uncertainty, particularly as the effects of the crisis and its second order effects extend beyond 2020.

Globally, a degree of market turbulence is expected as the world’s largest economy — the United States — enters an intense phase of its presidential election cycle, with market reactions expected to be closely followed in the period leading up to, and following, the 3 November election.

In South Africa, annual GDP forecasts of the major banks for 2020 range from a 7–8.5% contraction. Although subject to significant estimation uncertainty, PwC’s research suggests that South African economic output could take between two and seven years to return to 2019 levels.

In recognition of the wholly uncertain domestic operating environment, the major banks have all withdrawn pre-crisis medium-term financial targets.

Expectations for the industry to remain profitable over 2020 are well founded in view of the resilience shown by the major banks over 1H20. The combination of dividend suspension and muted loan growth expectations for the rest of the year will sustain capital levels.

While maintaining run-the-bank operations, management teams have mobilised programmes of work to revisit longer-term strategies, challenge and validate business and risk assumptions, and devise new or refreshed strategies for a ‘post-COVID 19’ world — or at least one in which the pandemic stabilises to manageable levels. Doing so will require striking a difficult balance between risk, strategy and resilience in an unprecedented operating climate. The banks that will navigate the current crisis best will be those that maintain the financial and operational resilience to deal with heightened profitability risks and non-performing loan formation, while leveraging crisis learnings to underpin reimagined purpose-led, platform-based strategies.

Strategies grounded in customer centricity, responsiveness to demographic shifts and evolving customer expectations, while maintaining pace with technological change, are those that will best provide a foundation for success.
Headline earnings

The South African major banks have a consistent track record of generating profit growth in relatively close proximity to domestic annualised GDP growth, as depicted in Figure 2.1. This track record — reflecting a three-year compound annual growth rate (CAGR) of 7.3% — has been disrupted in 1H20 owing primarily to a sharp increase in credit impairment charges under IFRS 9’s expected credit loss model.

Combined headline earnings of R14.6bn in 1H20 declined 65.5% relative to 1H19 (65.1% against 2H19). This was driven by a steep increase in the combined credit impairment charge of 2.3 times against the comparable period. On the back of lower organic capital growth (retained earnings) given depressed earnings generation, the combined ROE fell to 5.4% (18.5% at 1H19 and 17.1% at 2H19).

Figure 2.1  SA major banks headline earnings growth, 1H16–1H20 (Rm)

Source: PwC
Pre-provision operating profit (PPOP) at 1H20 reflected the resilience and strength of the underlying franchises that the major banks entered the crisis with, and the continuing efforts to navigate current conditions growing 4.4% against 1H19 (down 3.7% against 2H19).
## Table 2.1  Combined income statement (Rm)

<table>
<thead>
<tr>
<th></th>
<th>1H20</th>
<th>2H19</th>
<th>1H19</th>
<th>1H20 v 2H19</th>
<th>1H20 v 1H19</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net interest income</td>
<td>101 267</td>
<td>102 534</td>
<td>99 644</td>
<td>-1.2%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Non-interest revenue</td>
<td>72 441</td>
<td>76 960</td>
<td>74 261</td>
<td>-5.9%</td>
<td>-2.5%</td>
</tr>
<tr>
<td><strong>Operating income</strong></td>
<td>173 708</td>
<td>179 494</td>
<td>173 905</td>
<td>-3.2%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>-95 411</td>
<td>-98 221</td>
<td>-98 903</td>
<td>-2.9%</td>
<td>-3.5%</td>
</tr>
<tr>
<td><strong>Pre-provision operating profit</strong></td>
<td>78 297</td>
<td>81 273</td>
<td>75 002</td>
<td>-3.7%</td>
<td>4.4%</td>
</tr>
<tr>
<td>Bad debt charge</td>
<td>-52 076</td>
<td>-17 358</td>
<td>-15 964</td>
<td>200.0%</td>
<td>226.2%</td>
</tr>
<tr>
<td>Other</td>
<td>-7 036</td>
<td>-3 802</td>
<td>-1 168</td>
<td>85.1%</td>
<td>&gt;100%</td>
</tr>
<tr>
<td>Direct tax</td>
<td>-3 557</td>
<td>-13 217</td>
<td>-14 038</td>
<td>-73.1%</td>
<td>-74.7%</td>
</tr>
<tr>
<td><strong>Profit after tax</strong></td>
<td>15 628</td>
<td>46 896</td>
<td>43 832</td>
<td>-66.7%</td>
<td>-64.3%</td>
</tr>
<tr>
<td>Headline adjustable items</td>
<td>-976</td>
<td>-4 865</td>
<td>-1 346</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Headline earnings</strong></td>
<td>14 652</td>
<td>42 031</td>
<td>42 486</td>
<td>-65.1%</td>
<td>-65.5%</td>
</tr>
</tbody>
</table>

Source: PwC

### Net interest income

Combined growth in net interest income amounted to 1.6% compared to 1H19, but declined 1.2% against 2H19, reflecting the markedly different operating conditions during the first six months of 2020.

### Balance sheet mix and economic impacts

Gross loans and advances grew 8% against 2H19, while deposits grew 9.5% for the same period. Overall balance sheet growth across both advances and deposits continues to support net interest income generation.

Strong origination of loans and facility drawdowns in corporate loan portfolios was observed, while there has been continued, albeit moderate, credit growth in retail lending portfolios.

Higher deposit levels were observed across retail and corporate segments as clients held on to liquidity sources in light of the uncertain environment.

The major banks have continued to place strategic focus on improving pricing strategies and appropriately pricing for risk taken on in their balance sheets. Income generated from asset growth continues to be the main driver underpinning net interest income (NII). Balance sheet mix is, however, counteracted by competitive pricing strategies and the benign interest rate environment.

While the downward cycle in interest rates contributed to margin contraction, the effect of lower rates provides customer relief and, potentially in ‘normal’ times, aids further borrowing and spending due to lower debt-service costs. However, the combination of the current environment, depressed consumer confidence levels and dim prospects for the South African unemployment rate bodes negatively for credit appetite in most consumer segments for the rest of the year.
Net interest margin analysis

The combined net interest margin (NIM) compressed 28 basis points over the period from 4.2% at 2H19 (4.3% at 1H19) to 3.9% at 1H20, as widespread interest rate cuts resulted in negative endowment impacts on capital and deposits. Those banks using their physical footprints or regional operations outside South Africa to grow lending will have seen their foreign currency translation reserves continue to be impacted by volatile foreign exchange markets over the period.

While the major banks have different structures, operating models and strategies with regard to offshore operations, it is clear that volatile foreign exchange markets introduce added complexity for the banks to navigate in managing their margins. The still uncertain exchange rate outlook over the short term will continue to be a focus area as the major banks look to hedge exposure to currency risks.

Figure 2.3  Net interest margin (Rm)
Non-interest revenue

Net fee and commission income

The primary contributor to non-interest revenue (NIR) continues to be fee and commission income, constituting 65% of NIR for 1H20 (69.2% for 2H19, 68.8% for 1H19). Within the context of the lockdown environment and constrained operating conditions, net fee and commission income declined by 11.6% compared to 2H19 (down 7.8% compared to 1H19).

While transactional activity shifted swiftly towards online and mobile channels over the lockdown period, overall fee income was, on the whole, negatively affected. Increased digital transaction volumes and modest to no fee increases were insufficient to offset the significant lockdown-related decline in physical channel volumes, business turnover reductions, a drop in trade activity and regulatory restrictions introduced on certain fees in some regional operations.

Management teams continue to diversify net fee and commission income across regional operations, given the relatively mature state of the banking market in South Africa and muted opportunities for significant further growth domestically.

Knowledge-based fee income, largely associated with investment banking advisory activity, has historically shown resilience during tough trading conditions. The current economic uncertainty could, however, impact negatively in the near term as large scale-financing decisions, listings and corporate activity are delayed.

Trading and fair value income

Trading income was underpinned by increased levels of market volatility and higher client trading volumes during 1H20, which is characteristic during periods of heightened market stress. Trading income reported strong growth with an increase of 24.9% compared to 2H19 (19.5% compared to 1H19). This revenue category now constitutes 24.9% of total NIR (18.8% in 2H19, 20.3% in 1H19).

Private-equity income declined due to downward revaluations of unrealised investments as the subdued macroeconomic environment impacted the profitability of investee companies ‘on the ground’, listed market prices and valuation multiples declined, while cost of equity increased on the back of higher risk premia.

Insurance and bancassurance income declined 17.9% compared to 2H19 (an increase of 27% compared to 1H19), due to the impacts of higher actuarial reserves and the effect of poor JSE market performance on shareholder funds. However, this was offset by improved non-life claims experience relative to the prior year due to the comparative absence of weather-related events.

Figure 2.4 Non-interest revenue (Rm)

Source: PwC
Efficiency

Cost-to-income ratio analysis

A perennial focus for the major banks over recent reporting periods has been tight cost control and disciplined management of the overall cost base. Notwithstanding the uncertain operating environment that prevailed over 1H20, the major banks cut expenses by a combined 3.5% against 1H19 (2.9% against 2H19). The combined cost-to-income ratio improved from 56.2% in 2H19 to 55.1% in 1H20 and remained flat against 1H19.

Key cost drivers

Staff costs as a percentage of total costs have declined from 57.1% in 2H19 to 56.2% as at 1H20 (flat against 1H19). The major banks responded to the trend of rising staff costs seen in previous years by limiting salary increases and bonuses, which assisted in their 4.5% average decline in staff costs compared to 2H19 (down ~1% against 1H19). Combined headcount of 160 699 employees remained relatively stable, declining 1.4% against 2H19 and 2.8% against 1H19.

Lockdown-driven reductions in discretionary spend, for example in travel and entertainment, were offset by increases in IT costs. On average, costs spent on IT have increased from 2H19 by 8.6% (up 13% from 1H19), an unsurprising trend given the shift to remote working by staff and the elevated need for business continuity and resilience management.

Figure 2.5 Operating expenses and cost-to-income ratio (Rm)

Source: PwC
Asset quality
Credit growth

Notwithstanding the crisis conditions and elevated levels of operating uncertainty that prevailed over 1H20, the aggregate loan portfolio registered growth of 8.0% against 2H19. This was driven primarily by corporate and interbank balances, as well as resilient loan growth in regional operations outside South Africa.

Unsurprisingly, credit demand was nuanced across customer segments and geographies.

From a corporate perspective, client-driven loan growth was evident through, inter alia, facility drawdowns in anticipation of the uncertain environment. Further offsetting muted credit conditions, those banks with sizeable operations outside South Africa benefited from stronger period-end balances, which were converted into ZAR using a weaker ZAR/USD exchange rate.

National lockdown measures and acutely depressed household and business confidence levels combined to constrain new loan extensions in the retail and business banking segments, which contracted 1% against 2H19, owing to a sharp decline in vehicle and asset financing and flat mortgage growth. Lending contractions within secured lending portfolios were attributable to closures of deeds and vehicle registration offices over the initial periods of the lockdown.

Where credit growth was observed, this originated in large part from existing customers as the major banks were instrumental in supporting the economy through the crisis with various relief programmes implemented to assist customers through the difficult period.

Additional credit risk monitoring processes and controls have been implemented to manage the credit risk that might arise from debt relief portfolios.

No significant changes to overall portfolio mix (Figure 3.1) or retail product classes (Figure 3.2) were observed over the period.
Impairments and coverage ratios

Given the front-loaded nature of expected credit loss estimation under IFRS 9, the combination of a markedly worse economic outlook, deteriorating customer risk profiles and pandemic-induced social containment measures resulted in the combined bad debt charge increasing 3.3 times relative to 1H19. These elevated impairment levels were last seen during the global financial crisis. Increased impairments deteriorated the combined credit loss ratio to 232 bps (78 bps at 1H19 and 83 bps at 2H19).

Given the uncertain economic outlook, it is important to note that the increased credit impairments observed over the period incorporate a forward-looking view and a large part of the bad debt charge is yet to materialise in actual customer delinquency or default. Banks will now focus on tightly managing their credit risks across all portfolios through the uncertain short to medium term, with the possibility of releasing some impairment raised over time if economic conditions turn out to be better than the macro and provisioning models currently reflect.

Overall, the major banks show sound levels of coverage with a total loan book impairment coverage ratio of 3.6% (2.8% at 1H19 and 2H19) and non-performing loan coverage of 43.3% (45.0% at 1H19), while loans in arrears and loans with a significant increase in credit risk (Stage 2) registered a combined coverage ratio of 8.0% (7.2% at 1H19).

Coverage ratio increases were observed across all customer segments and lending products, but the largest increases were noted in the vehicle and asset finance, and business banking exposures, while corporate and regional lending operations also registered higher impairments.

Altogether, the combined performing book coverage ratio at 1H20 averaged 154 bps as depicted in Figure 3.3 (112 bps at 1H19 and 2H19), while the combined non-performing coverage averaged 43.3% (Figure 3.4).

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**Figure 3.3** Performing book impairment coverage ratios (Rm)

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Source: PwC
Under the IFRS 9 accounting standard, contrasting Stage 2 (significant increase in credit risk) and Stage 3 (non-performing) loan composition provides a reflection of credit quality over time. For the current period, Stage 2 loan balances increased 42.4% against 2H19 (43.3% against 1H19), and comprised 10.2% of the total loan book (7.7% at 2H19). Stage 3 loan balances increased by 33.4% against 2H19, comprising 4.9% of the total loan book at 1H20, deteriorating from 4.0% at 2H19.

Portfolio migration to Stages 2 and 3 and the decrease in overall credit quality was largely due to the negative impact of a difficult environment, acute levels of uncertainty and the effects of measures taken to contain the spread of COVID-19, particularly in South Africa.
Expected credit losses for banks under IFRS 9: What next?

Adapted from PwC’s International Financial Reporting Standards blog

Like many, I’d hoped for a quick lockdown, V-shaped recovery and rapid vaccine. Yet with the first two ‘crisis quarters’ behind us, it’s becoming clearer that’s unlikely to be the case. For estimating expected credit losses (ECLs) for banks under IFRS 9, that warrants a pause to think about where we are and what challenges might be next, including any necessary changes to adapt ahead of year-end reporting if crisis uncertainty continues to loom.

Thus far, billions have been booked in incremental provisions, while defaults are yet to rise. In many cases, delinquencies haven’t transpired thanks to payment holidays and enormous government support. For banks, that means a few things. Firstly, losses are likely coming. Provisions set aside will be consumed as delayed defaults come to fruition. Secondly, risk will continue to be very challenging to measure. Put simply, normal rules don’t apply. Being jobless or unprofitable usually reduces one’s ability to pay, which leads to delinquencies and ultimately to defaults.

Of course, in many ways, all that we really know is that we don’t really know. That’s important since what comes to pass will determine the credit losses that eventually transpire. In estimating ECLs today, we average the good, the bad and the ugly by probability-weighting different outcomes. In real life, we don’t. For that reason, provisions are sure to evolve as reality unfolds.

Given all of the above, to date most have adapted their estimates by moving away from core models and doing new or different analytics, adding a lot of (necessary) judgement along the way. Thinking ahead to year end, things to focus on now are:

- continuously refining the estimate as conditions evolve — for example, reflecting epidemiological developments and changes to government stimulus packages;
- assessing whether adding more alternative scenarios, when modelling estimates, might be a better way to address increased uncertainty;
- testing judgements, including by comparison to peers, market inputs (such as credit default swap spreads), current pricing of similar loans, and consistency with fair-value disclosures;
- focusing on governance, process and controls in order to bring the same level of rigour to new or changed methods as would normally be applied to core models;
- thinking differently about validation, including whether overlays and other adjustments can be covered by similar processes;
- considering what new data might become available — such as cash flow information from the borrower’s different accounts or changes to government programmes and how it will be collected and incorporated into estimates;
- planning for an agile future by rethinking the ‘model’ definition and implementing frameworks that allow for quick pivots from core models to risk analytics without having to compromise on quality; and
- putting transparency first by considering what disclosures might be most useful for users, depending on how things develop between now and year-end.

The only certainties right now are that none of us really knows where we’ll be in six months’ time, and that what worked in the past isn’t working now. The focus to date has been on finding ways to estimate until things become clearer. In the event they become less clear, it’s worth figuring out how to migrate from short-term fixes into longer-term solutions.
The major banks entered the crisis with resilient balance sheets, sound capital and liquidity levels and strong franchises, enabling them to maintain capital and liquidity positions above regulatory minimum levels through the period.

Supported by the temporary regulatory relief measures provided by the PA, the major banks swiftly turned attention to ensuring the safety of their workforces, maintaining cost discipline, operational and balance-sheet resilience, and providing support to colleagues, communities and customers.

**Capital supply and demand**

On the back of lower organic capital growth as a result of depressed earnings, the combined ROE fell to 5.4% (18.5% at 1H19 and 17.1% at 2H19) while the combined Common Equity Tier 1 regulatory capital ratio contracted to 11.2% (12.3% at 1H19 and 12.5% at 2H19). The combined total capital adequacy ratio remained resilient at 14.5% (15.7% at 2H19), above regulatory required levels.

As part of a temporary relief package implemented by the PA to assist banks through the unprecedented stress event, the minimum capital required was reduced by removing the current additional Pillar 2A capital requirement (for South African systemic risk) from 1% to 0%.

**Figure 4.1** Regulatory capital and ROE

*Source: PwC*

*Regulatory minimum includes the Basel base minimum (8%), Pillar 2A (0%), Capital Conservation Buffer (2.5%) at 1H20. FSR’s ROE reflects a six month recalculated ratio*
The outlook for global financial stability continues to be uncertain. Factors that could heighten risks to the banking system include the trajectory of Covid-19 infections and containment measures, a protracted recovery period, and the unwinding and expiration of support measures. In addition, the banking system’s operational resilience will continue to be tested in light of the increase in remote working and banks’ reliance on technology and third-party service providers.

Against that backdrop, the banking system entered the COVID-19 crisis on a more resilient footing. Thanks in part to the Basel III post-crisis reforms, banks’ capital and liquidity resources are greater than during the global financial crisis, making them more resilient. The Basel Committee is currently consulting on a set of principles to enhance banks’ operational resilience. Committee members unanimously reaffirmed their expectation of full, timely and consistent implementation of all outstanding Basel III standards based on the revised timeline endorsed by the Group of Governors and Heads of Supervision earlier this year.

The Basel Committee reiterates its previous guidance that banks should make use of the Basel III capital and liquidity buffers during the crisis to absorb financial shocks and support the real economy by lending to creditworthy households and businesses. Supervisors will allow banks sufficient time to restore buffers, taking account of economic and market conditions as well as the circumstances of individual banks.

The Committee will continue to monitor the risks to the global banking system from Covid-19 and will pursue additional measures if needed. It will also continue to coordinate work on cross-sectoral financial issues with the Financial Stability Board (FSB) and global standard-setting bodies.

The Committee approved an updated work plan to evaluate its post-crisis reforms, which will incorporate lessons learned from the COVID-19 crisis. The Committee will conduct a range of empirical analyses to evaluate:

- the extent to which its post-crisis reforms have achieved their objectives;
- the interactions among the Basel III reforms and other post-crisis reforms; and
- whether there are gaps in the regulatory framework or significant unintended effects.
Liquidity and funding

Retail, business and corporate deposit balances increased in aggregate during the lockdown period as customers held additional liquidity to support uncertain cash flow demands, driving total deposits to increase 9.5% against 2H19. Some banks observed healthy growth in call, savings and investment products.

Meanwhile, stocks of high-quality liquid assets (HQLA) grew robustly at 10.8% against 2H19 and 19.3% against 2H19, reflecting the tilting of the balance sheets towards resilience over the crisis period.

The combined loan-to-deposit ratio at 1H20 of 91% (92.1% at 2H19 and 93.3% at 1H19) reflect positively on the funding structure of the major banks, a theme consistently observed over recent periods.

From a prudential perspective, the combined Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) of 123% and 118% respectively were maintained well above minimum required regulatory levels, as depicted in Figure 4.2.

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**Figure 4.2** LCR and NSFR levels

![LCR and NSFR levels graph](image)

Source: PwC
The South African major banks are highly regarded globally for their innovation and ‘purpose-led, platform-based’ philosophies, which have been at the core of their strategies since long before the onset of the pandemic.

Embracing technological shifts, digitising customer and internal capabilities and keeping pace with evolving technology and customer demographics has been a consistent and strategic theme for a decade.

Given the impact of the national lockdown on physical channels, reliance on their technology investments and digitised operations were key to remaining open for business over the period, while supporting customers, colleagues and the broader economy in the process.

Growth in monthly logins to digital banking channels, online transactional volumes and digitally active clients (as a percentage of total clients) were clearly discernible over 1H20 — averaging in the high double digits across these measures for all of the major banks.

The convergence between banking and big tech has been a closely focused area for many industry observers in recent periods, with the trend of broad-based digital disruption to the industry widely acknowledged.

Learnings from the development of new ‘digital-only’ banks globally and regionally bring into renewed focus that the core banking systems incumbents developed over several years are supported by traditional, stable IT architecture - which cannot be rebuilt or repurposed within a short period.

New platform-based applications and financial services ranging from mobile payments, micro-finance and e-commerce in open banking environments is rapidly proving to be at the centre of changing customer expectations.

These applications cannot be tacked onto core architectures which were designed for deposit, loan, and remittance services.

New services are cloud-native applications, developed based on new technologies that are open and agile. For this reason, a so-called “dual-mode architecture” is likely to emerge, one consisting of both stable and agile, distributed elements.

Digital disruption has evolved from an existential threat to a core strategy pillar for lenders around the world. Banks now increasingly resemble tech companies, while big tech firms such as Google and Alibaba are among the world’s biggest financial services companies.

—The Banker Masterclass, ‘Embracing digital disruption’ – September 2020
https://www.thebanker.com/Video/Embracing-digital-disruption
Accelerated by the pandemic, some commentators observe that the banking industry will see ‘non-traditional’ competitors in financial services become increasingly commonplace. Meanwhile, recognising the opportunity and mindful of their large customer bases and extensive distribution capabilities, mobile network operators are also increasing their propensity to actively participate in financial services.

This participation — in areas such as mobile money products and payment facilitation services — has already begun. The next frontier will be capturing customer focus and maximising customer convenience by providing financial services where, when and how customers seek it, typically through slick front-end solutions, cloud-based infrastructure and access to a broad variety of tangential financial products and services.

We have previously framed the focus on technology and digitisation by the major banks in the context of:

- **Customer experience**: evolving customer expectations and the imperative to provide richer, broader and more seamless banking experiences;
- **Safety and security**: shoring up online and technology security perimeters in recognition of growing cyber risks increasingly sophisticated malign actors seeking to exploit banking systems and networks;
- **Regulation**: embracing regulatory change in areas such as data-privacy and rules regarding risk/finance data integrity; and
- **Efficiency**: Standardisation, simplification and automation of internal, operational and back-office banking processes.

While these broad lenses continue to hold true and underpin the technology imperatives of the major banks, there is no doubt that recent experiences of customers across all segments, and of the banks’ themselves, will place strategic digital transformation at the centre of overall bank strategy. Enabling customer experiences through apps, application programming interfaces (APIs) and analytics lies at the heart of the open-banking era.
### Areas of focus for recovery in financial services

#### Repair
- **Portfolio management**: Prepare for restructuring and workouts
- **Fee-based revenue**: Develop new products, consider acquisitions
- **Trust**: Use the crisis to help regain the trust of society and regulators
- **New business capacity**: Rebuild capital, rationalise portfolios to rebuild capacity

#### Rethink
- **Management**: Adopt a more agile and less structured organisation and approach
- **Ways of working**: Rationalise real estate footprint, formalise remote working, integrate productivity tools
- **Talent and innovation**: Increase crowdsourcing and use of gig economy, upskill talent
- **Customer and strategy**: Accelerate move to digital channels, align business strategy to new reality

#### Reconfigure Report
- **Cost structure**: Drive 25–30% additional reduction
- **Change budget and focus**: Re-evaluate and rationalise to improve ROI
- **Emerging technology**: Drive adoption of cloud and use of AI and SaaS solutions
- **M&A**: As needed to re-establish scale, enter growth markets, exit markets/poor-performing businesses
- **Partnerships**: Increase partnerships with non-traditional providers, technology companies and fintechs
- **Business lines and products**: Align front-office resources, service models and capital to the most profitable products
- **Compensation and incentives**: Align to new strategies and objectives
- **Digitisation and productivity**: Accelerate digital labour and transformation initiatives

#### Report
- **ESG**: EU, other mandates
- **State aid**: SME assistance, capital, other support
- **Accounting standards**: CECL, IFRS 17
- **Regulatory**: Supervision and communication
- **Shareholders**: Enhanced disclosure
- **Society**: Purpose and value
- **Taxes**: Increasing transparency of tax contribution and strategy

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**How might the “4 Rs” help Financial Services firms plan for tomorrow, today?**

Take a look. [https://pwc.to/3kSBwXm](https://pwc.to/3kSBwXm)
Our other recent industry thought leadership

Non-executive directors: Practices and fees trends report 2020
The 13th edition in the series continues with its annual review of fees paid to non-executive directors of JSE-listed companies, companies listed on several African stock exchanges and non-executive of FTSE 100 and FTSE 250 companies. The report also sets out some thinking around what boards should be focusing their energy and attention on and provides insights into the following topics: Effective board committees, reporting on the internal pay ratio, boardroom culture and CEO personality, setting fees for non-resident NEDs, and responding to climate change, among others.

Beyond COVID-19: Five key priorities to accelerate post-crisis transformation for banking and capital markets
As lockdown restrictions begin to ease, the strategic focus within banking and capital markets (BCM) is pivoting towards how to succeed in the post-crisis world. The road ahead is challenging, but these circumstances also present a unique opportunity to accelerate transformation, boost growth and reassert the value of BCM organisations within society. Although COVID-19 is still taking a daily human and economic toll, the worst of the immediate crisis is probably behind us. As a business leader, you can now shift your focus from crisis mobilisation and stabilisation to a new set of more enduring, strategic goals.

Compliance. Transformed.
PwC has developed a microsite and online quiz to assist you in considering the opportunity and assessing your organisation against a range of design attributes (either for one compliance category, such as workplace safety, or organisation wide across all compliance categories).

The microsite can be accessed at the following link: https://www.pwc.com/gx/en/issues/compliance-transformed.html

There is also an article that further explores this topic, discusses five attributes of effective compliance and shares some case studies of leading examples:


The upskilling imperative for financial services firms

Even before COVID-19, financial services CEOs faced a rapidly changing industry. Developing their people with the right skills is critical to competing in the future, yet doing so requires making investments that won’t generate a return for several years. In the meantime, there is relentless pressure to hit short-term financial targets.

Judging from the results of PwC’s 23rd Annual Global CEO Survey, the industry has yet to solve this challenge, but it must. In a fast-changing economy, winning companies are adept at building new skills and capabilities, particularly those based on digital technology.

https://www.pwc.com/gx/en/ceo-agenda/ceosurvey/2020/trends/financial-services-people.html

IFRS 17: Managing data to optimise cloud strategy

Over the past five years, as insurers have prepared for the implementation of IFRS 17, which will dramatically affect finance — including underwriting pricing, and sales and marketing — they’ve steadily adopted cloud technologies and ramped up their investment in data engineering capabilities. More recently, to further prepare themselves for the new regulations and to modernise, they have also begun changing how they deploy these data applications and solutions.


Leading out of lockdown: Five key priorities for post-crisis asset and wealth management

As the road out of lockdown opens up, asset and wealth managers are turning their strategic focus to how to compete in the much-changed marketplace emerging from the crisis. The markets may be challenging, but there’s more scope for innovation, differentiation and winning new business. If you’re an asset and wealth manager, how can you put your organisation in the strongest position to succeed?


Market risk and valuations – considerations under COVID-19

The impact of COVID-19 on financial markets and the global economy has been severe and continues to unfold as governments consider various courses of action. The impact on almost all asset classes and industries has been pervasive, which may leave even the most sophisticated institutions grappling with how to best respond.

In this article we explore how the impact of COVID-19 on financial markets affects the valuation of financial instruments and the risk management efforts of financial institutions. We highlight some key considerations for entities with exposure to financial markets with regard to instrument valuations, pricing and risk management.

Key banking statistics – 1H20
<table>
<thead>
<tr>
<th>R million*</th>
<th>ABG</th>
<th>FSR</th>
<th>NED</th>
<th>SBK</th>
<th>Combined / Average</th>
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<tbody>
<tr>
<td><strong>Balance sheet</strong></td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td></td>
<td>1H20</td>
<td>2H19</td>
<td>1H19</td>
<td>1H20</td>
<td>2H19</td>
</tr>
<tr>
<td>Total assets</td>
<td>1 560 996</td>
<td>1 394 494</td>
<td>1 372 797</td>
<td>1 926 539</td>
<td>1 716 357</td>
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<tr>
<td>Gross loans and advances</td>
<td>1 088 652</td>
<td>1 006 459</td>
<td>978 915</td>
<td>1 311 095</td>
<td>1 259 326</td>
</tr>
<tr>
<td>Total deposits</td>
<td>935 766</td>
<td>870 406</td>
<td>844 332</td>
<td>1 114 000</td>
<td>1 024 000</td>
</tr>
<tr>
<td>Loan-to-deposit ratio</td>
<td>105.9%</td>
<td>106.6%</td>
<td>107.1%</td>
<td>85.4%</td>
<td>87.5%</td>
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<tr>
<td><strong>Profit and loss analysis</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>1H20</td>
<td>2H19</td>
<td>1H19</td>
<td>1H20</td>
<td>2H19</td>
</tr>
<tr>
<td>Net interest income</td>
<td>24 072</td>
<td>23 639</td>
<td>22 667</td>
<td>31 022</td>
<td>31 393</td>
</tr>
<tr>
<td>Non-interest revenue</td>
<td>16 006</td>
<td>17 251</td>
<td>16 404</td>
<td>19 635</td>
<td>22 056</td>
</tr>
<tr>
<td>Operating income</td>
<td>40 078</td>
<td>40 890</td>
<td>39 071</td>
<td>50 657</td>
<td>53 949</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>-21 613</td>
<td>-23 368</td>
<td>-22 989</td>
<td>-26 918</td>
<td>-28 358</td>
</tr>
<tr>
<td>Pre-provision operating profit</td>
<td>18 465</td>
<td>17 522</td>
<td>16 082</td>
<td>23 739</td>
<td>25 591</td>
</tr>
<tr>
<td>Bad debt charge</td>
<td>-14 661</td>
<td>-14 121</td>
<td>-13 695</td>
<td>-18 449</td>
<td>-5 934</td>
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<tr>
<td>Direct tax</td>
<td>-718</td>
<td>-2 925</td>
<td>-3 385</td>
<td>-357</td>
<td>-4 911</td>
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<tr>
<td>Other</td>
<td>-1 051</td>
<td>-912</td>
<td>-760</td>
<td>-1 112</td>
<td>-207</td>
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<tr>
<td><strong>Key ratios</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return on equity (ROE)</td>
<td>2.6%</td>
<td>15.2%</td>
<td>16.4%</td>
<td>4.6%</td>
<td>21.2%</td>
</tr>
<tr>
<td>Cost-to-income ratio (CIR)</td>
<td>53.9%</td>
<td>59.3%</td>
<td>56.7%</td>
<td>53.7%</td>
<td>52.1%</td>
</tr>
<tr>
<td>Credit loss ratio (CLR)</td>
<td>2.77%</td>
<td>0.81%</td>
<td>0.79%</td>
<td>2.87%</td>
<td>0.95%</td>
</tr>
<tr>
<td>Net interest margin (NIM)</td>
<td>4.23%</td>
<td>4.48%</td>
<td>4.52%</td>
<td>4.26%</td>
<td>4.64%</td>
</tr>
<tr>
<td><strong>Capital ratios</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CET 1</td>
<td>10.8%</td>
<td>11.7%</td>
<td>11.9%</td>
<td>10.6%</td>
<td>12.4%</td>
</tr>
<tr>
<td>Tier 1</td>
<td>11.7%</td>
<td>12.7%</td>
<td>12.7%</td>
<td>11.0%</td>
<td>13.2%</td>
</tr>
<tr>
<td>Tier 2</td>
<td>3.0%</td>
<td>2.9%</td>
<td>2.7%</td>
<td>2.4%</td>
<td>2.4%</td>
</tr>
<tr>
<td>Total capital adequacy ratio</td>
<td>14.7%</td>
<td>15.6%</td>
<td>15.4%</td>
<td>13.4%</td>
<td>15.6%</td>
</tr>
</tbody>
</table>

*Prior period restatements have not been adjusted for.

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