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Researching Capital Markets and Financial Services

BANKING SECTOR RESEARCH
For Subscribers Only

Banking Monthly

South Africa

Welcome to the third edition of the Intellidex Banking Monthly.

5 JULY 2022

We're halfway through the year, which means all eyes are on bank results in a few weeks' time. Global trends suggest that the pandemic is in the rear-view mirror and regulatory authorities have eased restrictions with regards to capital requirements. This is good news for shareholders as it means better dividends. However, inflation remains a headwind to earnings growth, despite increasing rates providing endowment benefit to the sector. All this combined makes it a very challenging environment in which to lend for our banks. However, this isn't new as South African banks have been navigating low growth for the last seven years. Balance sheet optimisation and growing non-interest revenue are some of the low hanging fruit we see in the current environment. To get a sense of how things are playing out we've reviewed bank trading updates, while picking up on an interesting trend in our stat of the month.

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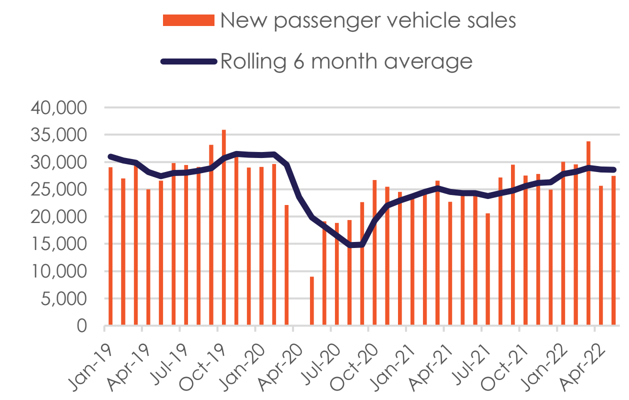
Stat of the month

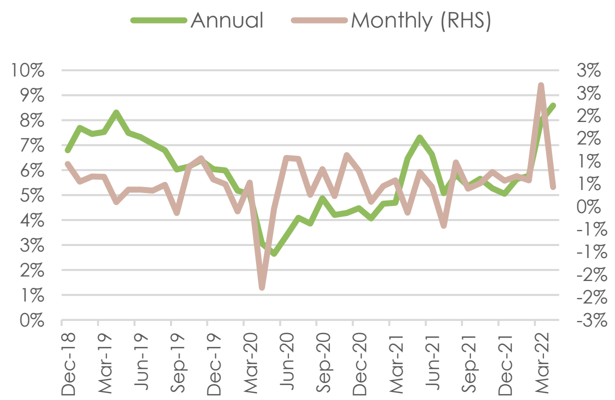
Recent bank trading updates suggest continued growth in vehicle financing, despite higher interest rates and fuel prices. The stats are showing some interesting trends:

- The six-month rolling average sales of new passenger vehicles has been recovering, however it is still below pre-pandemic levels. We think the slower recovery is due to growing demand in the second-hand vehicle market;
- We think the industry advance growth figures are better indicators of the supply and demand dynamics in the passenger vehicles industry as they include the financing of second-hand vehicles;
- On the back of this growth, we expect an uptick in stage one provisions in banks that have grown market share in this segment.

New passenger vehicle sales



VAF advances growth

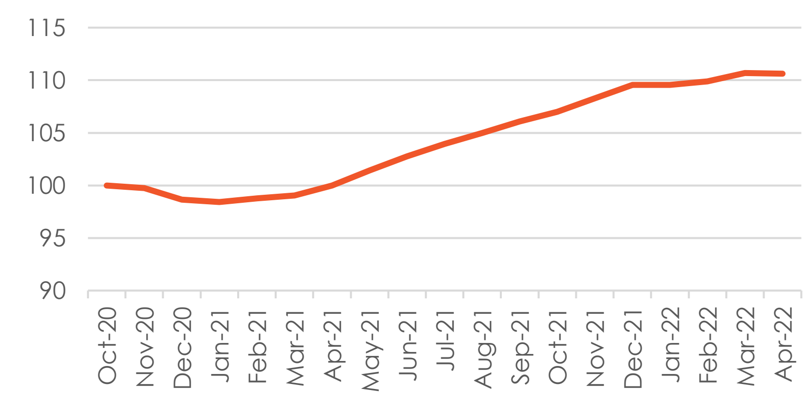


Source: SARB, Naamsa, Intellidex

Intellidex Bank Performance Index

How are SA banks doing? Our composite indicator reflects bank health at large. It factors in balance sheet growth, impairments, revenue growth and return on equity of registered banks as a group.

Intellidex Bank Performance Index



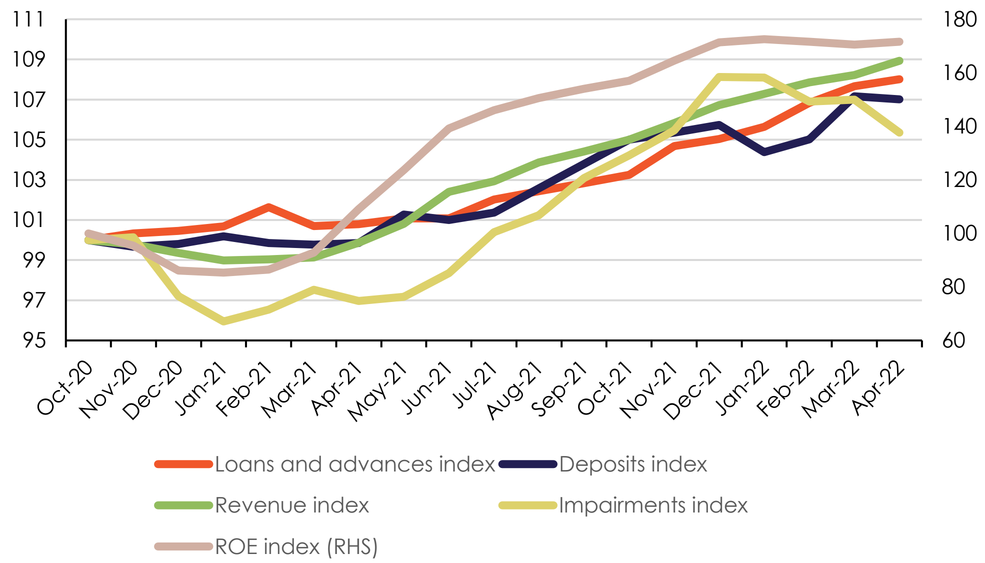
Source: Intellidex

The index shows a significant recovery of banks over the past year, however there is a clear slowing of momentum since the start of 2022.

A decomposition, shown in the chart below, shows the main drivers of the performance. Over the last 12 months there has been strong upward momentum in several drivers: balance sheet growth (both loans and deposits) and top line revenue growth (net interest + non-interest revenue). However, ROE is a standout performer, showing sharp improvements in profitability over the previous year (the index is based on the percentage change of rolling 12-month ROE in the latest month compared to the same period the previous year) so much so that we've put it on the right-hand side in the graph below. This is obviously helped by the low base effect of early 2021, when performance was sharply negative on the back of Covid fallout. The other main driver has been an improvement in impairments with a sharp decline in the costs of monthly impairments[1].

In April there was a change in impairments for performing loans. After showing signs of improvement in March, the impaired advances increased. We think this may be due to higher loan growth in February and March, which led to increases in stage one provisions. As such, we're expecting upside risks to credit loss ratios for the sector when it reports results in August. ROE has been stable since the start of this year, and this was likely caused by impairments as revenue growth momentum remains positive. Deposit growth also slowed in April.

Intellidex Bank Performance Index Decomposition



Source: Intellidex

In May we're expecting a similar trend of impairments to offset some of the momentum in revenue growth while deposits continue to slow down and loan growth maintains current momentum.

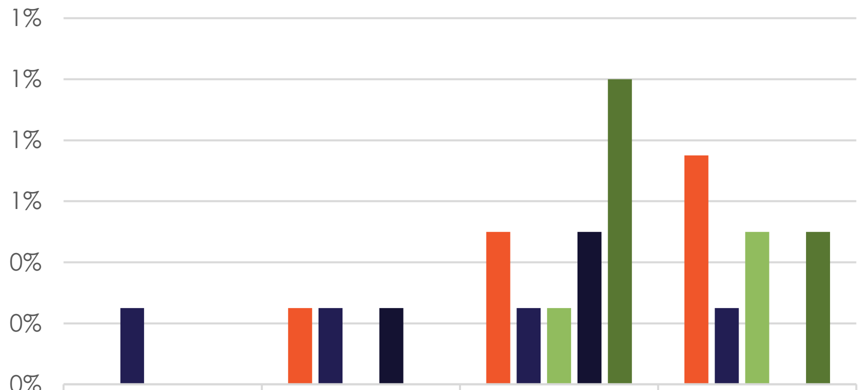
[1] The technically minded will want to understand how our index is made up: a 25% weighting for loans; 25% for revenue; 25% for deposits; 12.5% for impairments (inversed) and 12.5% for ROE. The composite should be a reliable indicator of overall bank health.

Global perspective

Tracking central bank hikes

Given the global interest rate upswing, we are tracking central bank monetary policy decisions. In this month alone we had the US, United Kingdom , Australia and Brazil hike rates in a range of 25 -100 basis points. The SARB is expected to come through with a 50bps hike next month. If it does, the repo rate will be 225bps higher than its trough of 300bps.

Central bank hikes



	Feb-22	Mar-22	May-22	Jun-22
United States	0%	0.25%	0.50%	0.75%
England	0.25%	0.25%	0.25%	0.25%
Australia	0%	0%	0.25%	0.50%
South Africa	0%	0.25%	0.50%	0%
Brazil	0%	0%	1.00%	0.50%

United States England Australia South Africa Brazil

Buy now pay later market grows and attracts more regulation

Buy Now Pay Later (BNPL) is a payment model that has been gaining popularity over the last three years. More recently it has been making headlines for increased regulatory scrutiny as well as traction as Apple is the latest company to offer it.

What is BNPL?

BNPL is a deferred payment method. Consumers can make a purchase if they pay a certain proportion of the purchase upfront and the remainder over a few weeks or months. No interest or fees are charged for the service; however, penalty fees are charged for any payments missed. No credit application is done, however there is an online vetting process. BNPL providers earn income from the retailer based on volume and value of transactions. Merchants gain from the additional sales enabled by the BNPL provider extending payment terms to consumers.

By way of example, a consumer goes to the retailer and purchases an item for R1,000. If she uses BNPL, she will pay R500 at the point of sale and then the remainder in equal amounts over three months.

The costs and benefits

	Benefits	Costs
Consumer	Enables the consumer to make a purchase and pay in instalments, interest free. As the consumer exhibits good payment behaviour, the limit on the purchase amount will grow over time.	If the consumer misses a payment the BNPL provider will charge a penalty fee. Is a form of off-balance sheet liability for the consumer which may complicate their debt management capabilities.
BNPL provider	It will typically generate revenue for the merchant/retailer and it will be based on the volume or value of transactions. The percentage will be negotiated between the retailer and BNPL provider.	It risks default from consumers, in which case the agreement converts to a credit agreement that is then collected. In some cases, the retailer is the provider.
Merchant/Retailer	As the BNPL signs up more consumers, transaction volumes are expected to increase. As such the fee paid to the BNPL provider should be offset by increased volumes of sales.	The merchant/retailer pays a fee which is typically a percentage of transaction volumes. BNPL costs the retailer less than credit card payments.

Why is it making headlines?

A year after Apple announced that BNPL would be available as a payment option, it has joined Amazon in introducing BNPL onto its platform. Initially it was going to be a partnership with Goldman Sachs, however Apple has decided to do the financing and credit checks on its own. Apple Pay Later lets customers split a purchase into four equal payments over six weeks, with no interest or fees to pay. Apple competes with that of other BNPL providers such as Klarna, Zip, Afterpay, Affirm, and PayPal. Amazon's BNPL service is provided by Amazon. And while these companies are adopting BNPL, globally it is coming under regulatory scrutiny. Last December, US consumer watchdog, the Consumer Financial Protection Bureau (CFPB), launched a market monitoring enquiry into BNPL. The concerns raised by the CFPB are the potential for debt accumulation, data harvesting and regulatory arbitrage. This month, the UK government announced plans to strengthen regulation of BNPL to protect millions of users. The government concerns were around consumer awareness of not meeting obligations and possible indebtedness. BNPL is in effect a form of shadow banking and as such it was inevitable that it would come under regulatory scrutiny.

In South Africa BNPL has been around for years and is gaining traction. Last year Tyme Bank was the latest financial services player and first bank to offer BNPL through its recently relaunched MoreTyme. It now joins BNPL fintechs Mobicred, Payflex, ZeroPay and PayJustNow. We expect other banks such as Standard Bank to also make the offering available. While the 45 or 60 months interest free offering on credit cards, has much the same function as BNPL, younger and lower income consumers will have easier access to this product.

We think once one of the big banks starts offering BNPL then the regulator will start paying attention. For now, there is little systemic risk as a bank such as

Tyme is still small and rolling out the product conservatively. The conduct risks, however, are growing as the market expands.

US banks get green light to boost returns to shareholders

Like many other central banks, the Federal Reserve conducts annual stress tests on the sector to assess whether the banks have sufficient capital to absorb losses during stressful conditions. Covid-19 led to a halt on share buybacks and lower pay-out ratios in an effort to preserve capital levels and buffers amid the pandemic. The latest stress test results came out favourably for the big US banks, as the regulator found that capital reserves exceeded requirements under the various scenarios. While some banks have chosen to increase their capital buffers despite the positive outcome, sector pay-out ratios and buybacks have increased on the back of the stress test results. The news was received well by the market as bank shares rallied.

Locally, our banks are already back to the target pay-out ratio ranges of 50-67%. Most recently Capitec declared a special dividend. We don’t expect other banks to follow suit, but rather expect pay-outs to average 50% for the sector for the current financial year. Following the market sell off, bank sector forward dividend yields are looking attractive at over 7%. We expect them to provide support for sector share prices.

Home front

Bank trading updates

With the sector now being in a closed period, we have summarised trading updates provided by each bank. The guidance covers the first five months of the reporting period in the case of Standard Bank and Absa, and the first four months for Nedbank. For most, revenue growth will be in the low teens and cost growth will exceed inflation. The trend in impairments differs across banks, with some upward pressure on the credit loss ratio for most in the sector. Overall earnings are guided to grow in excess of 20% and we expect a narrower guidance range in the coming weeks ahead of reporting in August.

	Metric	Guidance	Comment
Nedbank	NII	7-9%	NII benefitted from an ongoing NIMs expansion.
	NIR	11-13% (+3-4% excl fv adjustments)	NIR benefitted from prior non-recurring fair value losses & fee and commission revenue growth. This was offset by performance within CIB.
	Impairments	90 -100 bps	The R1,5bn Covid overlay remains but will be reviewed.
	Book growth	3-6%	Growth in CIB remained moderate while RBB grew 5-6%.
	Deposit growth	4-7%	Remained ahead of advances growth.
FirstRand	NII	N/A	Impetus being gained in the retail and commercial credit cycle, resulting in healthy net interest income.
	NIR	N/A	An improving trend underpinned increased activity levels, as fee and commission income, as well as insurance premium income grows.
	Impairments	N/A	Group credit impairments continue to reduce, and non-performing loan formation remains in line with expectations.
	Earnings	>20%	
Standard Bank	NII	11-13%	Growth was driven by a larger average balance sheet.
	NIR	11-13%	Fees grew by mid-single digits. Trading revenue grew mid-teens. Insurance premiums growth was partially offset by short term claims.
	Costs	6-9%	A result of higher staff costs, normalisation of certain post pandemic spend, and inflation.
	Impairments	70-85 bps	Decline in charges in CHNW partially offset by the normalisation of CIB.
	Earnings	>20%	Liberty was consolidated from 1 Feb. Liberty's contribution was marginally negative. ICBC recorded an operational profit.
Absa	NII	11-13%	Loan growth and the margin benefit of rising interest rates led to the growth.

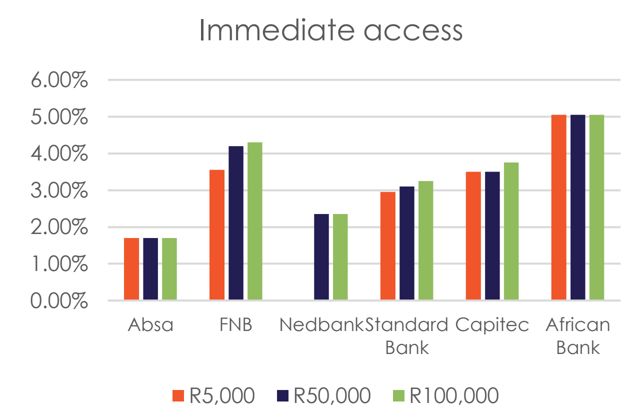
NIR	11-13%	Insurance revenue rebounded, fee & commission income grew mid-single digits, while trading revenue was at similar levels.
Costs	7-9%	There were considerably higher incentives during the period.
Impairments	100-110bps	Slightly higher than TCC range of 75-100 bps due higher VAF impairments.
Loan growth	7-9%	RBB growth was driven largely by home loans and VAF.
Deposit growth	5-7%	RBB deposit growth was partially offset by lower CIB deposits.
Earnings	>+20%	Pre-provision profit growth in the mid-teens.

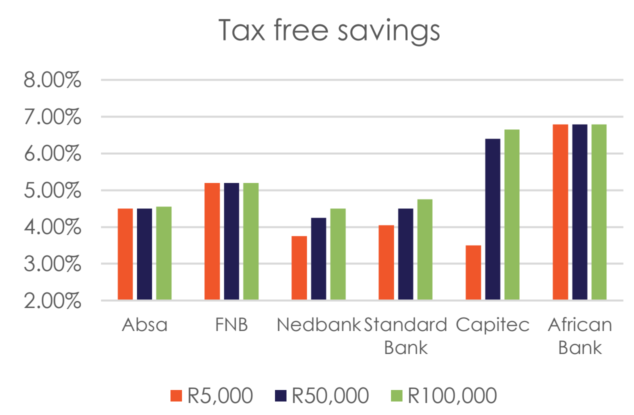
Interest rate tracker

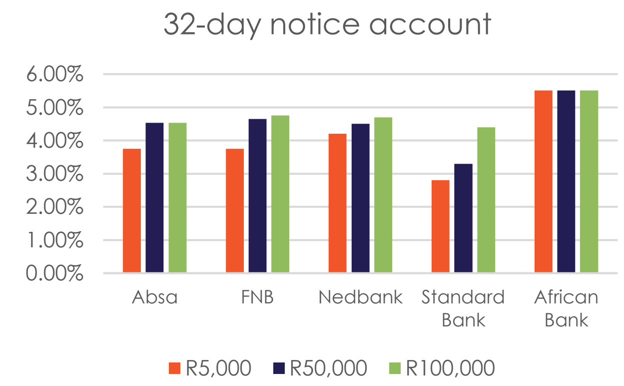
July is savings month, providing ample opportunity for banks to push their savings products to the market. We have been watching a shift in bank liability profiles toward shorter duration, with a fall particularly in >six month deposits since the pandemic. That is now showing some reversal with growth in the six month bucket during the first quarter. Competition for longer duration liabilities could now increase as banks again look to increase lending on the asset side.

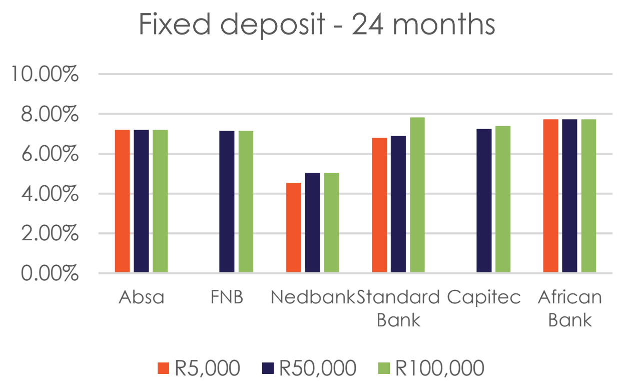
We compared rates offered for R5,000, R50,000 and R100,000. We expect these rates to help explain some of market share dynamics when it comes to retail deposits. African Bank consistently offered the best interest rate across all products, while Nedbank offered the lowest rate in three out of the four products. As the SARB continues to hike rates this will drive up deposit rates, making savings products more attractive for consumers (but at the same time shifting the value for banks to shorter term deposits which enhance the endowment effect). As such the rates could provide a tailwind for sector deposit growth.

Retail deposit interest rates









Source: Companies, rates as at 30 June 2022

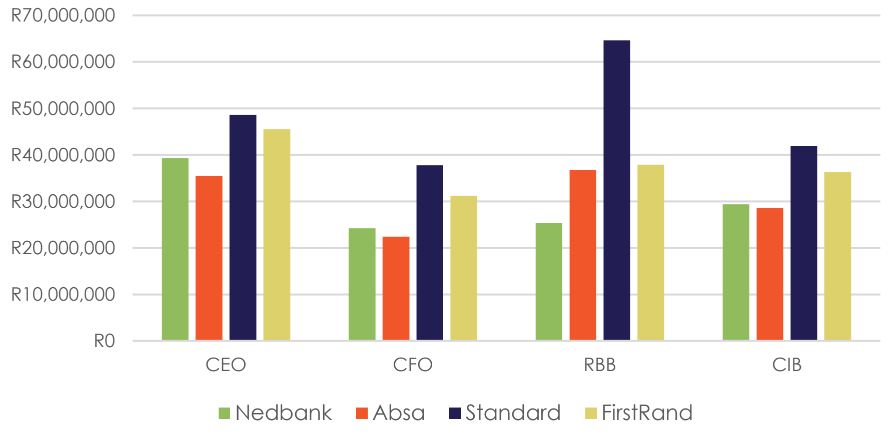
Rem roundup

The results for all the AGMs held over the last two months are now in. While investors mostly supported remuneration policies, there was more opposition with regards to the implementation report, with Capitec and Absa receiving the lowest support.

Bank	**Date**	**Remuneration policy**		**Implementation report**	
		Votes For	Votes Against	Votes For	Votes Against
Nedbank	27 May 2022	71.70%	28.30%	72.86%	27.14%
Capitec	27 May 2022	79.08%	20.92%	52.54%	47.46%
Standard Bank	31 May 2022	75.50%	24.50%	75.91%	24.09%
Absa	3 June 2022	81.45%	18.55%	58.85%	41.15%

In light of the dissenting votes on the implementation report, we did a peer analysis of the remuneration outcomes for the 2021 financial year of each of the big four banks. In Figure 1, we show the remuneration outcomes for the CEO, CFO, and heads of RBB and CIB. In the case of Standard Bank, there was a restructure and remuneration reflects the pay of the head of CHNW and BCC, which make up the retail and business banking operation.

Figure1: C-Suite remuneration packages



Source: Companies, Intellidex

To ascertain whether the pay differentials make sense, we compared the following:

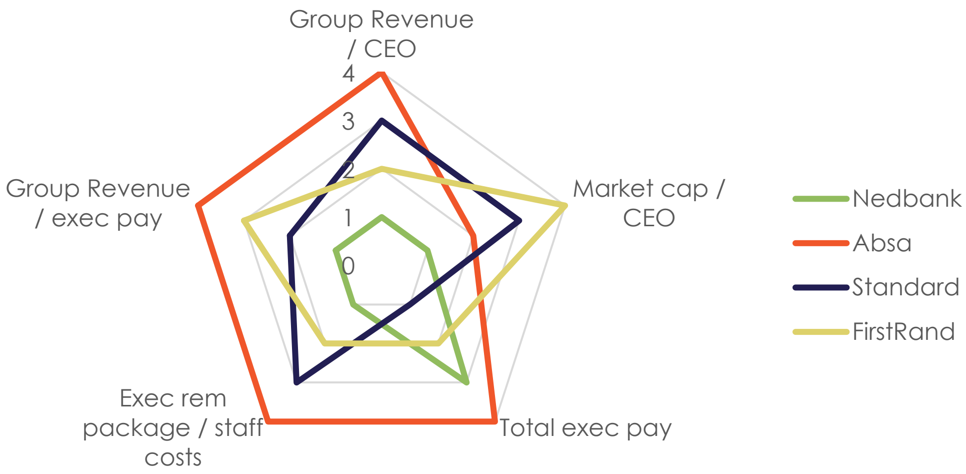
- CEO pay to the revenue generated by the group
- CEO pay to the market cap of the bank (market cap based on year-end date 31 December or 30 June)
- Total executive pay as reported in the remuneration policy
- Proportion of both revenue and staff costs are made up of executive pay

These provide different measures of the relative size of pay. We have not looked at performance – the incremental value created for shareholders, though this would be a key driver of pay outcomes.

Key findings: Standard Bank offers the highest pay. This might be expected given that the size of operations is the largest (though we would prefer profitability to be the key driver). Absa had the lowest pay in three of the four positions, however Absa's pay may be distorted by the resignation of the CEO, resulting in pay being for acting roles. We consistently found that CFOs earned less than the other executives

In the spider diagram we rank the banks from lowest to highest. A bank that scored one has the most unfavourable outcome relative to peers while a ranking of four indicates the most favourable outcome.

Figure 2: Relative pay



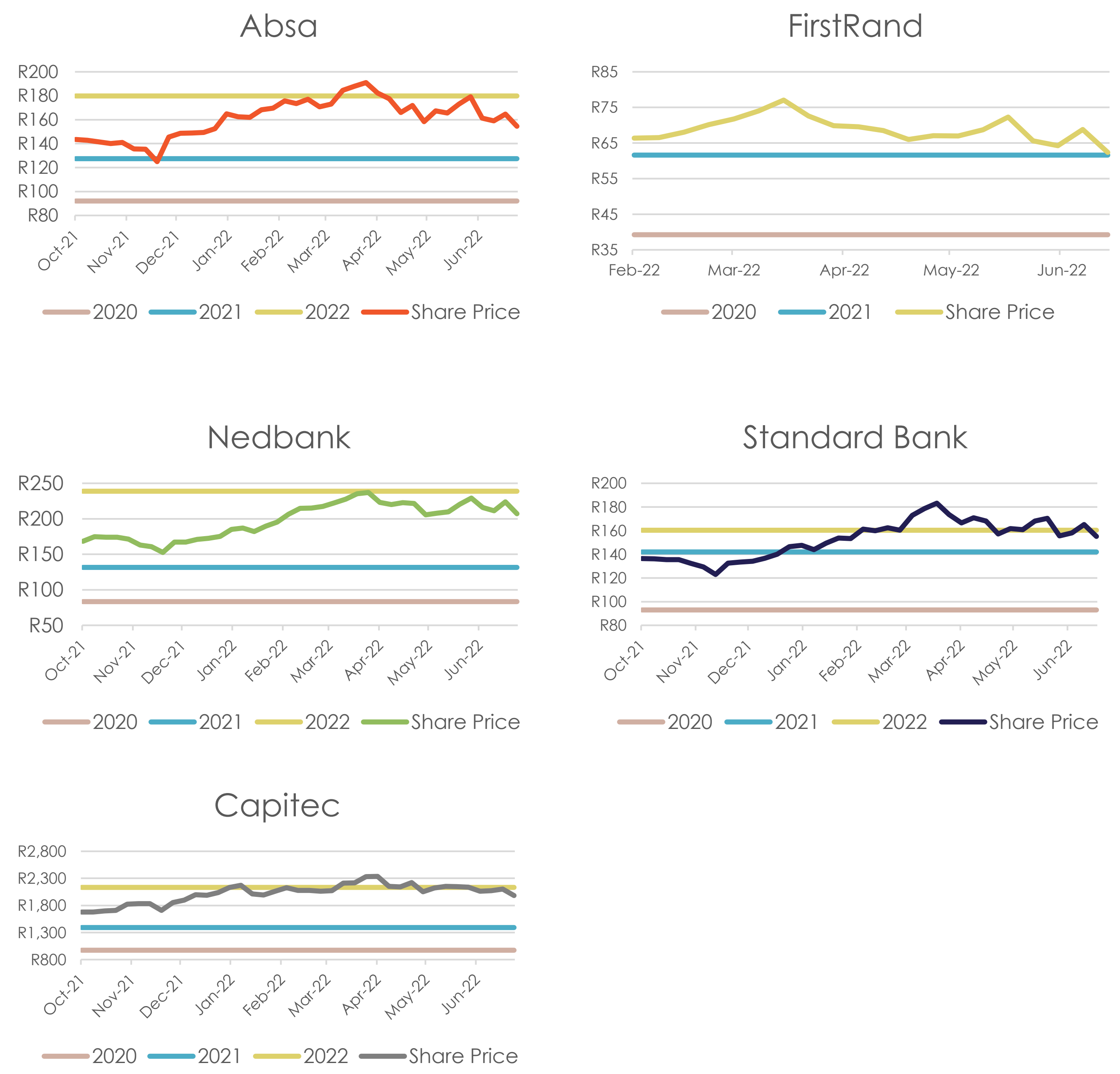
Source: Companies, Intellidex

Key findings: Overall, Absa was ranked the best having scored most favourably in four out of the five categories. This implies that the group isn't overpaying executives relative to the size of operations. Nedbank was ranked the worst, with executive pay not reflective of its smaller operations. FirstRand's CEO had the most favourable outcome when compared to the market cap size. Market cap is at the end of the financial reporting date.

In or out the money

Remuneration of executives has always been a topical issue, especially when Covid-19 resulted in many share awards being placed under water. As a result,we are tracking the performance of share awards awarded from 2020. We consider long-term incentive (LTI) awards which usually vest in two or three years. Where banks have a December year-end, we expect awards to be granted during April. In the case of a June year-end such as FirstRand, the awards are issued around October and in July for Capitec, which has a February year-end.

Figure 1: Bank LTI performance



*Source: Intellidex, Infront *Share prices as at 30 June 2022*

In the table below we show total price return of the awards since grant date. Vesting period will vary from three to five years. Options granted in 2020 and 2021 are in the money for the entire sector, with Capitec and Nedbank options being the best performers. All the options have been affected by the poor market returns over the last three months.

	2020	2021	2022
Absa	68%	21%	-14%
FirstRand	59%	1%	
Nedbank	149%	58%	-13%
Standard Bank	67%	9%	-3%
Capitec	104%	42%	-7%

SENS roundup

The following announcements were made in June:

	Date	Announcement
Absa	3 June	Results of Annual General Meeting
	10 June	Changes to Absa Group Board Committees
	21 June	Trading Update for the five months ended 31 May 2022 and Trading Statement for the six months ended 30 June 2022
	22 June	Absa Group remuneration implementation report shareholder engagement
Capitec	10 June	Acceptance by Directors and Prescribed Officers Of Options Granted In Terms Of A Share Incentive Scheme. Option strike price of R2067.19
	15 June	Dealing In Securities By An Associate Of A Director
	29 June	Appointment of Chief Financial Officer and Financial Director. The appointment of Grant Hardy is effective 1 July 2022
	30 June	Quarterly Disclosure In Terms Of Regulation 43 Of The Regulations Relating To Banks
Nedbank	3 June	Disclosure of beneficial interests in securities. Allan Gray interest is now 9.9974% of the total issued ordinary shares
	27 June	Disclosure of beneficial interests in securities. NinetyOne interest is now 5.02% of the total issued ordinary shares
	28 June	Nedbank Group pre-close investor update
Firstrand	3 June	Trading statement for the year ending 30 June 2022
Standard Bank	6 June	Appointment of a non-executive director
	9 June	Amendments to Board Nomination and Appointment Policy. The amendments were to paragraph 4.22 and the inclusion of paragraph 4.23 to provide clarity on the maximum number of directorships on external engagements
	14 June	Voluntary trading update and trading statement

Regulation update

Below are the reforms we are tracking:

Reform	Date Released / Gazetted	Due date for consultation	Status	Next steps	Forecast implementation	Explanation
Specific reforms						
Financial Sector Laws Amendment Bill	17-Jun-20	17-Aug-20	Under consideration by the NCOP	President signing	2022	The bill aims to bolster consumer protection. Among other things it proposes a deposit insurance payable by banks operating in SA to prevent the repercussions of any reckless behaviour.
Pension Funds Amendment Bill	18-Sep-20	02-Nov-20	Under consideration by the National Assembly	NCOP	2022	The draft Bill therefore seeks to amend the Act in order to allow for pension fund members to obtain a loan, secured by a guarantee from a registered pension fund. A max of 75% of value of the members fund may be accessed to secure such loan
South African Reserve Bank Amendment Bill	02-Nov-20	16-Nov-20	Under consideration by the National Assembly	?	Not within forecast horizon	The EFF bill aims to provide for the appointment of certain board directors by the Minister, makes the State the sole holder of the shares in the Bank and gives the Minister the power to appoint auditors of the Bank.
Cofi (Second draft of the COFI Bill)	13-Oct	30-Oct-20	Awaiting final version sign off by cabinet post consultations - To be introduced later this year to parliament	Cabinet approval then National assembly	2024	The Bill, which theoretically aims to bolster the financial sector's regulatory framework through underpinning customer treatment as well as general market conduct, details some of the main principles that both industry players and consumers can expect from financial institutions.
Draft Amendments To Regulation 28 In Terms Of Pension Funds Act	01-Mar-21	29-Mar-21	Closed for comments	Second draft, consultation response document	2022/23	The regulation maximum holdings of asset classes for funds to spread risk and protect savers from over-concentrated investments. The proposed amendment does not add infrastructure investments as a specific asset class alongside the existing list of asset classes but makes provision for infrastructure investment to be recognised within the asset classes
Financial Sector and Deposit Insurance Levies Bill	24-Feb-21	31-Mar-21	Under consideration by the National Assembly	NCOP	2022/23	With the implementation of the Twin Peaks regulatory system since 1 April 2018, regulated companies in the financial sector will be expected to pay a levy towards the regulatory costs. The bill imposes levies on the financial sector and the resulting revenue will fund the Prudential Authority, the Financial Sector Conduct Authority and other entities
South African Postbank Amendment Bill	12-Mar-21	12-Apr-21	Closed for comments	Cabinet approval then National assembly	2023	The Amendment Bill provides for the amendment of the shareholding arrangements for the Postbank through the creation of a new holding company to facilitate its establishment and registration as a Bank Controlling Company (BCC) in terms of the Banks Act and for matters connected therewith and other sections of the Postbank Act impacted by the change in the Postbank ownership structure.
Draft Financial Inclusion Policy	28-Oct-20	04-Dec-20	Closed for comments	New draft?	>2023	The draft Financial Inclusion Policy establishes a policy framework for financial inclusion in South Africa, sketches the approach to implementing the policy, and provides a basis on which the financial services sector, regulators and all relevant stakeholders will promote and support financial inclusion.
Deposit insurance	18-Feb-21	16-Apr-21	Closed for comments	Draft Amendment Bill	2023/2024	The document provides details about the membership of the proposed deposit insurance scheme (DIS) for South Africa. The paper also presents proposed coverage rules for different types of depositors, types of accounts, product types and account features
Reform workstreams						
Domestic card scheme consultation	02-Mar-21	31-Mar-21	Closed for comments	Policy white paper	Unlikely	The consultation paper seeks to gather input on the feasibility of establishing a domestic card scheme
Platform competition commission review	Feb-20	12-Mar-21	Full TOR for inquiry published, inquiry launched	Publishing of final report	Ends 2022	The competition commission review has important implications of online platform businesses including those being developed by banks
Climate taxonomy			Ongoing	Draft publication H2 2021	2023	A green taxonomy is a tool that sets out the rules and results for what is green (included as taxonomy-aligned) mutually for all actors
Climate disclosure			Ongoing	Strategy paper H2 2021	2022 voluntary 2025 mandatory?	South Africa is likely to be forced by global regulatory norms and a ratchet on commitments being made at UN.
Climate stress tests			Internal SARB PA work	Launch end 2021?	2022	The SARB will be undertaking climate related stress testing of the banks as outlined in the Sustainable Finance paper from NT.
Crypto/disruption regulatory workstream			Position paper published by working group	Overarching Crypto legal structure	2022/23	Ongoing multilateral work between NT, SARB, FSCA, SARS, CompCom. Looking to put in place a cross body white paper first and then an overarching regulatory framework.
Exchange control reform			Ongoing	Republication of circular	2022	Exchange control is one of the low hanging fruits on the policy reform front and liberalisation could help unlock more robust activity in the financial services industry, especially if the political will can be found to pursue a regional financial hub strategy.
Fx listing reforms			Ongoing	Action from JSE/SARB circular	2022	A new capital flow management framework will replace exchange controls
Financial centre policy			Ongoing	Further direction from NT and Presidency	>=2023	NT and Presidency remain interested and the exchange control and FX listing reforms were a step on this path, but much more concerted work is needed, as well as public marketing, yet for now NT prefer to work below the surface
State bank/Post bank			Cabinet memo being considered	Policy white paper, launch of bank entity	2022	We believe that NT has recommended that the Post Bank become the state banks and that it proceed will setting up a holding company and apply for licencing