Banking Monthly

South Africa

2 AUGUST 2022

Welcome to the fourth edition of the Intellidex Banking Monthly.

In July, all eyes were on central bank policy decisions, again. The steeper hiking cycle we find ourselves in will drive NIM expansion for the banking sector. The endowment benefit will last for the next 6-12 months. Our banks report in August and our performance index shows us that revenue growth has some upside risk, while impairments remain under pressure. We still expect improvements in ROE which will benefit share prices... and long-term incentives. Looking at global events, the Chinese mortgage crisis seems to have taken a turn for the worse last month and regulators are now stepping in. We're keeping an eye on this, as it could have a negative effect on global growth.

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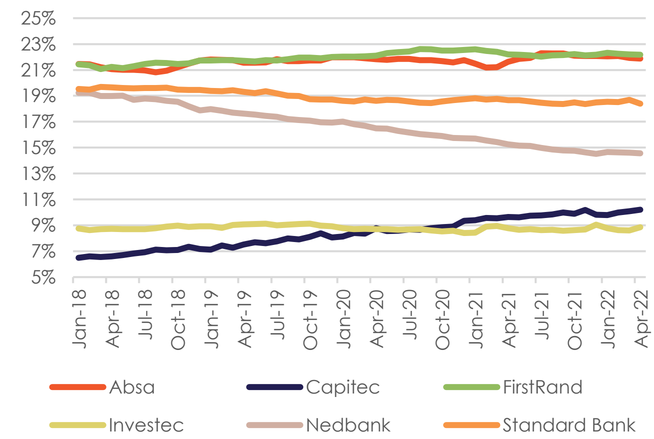
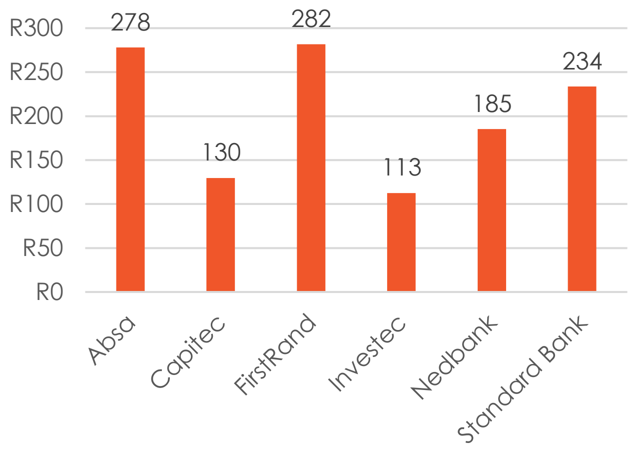
Stat of the month

With July being savings month, we took a look into retail deposits. The big six banks made up 96% of total retail deposit share in the market. As at the end of April, FirstRand has the highest deposit base at R282 billion, followed closely by Absa at R278 billion. The market share losers have been Nedbank and Standard Bank, with Nedbank's market share losses being more pronounced. Meanwhile, Capitec has been growing its deposit base aggressively, though its asset growth has not kept pace. With bank results out in August, we will be looking to answer two questions: Has Absa overtaken FirstRand to become the biggest retail deposit franchise? Has Nedbank stopped bleeding market share?

Retail deposit market share



SA retail deposits (Bn)

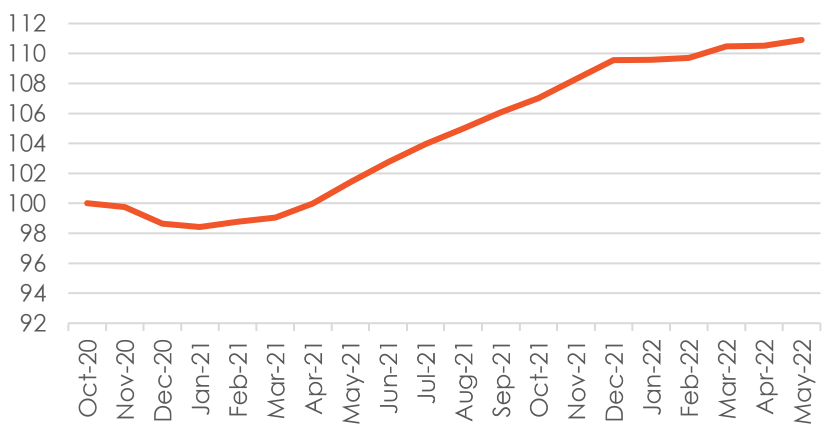


Source: SARB, Intellidex BankAnalyser

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



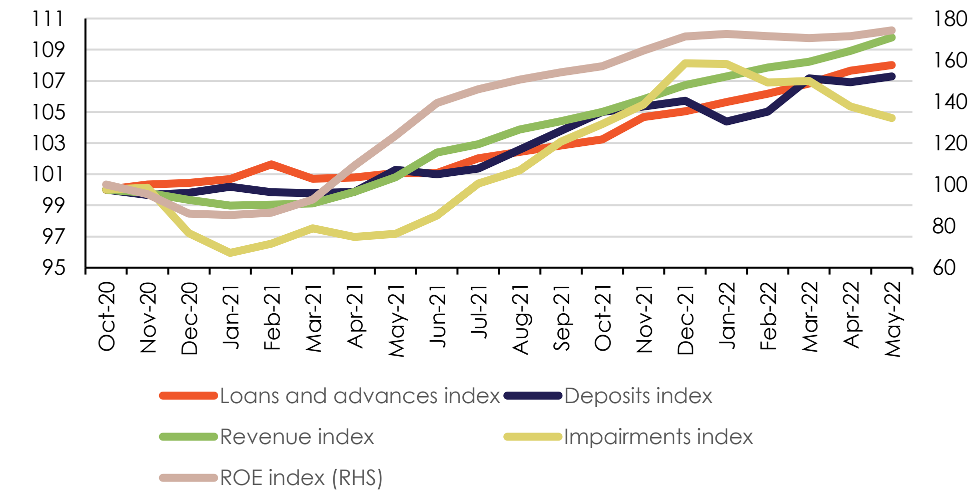
Source: Intellidex

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]. The impairments have however taken a turn since the start of 2022.

In **May** there was continued slowing of momentum. Revenue growth remains the standout performer with momentum remaining strong. The recovery on non-interest revenue components such as insurance income, as well as the net interest margin expansion from higher rates remains a tailwind for revenue growth. Year-on-year loan growth remains robust, despite the challenging macroeconomic outlook. That said month-on-month growth in May was 0.33%, coming in lower than the April figure of 0.77%. This possibly signals banks pulling back risk appetite. As such, we expect momentum to slow in the coming months. The deteriorating impairments performance could begin to swamp improved margin and revenue at the net earnings level. There was a small rebound in deposits in May and the latest SARB data indicate an even stronger growth in June. Higher rates are potentially driving some growth back into deposits. ROE seems to be benefitting from revenue growth, with some improved momentum taking place over the last two months.

Intellidex Bank Performance Index Decomposition



[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.

Source: Intellidex

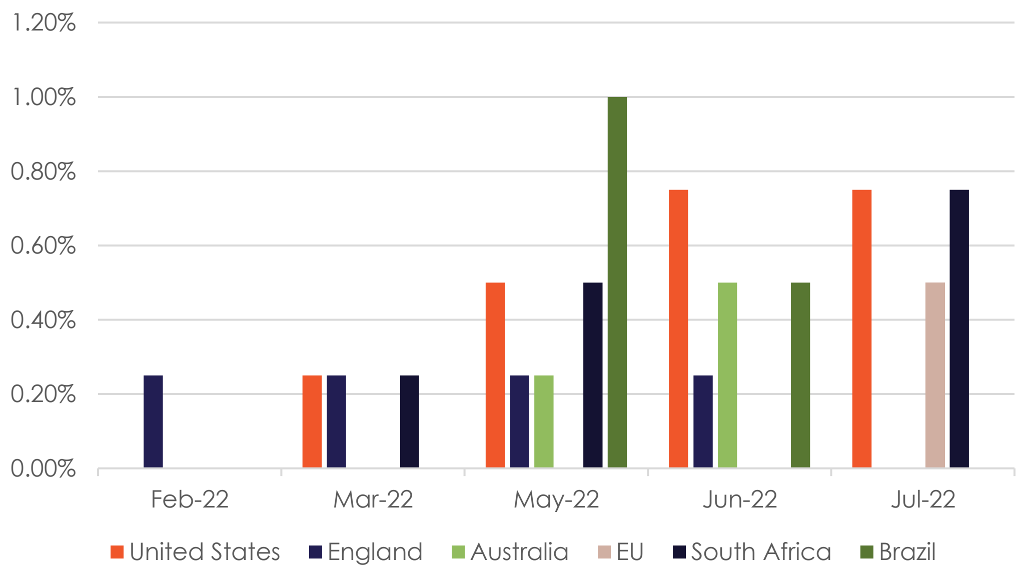
As the low base effects of Covid roll out, overall sector momentum is beginning to slow. There are however some green shoots in the revenue growth that will continue to show strong momentum over the coming months. Impairments is the one component that has further downside risk.

Global perspective

Tracking central bank hikes

Given the global interest rate upswing, we are tracking central bank monetary policy decisions. The EU has finally come to the hiking party with a 50bps hike in July. The Fed enacted a second consecutive 75ps hike and commented on slowing the pace of increases to assess the effect of the policy adjustments on the economy and inflation. We find this comment interested as this is the first central bank to say "let's see if this is working". SARB also hiked by 75bps point in July and we expect two more 50bps. A question we have is whether SARB will take queues from the Fed and pause and reflect?

Central bank hikes



Central bank digital currencies update

Over the last two years, there has been much traction in central bank digital currencies (CBDCs). The main attraction for CBDCs is their potential to address challenges in the cross-border payments market. These challenges include high costs, low speed, limited access and insufficient transparency.

Global bodies such as the BIS Innovation Hub, International Monetary Fund and World Bank have been involved in the exploration of the role CBDCs can play in cross-border payments. This month, these bodies released a joint report on different options for access to and interoperability of CBDC systems to facilitate cross-border payments. According to the report there is no "one size fits all" model for access and interoperability of CBDC systems. There are three access options identified in the report. The first is access by foreign banks and other payment service providers (PSPs) to wholesale and retail CBDC systems. The other would be access to retail CBDCs by non-residents. There is also a third model which would be closed access, where only domestic PSPs are granted access to the CBDC system. Each access model has different implications for macro-financial risks, resilience, efficiency and interoperability.

While CBDCs are expected to enhance cross-border payments, there will be some implementation challenges. Some of these challenges relate to establishing the required legal authority to issue CBDCs, the controlling and monitoring of CBDC holding and the macro-financial implications.

Some further building blocks identified relate to measures that will improve existing payments systems. These improvements will benefit cross-border payments with CBDCs. Some improvements cited are extended operating hours, interlinking of fast payment systems and broader access.

There are 13 CBD projects that are either underway or completed. The South African Reserve Bank is part Project Dunbar which completed phase one in March 2022. Project Dunbar explored a common platform that enabled issuance of multiple CBDCs by different central banks. We expect phase two to be underway during the course of this year.

Chinese mortgage crisis

The troubled Chinese property sector is facing a mortgage crisis. S&P[2] estimates that national property sales will plunge by as much as a third this year. The drop in house prices coupled with boycott has placed a significant amount of pressure on the Chinese banking sector and economy.

Brief background

Chinese developers typically rely on presales for the funding of projects. Over 90% of properties sold in 2021 were presales. A large portion of the presold projects have not been completed due to long delays, and as a result, buyers are withholding mortgage payments. This has a knock-on effect of creating a liquidity crisis for developers. Following solvency issues in China's second biggest developer, Evergrande, the Chinese government cracked down on debt financing to the property sector. As a result developers have struggled to secure financing. The Chinese regulator, China Banking and Insurance Regulatory Commission, is pledging to provide support and extend loans to qualifying developers. Despite this move, investors have sold off Chinese banking stocks and bonds.

The outlook

Chinese banks may have to take on the risk to ensure developers complete projects. Failing to do so could not only result in heavy losses for the banks, but also downward pressure on housing prices. The real estate sector is estimated to contribute 25% to China's GDP. The World Bank's most recent real GDP growth projection for China of 4.3% has been downgraded from 5.1% projected in December and risks remain to the downside. The longer the

[2] https://www.spglobal.com/ratings/en/research/articles/220726-china-property-sales-set-to-drop-by-a-third-as-mortgage-strikes-break-out-12450979

mortgage crisis continues the worse the outlook for global growth, with China being the second largest economy in the world.

World Bank Global Findex Report

Last month the World Bank released its report on the Global Findex Database 2021. This is a global study assessing financial inclusion that is updated every two years. On many measures, South Africa compares well with other developing regions. In the decade ended 2021, South Africa made significant progress in financial inclusion. However, it shows the informal market is significant when it comes to financial services such as saving and borrowing, with banks still needing to penetrate to reduce cash reliance and increase digital adoption. Below we share some of the findings:

Financial Access

Account ownership remains a fundamental measure as it implies access to financial services. That said, on its own it is insufficient to drive development outcomes.

- Account ownership reached 76% of the global adult population.
- Developing economies had a higher growth rate in account ownership over the last decade. Ownership in developing economies went from 42% in 2011 to 71% in 2021.
- In sub-Saharan Africa, mobile money is driving growth in account ownership and 33% of adults had a mobile money account
- 35% of unbanked adults in sub-Saharan Africa do not have a mobile money account. Lack of a mobile phone was cited as the main reason.
- Adults who are active in the labour force, whether employed or seeking work, are more likely to have an account than those who are out of the labour force.

Findings on South Africa:

- *84% of adults have an account with a financial institution*
- *85% of female adults have an account with a financial institution*
- *83% of male adults have an account with a financial institution*
- *37% of adults have a mobile account*

Our take: South Africa comes out favourably when comparing financial access globally and within sub-Saharan Africa. Globally, it was found that there is a four percentage point gender gap in account ownership, with 78% of males owning an account compared with 74% of females. The report finds that South Africa has "no gender gap". This is in line with women being breadwinners in many South African households.

The high level of account penetration in South Africa means that the majority of users with mobile money accounts also have traditional bank accounts. As such we don't see mobile money accounts being a threat to bank account growth. There is potential to target foreign nationals from sub-Saharan regions, especially where banks have subsidiaries in those African countries.

Banks have been encouraging usage of mobile wallets by lowering fees as well as allowing users to make withdrawals and deposits at retail outlets. This is being done to not only capture more bank clients but also to generate more revenue from services such as airtime and electricity purchases. We believe economic activity remains key to driving more revenue from account offerings

Use of Financial Services

Following from account ownership, there needs to be access to services and tangible benefits of account ownership. This is a primary goal for financial inclusion. Access to services includes digital payments, savings accounts and borrowing.

- The share of adults utilising digital payments in developing countries was 57% in 2021.
- 25% of adults in developing economies saved using an account; 15% made use of a mobile money account to save.
- Half of adults in developing economies borrowed money.
- The dominant form of borrowing in high-income economies is through credit cards.
- In developing economies, borrowing from friends and family is as common as borrowing through formal methods

Findings on South Africa:

- *3% of adults borrowed money using a mobile money account*
- *18% of adults borrowed from a financial institution*
- *46% of adults use of a debit or credit card in-store*
- *26% saved using a savings club or person outside the family*
- *28% of adults used a mobile phone or the internet to pay bills*
- *53% of adults used a mobile phone or the internet to check account balances*

Our take: The low penetration of borrowing from financial institutions shows that only a small proportion of the working population has access to lending through formal channels. Additionally, mobile money is not yet widely adopted as a source of borrowing. There is likely to be a significant proportion of the population borrowing through informal channels. Additionally, there are other types of credit such as retail store cards which are likely excluded from the borrowing statistics. Retail credit is more common among lower-income groups.

Debit and credit card usage at 46% of adults reflects the cash-based nature of the economy. Many adults are still using cash for everyday transactions such as food and transport.

When it comes to saving, stokvels are still a significant form of saving with 26% of adults using them. While banks have introduced offerings that cater for stokvel clubs, these have not gained much traction.

We think the introduction of the Rapid Payments System and penetrating the informal market is probably the biggest lever to drive down cash transaction volumes. From there, there will be increased usage of the services made available to those with bank accounts.

Financial Well-Being

The access to financial services should enhance financial wellbeing. This is because being able to borrow or having adequate savings enhance financial resilience. The survey assessed financial resilience by asking respondents how they would come up with extra money should an unexpected expense arise. Below we detail some findings.

- In developing economies, 55% of adults could access emergency money in 30 days without difficulty.
- For 30% of adults, family and friends were the first-line source of emergency money in developing economies.
- 33% of adults in high-income economies are very worried about one or more common financial expenses; this compares with 63% in developing economies.
- 54% of adults in sub-Saharan Africa worry over school fees.

Findings on South Africa:

- *Paying for school or education fees was the most worrying financial issue for 15% of adults.*
- *Paying for monthly expenses was the most worrying financial issue for 30% of adults.*
- *Over 70% of adults found it possible to come up with emergency funds in 7 days.*

Our take: A significant portion of children are enrolled in free public schools, which is why school fees was a worry for a low proportion of adults. More than a third of credit active consumers have impaired records due to missed payments, which explains why 30% of adults worry about meeting monthly expenses. Given that the survey revealed that 18% of adults borrow from a financial institution, we expect many adults make use of family and friends, as well as informal markets, for borrowings in the event of emergency.

Home front

SARB assessment of money laundering and terrorist financing risk

As part of its ongoing supervision of anti-money laundering and counter-financing of terrorism (AML/CFT), the Prudential Authority (PA), released its assessment of AML/CFT risk in the banking sector. This comes as the financial sector faces greylisting by the FATF on account of the high risks identified during the Mutual Evaluation published in October last year. In its assessment, the PA also concluded that the risks are indeed high. The threats common to the banking sector identified included fraud, bribery and corruption; illicit cross-border flows; tax-related offences or crimes; and illegal investment scams. Some of the vulnerabilities mentioned were the inability of banks to obtain beneficial ownership information; non-face-to-face client onboarding and interactions; products that allow large volumes of cash deposits; the lack of a single client view across a bank when a client has multiple business relationships or accounts with different business units within the same bank; and data issues, including misalignment, inaccuracies in and integrity of data.

The risk was found to be higher in large banks as well branches of foreign banks. Medium to small locally controlled banks were found to have medium risk. The more complex company structures found in large bank client bases was cited as one of the reasons for the relatively higher risk. Medium to small bank risks arose due to significant exposure to cash and increase use of remote service delivery channels. Foreign banks risks arose due to exposure to foreign country risk and complex high-risk products offered to clients.

We see some of the vulnerabilities identified not being unique to South Africa. The advancement of technology lends itself to the higher prevalence of non-face-to-face interaction and remote service delivery. This was accelerated by the pandemic. Additionally, foreign banks present in South Africa operate in multiple jurisdictions and will face similar risks in those regions. Many banks have been making system changes to allow for a single client view and so it is likely a risk that will be mitigated in the near term. Additionally, the banks will have already started addressing some of the risks with the additional guidance notes related to AML/CFT that were issued last month by the PA. Law enforcement agencies also have a significant role in enforcing legal action on information provided by the sector.

Household credit review

The latest data provided by the National Credit Regulator, shows activity peaked in December 2021 and will taper off from hereon. The data is based on over 26 million credit active consumers and details long-term trends in consumer credit activity. While there was a quick recovery in credit applications and disbursements during the pandemic, this was largely driven by mortgages. The rejection rate on credit applications has been consistent at around 66% since the start of the pandemic. After peaking at R168 billion in the last quarter of 2021, credit disbursements were lower in the first quarter of 2021. The steep interest rate hiking cycle is expected to be a headwind for credit demand across secured lending categories such as vehicle finance and mortgages. On the flip side, we're seeing unsecured lending disbursements back at pre-pandemic levels from the last quarter of 2021 and we expect the demand to continue. And while there has been a good recovery in disbursements there are emerging signs of more consumers records becoming impaired. With inflation risks being to the upside, we expect further pressure on household incomes to manifest into more impaired consumer records. By our forecast there are two more 50 basis points hikes this year which will provide headwinds to credit growth.

For more detailed analysis, you can download our note *here*

Banks reporting preview

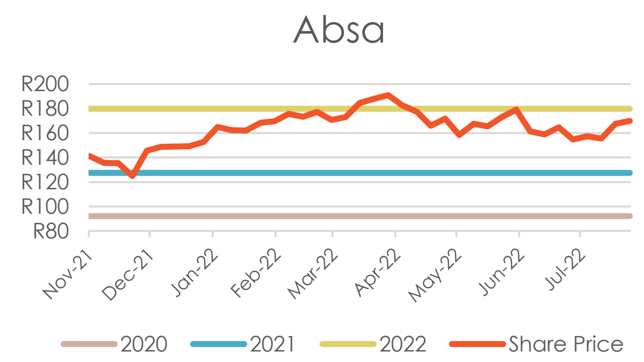
The banks will be reporting results in August. Below we summarise reporting dates and important things to look out for:

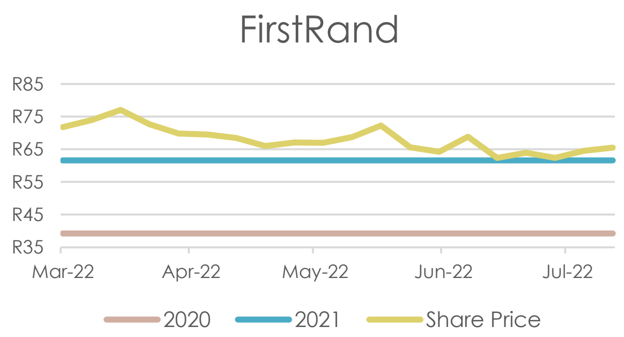
Bank	Reporting date	What to look out for
Nedbank	Wednesday, 10 August	• Credit loss ratio on unsecured lending book • Retail deposit market share dynamics and steps taken by management to prevent further market share losses • NIM expansion • Progress on Avo, including when management expects to generate return on investment • Whether strategic portfolio tilt 2.0 has been successful • Market share in renewable bids • Wealth management earnings recovery to pre-covid levels • Balance of macro-overlays
Absa	Monday, 15 August	• Credit loss ratio of VAF • Retail client gains • Market share in renewable bids • Momentum on retail deposit share market gains • Further improvement to the cost-to-income ratio • Improved payout ratio • Commentary on management and organisational structure changes
Standard Bank	Friday, 19 August	• Momentum in client acquisitions • Trading revenue growth • Mortgage and VAF disbursements during the period • Operational performance of ICBCS • Provisioning in VAF and card portfolios • Performance of West Africa regions • Progress on integration of Liberty • Commentary on multiple instances of IT disruptions and management changes

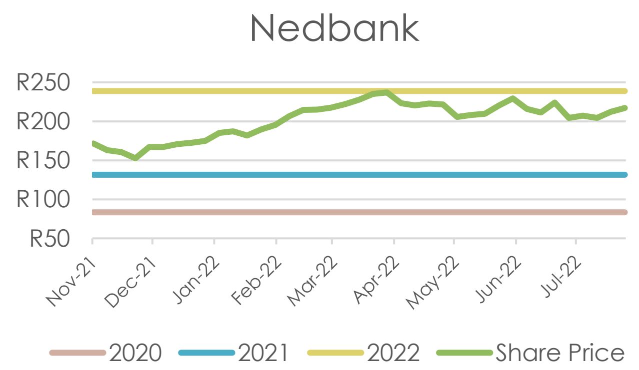
In or out the money

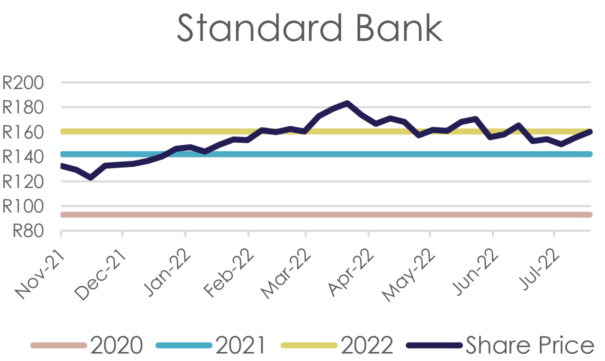
Remuneration of executives has always been a topical issue, especially when Covid-19 resulted in many share awards being placed under water. As a result, we are tracking the performance of share awards awarded from 2020 onwards. We consider long-term incentive (LTI) awards which usually vest after three 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. The Banks index, having delivered a 9% price return YTD, has outperformed the ALSI, which has negative returns YTD. As it stands all the awards issued in 2022 are marginally out of the money, and we expect this to continue amid the market volatility.

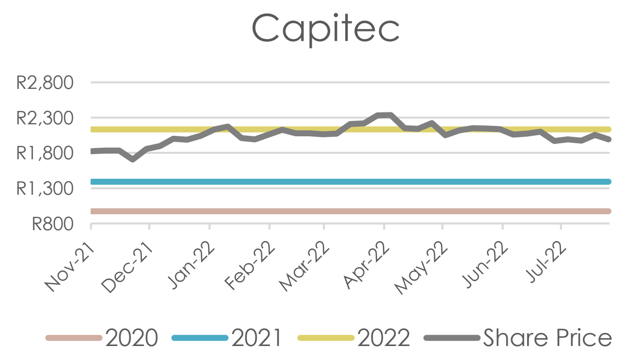
Bank LTI performance











*Source: Intellidex, Infront *Share prices as at 31 July 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. Absa's share price performance seems to be closing the gap with Capitec.

	2020	2021	2022
Absa	85%	33%	-5%
FirstRand	67%	6%	
Nedbank	160%	65%	-9%
Standard Bank	72%	13%	0%
Capitec	105%	43%	-7%

SENS roundup

The following announcements were made in July:

	Date	Announcement
Absa	1 July	Results of Absa group remuneration implementation report shareholder engagement
Capitec		None
Nedbank	20 July	Trading statement for the six-month period ended 30 June 2022. Guidance for HEPS to be between 23% – 28% higher
Firstrand	8 July	Repurchase offer to FirstRand preference shareholders
Standard Bank		None
Investec	4 July	Share buyback. Company has repurchased 9,996,839 Ordinary Shares by 1 July 2022, representing 3.13% of the issued Ordinary Share capital
	29 July	Basel III disclosures at 30 June 2022

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