South African Peer Bank Analysis - H1:21

An EY Banking & Capital Markets Benchmark Report (summarised)

August 2021

EY

Building a better working world

Executive summary

Banks benchmark report 2021

While we have learned much about COVID-19 and its implications, the situation continues to evolve, and heightened uncertainty remains. Countries that were thought to be over the worst are seeing rising COVID-19 cases - such as China, Israel and the United States. South Africa, which has been emerging from the worst recession in a century in 2020, continues to battle the third wave with future waves of the pandemic likely.

In addition, poor economic conditions, worsened by the pandemic and a delicate political situation, resulted in the riots in July which caused R50bn in property damages, according to the SA Property Owners Association and has led to downward revisions to the economic outlook for the year. Over and above this, trade has been affected by the recent cyber-attack at Transnet at the end of July.

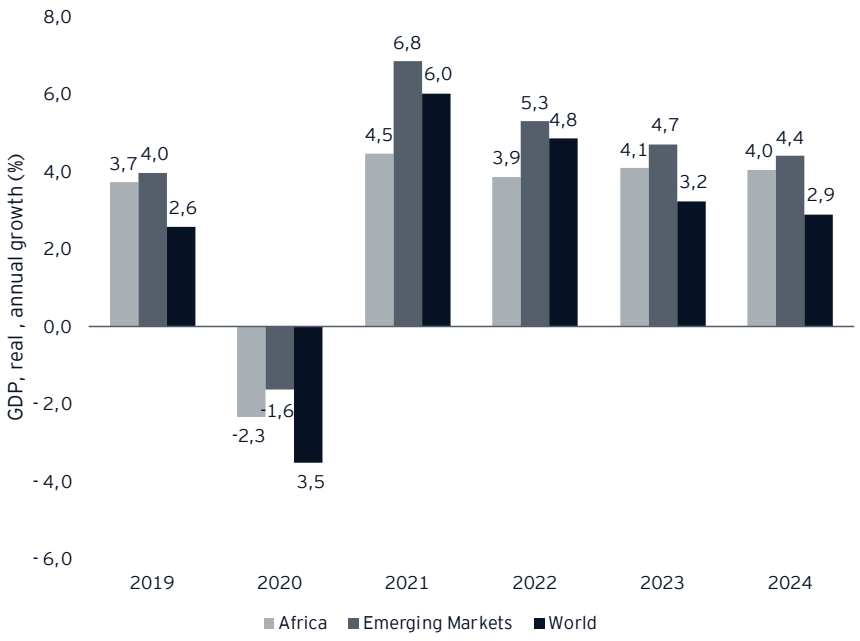
The developing international and local events underline the continued importance of considering economic risk. Although it is difficult to know the future unknowns, or accurately quantify their effects, having considered the possible impacts is better than being completely caught unaware.

Strategic themes noted in H1:21

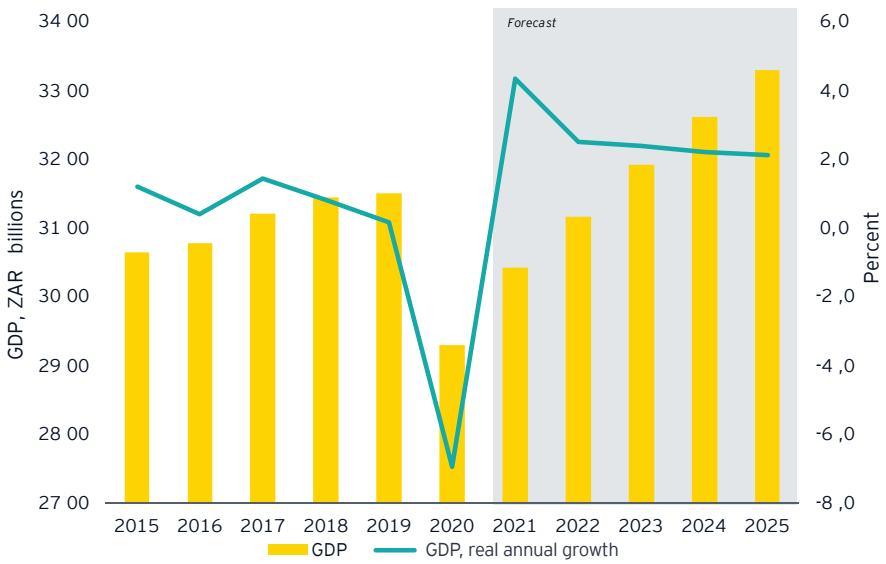
Outlook

EY Economic outlook

GDP growth outlook



South Africa GDP



Following the erratic movements in quarterly output in 2020 the South African economy is expected to grow by 4.3% in 2021 before easing to growth rates of 2.5% and 2.4% in 2022 and 2023 respectively. The evolution of COVID-19 variants globally and country responses, and the success of the vaccine roll-out make these projections uncertain. The total level of economic output in South Africa is not expected to reach 2019 levels until the first quarter of 2023, according to Oxford Economics. However, there has been progress on key economic reforms of late, most significantly the release of the regulations to raise the threshold for embedded generation to 100MW which will bolster investor confidence, reduce the cost of doing business and support economic growth in the medium term. The extension of the COVID-19 grant of R350 to March 2022 will support individuals affected by joblessness in the short term and may reduce the likelihood of further unrest. However, there is a concern regarding pressure to make this grant permanent and the effect this would have on the government's fiscal consolidation path.

Banks' outlook

GDP Growth

Absa	Nedbank	Standard Bank
4.0%	4.2%	4.0%
GDP reduced by 7% in FY20, growth of 4.0% is forecasted for FY21. GDP to grow by 2.3% (baseline scenario) in FY22	Previous forecast of 5% reduced to 4.2% due to civil unrest in July 2021 and introduction of adjusted lockdown 4. GDP to grow by 2.0% in FY22	GDP is expected to grow 4.0% in FY21,recent civil unrest will not impact recovery. GDP to grow by 2.10% in H1:22-25

FY '21 Outlook

Repo Rate

Absa	Nedbank	Standard Bank
3.5%	-	3.5%
Repo rate to grow to 3.9% by FY22 and then grow to 4.6% by FY23		Repo rate to grow to 3.5% by FY21 and then grow to 4.0% by FY22

CPI Inflation

Absa	Nedbank	Standard Bank
3.7%	4.4%	4.15%
Inflation to increase to 3.7% by FY21, 4.0% in FY22 and 4.1% in FY23	Inflation to increase to 4.5% by FY22 and remain stable at 4.4% after FY22	Inflation to increase to 4.15% by FY21, 4.40% in H1:22-25

FY '21 Outlook

Prime Interest Rate

Absa	Nedbank	Standard Bank
no change	7.0%	7.0%
Policy rates are unlikely to change in FY21, expected to rise by 75 bps in FY22	Prime interest rate to grow to 8% by FY22 and remain constant until FY23 then grow to 8.5% by FY24	Interest rates are expected to be 7%, unchanged for the remainder of the years

KPI outlook

	NII	CLR	ROE	Expenses
Absa Indicator Comments	NII Mid-single digit growth expected	Around the mid-point of their through-the-cycle range of 75 to 100 bps	RoE will improve materially in 2021 relative to 2020 will be broadly in line with cost of equity	Low single digit cost growth is expected, CIR likely to be in line with 2020's 56%
Nedbank Indicator Comments	Growth to be between 5% and 7%	Expected to be between 80-110 bps in FY21 and targeted 60-100bps in the future	Expected to be more than 15% by 2023	Growth to be between 6% and 8%
Standard Bank Indicator Comments	Similar to H1:21 (361 bps)	In the range of 70 to 100 bps	Higher than FY20, below Cost of equity	Sub-inflationary target

Source: Absa, Nedbank and Standard Bank Annual & Interim Reports
*FirstRand is excluded from the analysis as their 2021Q2 results will only be released in September 2021

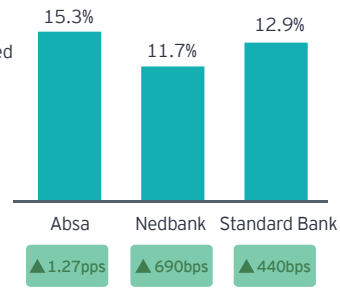
Financial performance snapshot

- Banks reported higher YoY RoE driven by declining provisions, moderate revenue growth and prudent cost control. Absa posted the highest gain in its H1:21 RoE
- Efficiency ratio improved for Absa and Standard Bank driven by increase in revenue; lower non-II at Nedbank resulted overall revenue decline
- Absa and Nedbank managed to grow NIM
- Loans to deposit ratio declined at all the banks on the back of an increase of H1:21 deposits growth
- Except Absa, non-performing loans deteriorated at other banks
- Banks remain well capitalised posting CET1 to grow by an average of 130bps
- As lockdown restrictions continue to ease, economic activity started to resume. As a result banks posted revenue growth in H1:21 however not at a pre-COVID rate, barring Absa

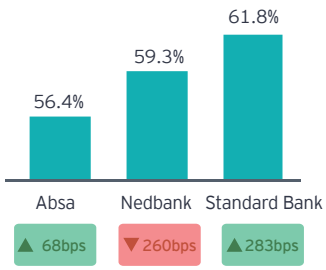
▲ Improved
▼ Deteriorated

Absolute YoY growth

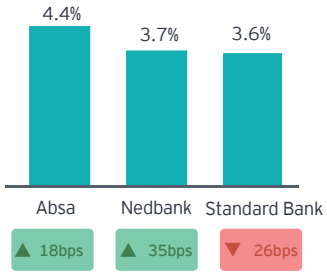
Return on Equity (RoE)



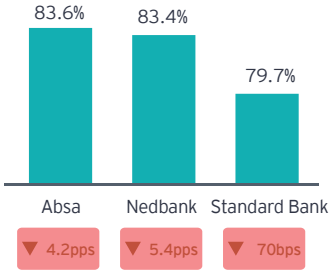
CIR ratio



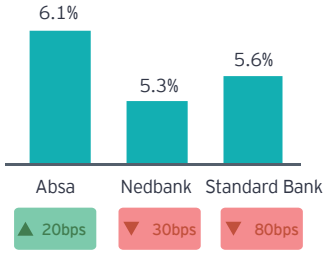
Net interest margin



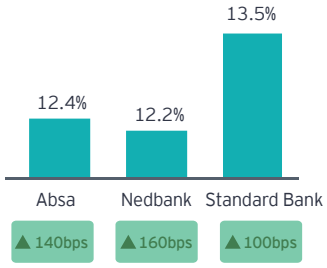
Loan-to-deposit ratio



NPL ratio (Stage 3 Loans / Gross Loans)



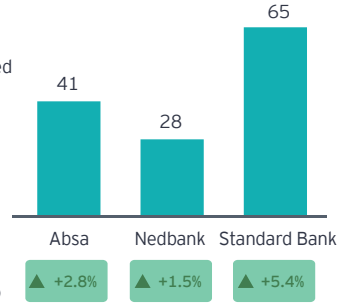
Common Equity Tier 1 (CET1) ratio



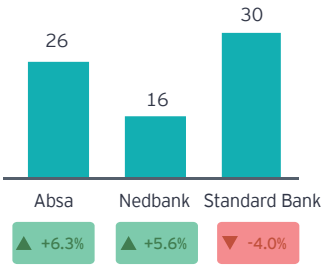
▲ Improved
▼ Deteriorated

YoY growth (%)

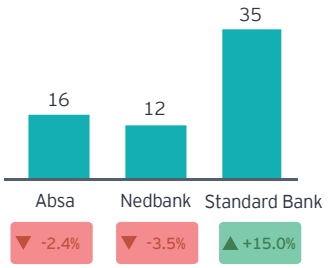
Revenues (in ZAR billion)



Net interest income (in ZAR billion)

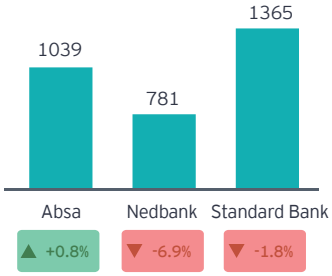


Non interest income (in ZAR billion)

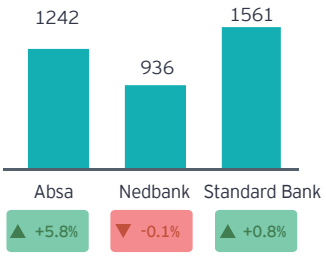


YoY growth (%)

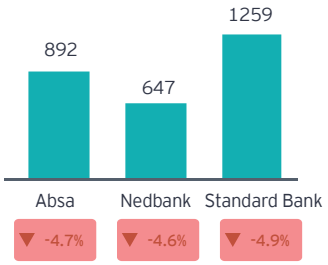
Loans (in ZAR billion)



Deposits (in ZAR billion)



RWAs (in ZAR billion)

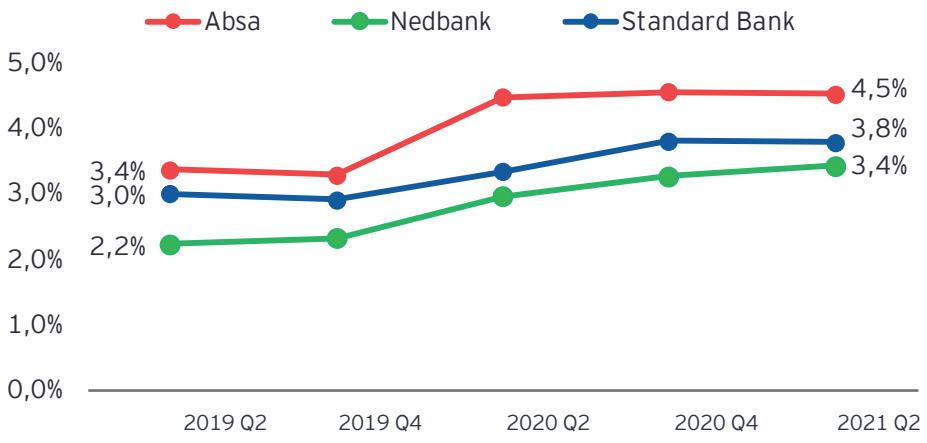


Source: Absa, Nedbank and Standard Bank Annual & Interim Reports
*FirstRand is excluded from the analysis as their 2021Q2 results will only be released in September 2021

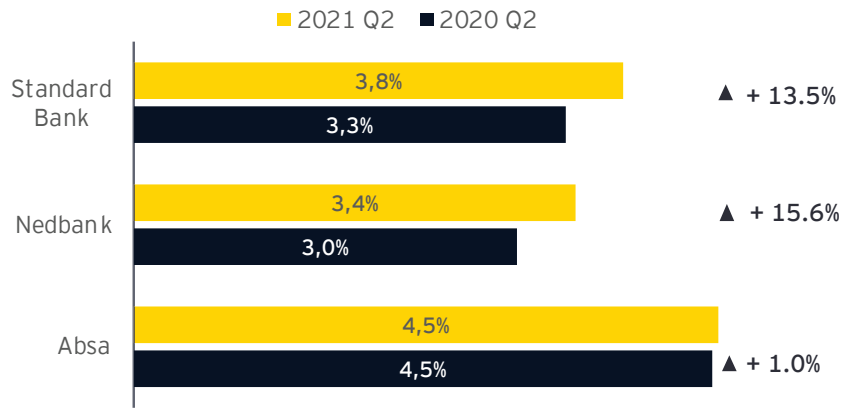
A key focus on ECL

ECL coverage ratio movements

Change in ECL Coverage Ratio - 2019Q2 - 2021Q2*



Change in ECL Coverage Ratios - Post COVID-19*



Source: Absa, Nedbank and Standard Bank Annual & Interim Reports
*FirstRand is excluded from the analysis as their 2021Q2 results will only be released in September 2021.

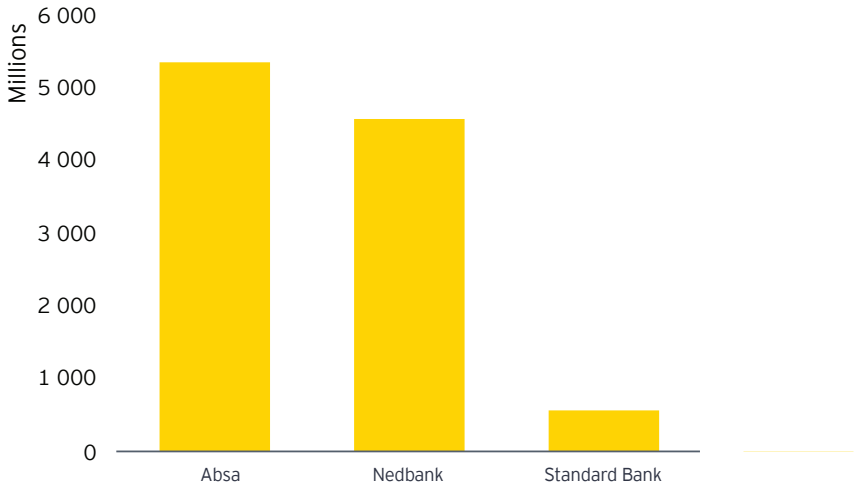
For further analysis on the coverage ratios, refer to page 11

Increased stability in coverage ratios post 2020 Q4

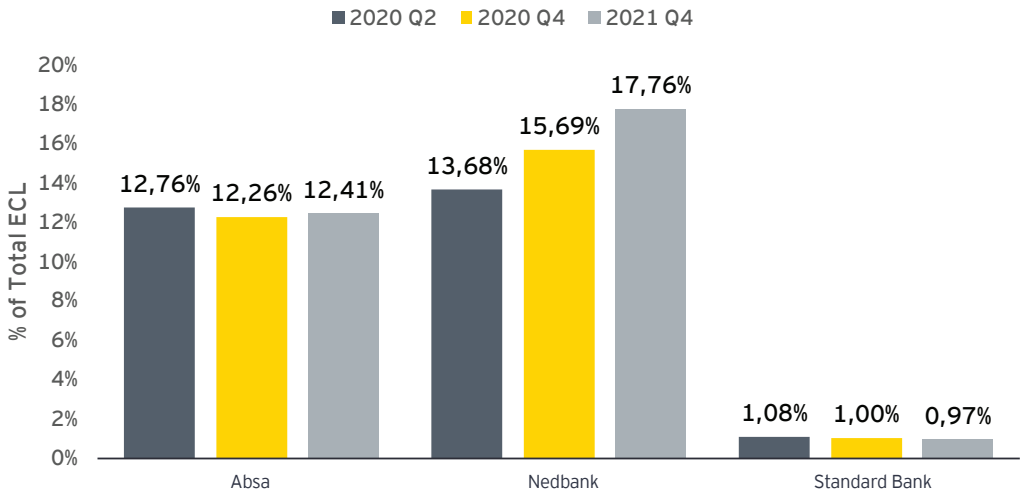
- Coverage ratios have remained relatively stable after the 2020 Q4 reporting period across all three banks.
- The coverage ratios for Nedbank and Standard Bank increased by 15.6% and 13.5%, respectively. Absa's ECL coverage ratio increased with 1%, which is the lowest increased observed across the three Banks. Management disclosed in the interim financial statements that this was influenced by lower impairments as a result of "improvement in portfolio performance and benefits realised from the model enhancements in RBB".

Management Overlays

IFRS 9 ECL Management Overlays – 2021 Q2*



Change in Management Overlays – 2020Q2 to 2021 Q2*



Management overlays indicative of continued shortcomings in credit risk models

- Management overlays and out of model adjustments have remained prevalent in 2021 Q2 due to continued uncertainty around the 3rd wave of the COVID-19 pandemic.
- 2021 brings its own challenges and it is expected that banks will continue to focus on:
  - How to incorporate post COVID data into the ECL models
  - Redevelopment of macroeconomic models, scenarios and weightings
  - Unwinding of management adjustments or overlays

Source: Absa, Nedbank and Standard Bank Annual & Interim Reports
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Expected long-term impacts of the COVID-19 pandemic on model stability and reliability

Adjusting credit risk models in response to the COVID-19 pandemic is not only a necessity for banks, but also a way to gain competitive advantages. Credit risk models need to incorporate post COVID-19 pandemic related points to ensure their input remains valid and robust. Better and deeper insights can be achieved by tapping into a broader range of data sources, develop models that are more responsive as well as upgrading data platform technologies. Faced with the un-precedented pace and magnitude of economic disruption from the COVID-19 pandemic, risk modelling teams are chal-lenged to develop a now, next and beyond response.

Over the last couple of years, credit risk models have been subject to significant scrutiny driven by regulatory expectations and a determination that they are deemed "fit for purpose" prior to use. So, why did they become unstable and unreliable in a matter of days and what would the long term impact be on model stability and reliability?

Most of the models were built on historical data from the last decade, which is not representative of the current environment. Also, credit models generally presume a gradual impact of the environment on losses, with lags ranging from 1 to 6 months. The estimated model parameters are likely to be less reliable in an environment with sudden and significant macroeconomic movements. Current economic volatility is likely to generate unreliable estimates if one relies heavily on models. The various payment relief schemes have clouded typical indicators, such as current delinquencies, that are often used to project future losses. Credit models rely on inputs about the presumed macroeconomic forecasts that typically use traditional economic theory concepts of general or partial equilibrium at their core to project the future. Such forecasts may be completely unreliable as the artificial shutdown of many consumer goods and services markets has pushed the economy into a state of disequilibrium.

Credit risk models will also need to be recalibrated with the data post March 2020 (post COVID) to reflect a forward- looking impact of macroeconomic scenarios on structural credit factors, challenging where historical relationships hold – and applying new approaches where they don't. Once applied to the COVID-19 pandemic, the approach can also be leveraged and extended to other use-cases related to an external shock impact on credit portfolios. The traditional data sources they typically use (financial and behavioural) struggle to capture the complexity and pace of the current economic environment. Economic indicators and borrower financial information are often observed on a lagged basis, and certain current indicators are distorted by the private and public relief programs offered in response to COVID-19. Greater emphasis is needed on augmenting traditional data with inferences from alternative data sources. Traditional data offers a highly accessible, real- time indicator of financial health in both retail and non-retail portfolios that can enhance various components of the credit life cycle.

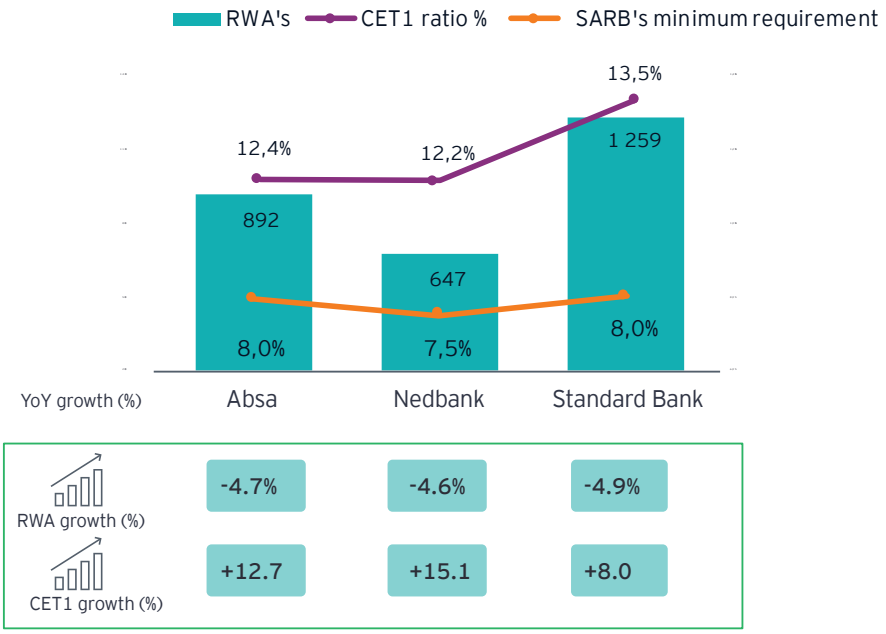
Analytics around high frequency data can provide deeper insights on credit capacity, quality and behavioural changes, particularly across retail and micro business. Analysis of current transaction flow (level, frequency and volatility) against pre-COVID-19 levels can help track the performance (and risk) of SMEs and Corporates during the recovery period and allow targeted intervention. Going forward, banks should explore opportunities to gain better insights by using non-traditional credit risk data. This will raise the question around the suitability of current data management infrastructures, data sourcing, manipulation and quality control for new and unstructured datasets.

Institutions that, until now, were reluctant to invest in high-frequency big data platforms may now need to accelerate their technology spend as part of their next and beyond post COVID-19 initiatives. To gain access to untapped data sources, banks may need to expand their ecosystem and establish new relationships with external providers.

To summarise, we are expecting the following challenges and key trends associated with credit risk models post the COVID-19 pandemic:

Capital

RWAs (ZAR billion) and CET1 ratio – as of June-21



CET1 internal target by banks, and buffer against minimum requirements

Dec -20	Internal target	Change from Jun-20	Surplus compared to requirement
Absa	11.0-12.5%	+140bps	+440bps
Nedbank	10.0-12.0%	+160bps	+470bps
Standard Bank	>11.0%	+100bps	+550bps

Capital metrics remained resilient, improved further in H1:21 and now above 2019 levels; banks maintain enough buffer over SARB's CET1 requirement

- Nedbank's RWA decreased from R678bn to R647bn supported by credit RWA optimisation and normalisation of market RWA as volatility moved through the models
- CET1 ratio of Nedbank is around top end of the bank's internal range and well above the SARB requirement
- Absa's RWA declined 5% to R891.8bn, largely due to 5% lower credit risk RWAs, while traded market risk RWAs reduced 17%. The Group remains well capitalised, comfortably above minimum regu-latory capital requirements
- CET 1 ratio of Absa increased to 12.4%, at the top end of the Board target range of 11.0% to 12.5%
- Standard Bank Group's RWA declined 7% in H2:20 due to ZAR strength relative to H1:20 and a decline in CIB exposures
- Standard Bank Group maintained strong capital adequacy ratios, with a CET1 ratio of 13.5% (H1:20:12.5%) and a total capital adequacy ratio of 16.4% (H1:20 15.4%)

Source: Absa, Nedbank and Standard Bank Annual & Interim Reports
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Emerging trends

Basel III framework regulatory reforms

The Basel Committee on Banking Supervision (BCBS) is the primary global standard setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability. In addressing several shortcomings in the regulatory framework that existed pre-global financial crisis, the BCBS issued its reforms on the Basel III framework in December 2017. Setting out the various components to be amended with expected timelines to ensure a resilient banking system. Some timelines have been deferred as a result of the impact COVID-19 has had on the preparations and implementation of these reforms on both regulators and banks across the global banking system.

The Prudential Authority within the SARB, as a member of the BCBS, issued its latest updates on these regulatory reforms in the form of Guidance Note 4 of 2021, indicating the local South African implementation dates for the various reforms, with some components already adopted early in 2021, spanning up to 2024. **EY's recent Global Basel III Reforms Industry survey** conducted in 2021 has highlighted the continuous focus on preparations by banks globally to ensure they are able to implement these reforms timeously. It has been noticeable how the levels of preparedness differed significantly across the sector. The survey also highlighted that progress was dependant on the size of the organisation or group as more time needed to effect the changes given the magnitude and complexities of the Reforms.

Although this is a regulatory-driven change, the business and commercial impacts continue to top banks' priorities together with the underlying capital impacts expected. Data, system and operating model changes including the local regulatory reporting requirements continue to be a concern for banks.

To discuss our insights on the Basel III Reforms, please speak to one of our team members.

Crypto-asset: The global regulatory perspective

The use of crypto-assets in the financial services industry is increasing at a fast pace, with the COVID-19 pandemic contributing to its rise. To better serve their customers, a growing list of banks are building out custody solutions and trading capabilities for crypto-assets. We are also seeing cryptocurrency exchanges and other digital firms moving into banking to leverage their user base and digital asset expertise to launch new products. As the market continues to mature and find its place in the regulatory world, crypto-assets are becoming more of a priority for policymakers, regulators and international standard setters. Global initiatives and varying political approaches by governments and lawmakers have been launched to regulate the crypto-asset ecosystem and harmonize market infrastructure.

The global regulatory perspective, highlights some of the key regulatory concerns about crypto-assets, the latest crypto-asset regulatory developments by jurisdiction, and specific use cases and their regulatory implications. In our associated article, **Four key drivers of the global crypto-asset regulatory risk agenda**, we focus on the key drivers of crypto-asset regulation that present the highest risk to banks from a safety and soundness perspective.

Increasing importance of ESG reporting

The Banks are feeling pressure from all stakeholders, not just shareholders and particularly around sustainability. Therefore ESG reporting is becoming more imperative in the upcoming reporting period.

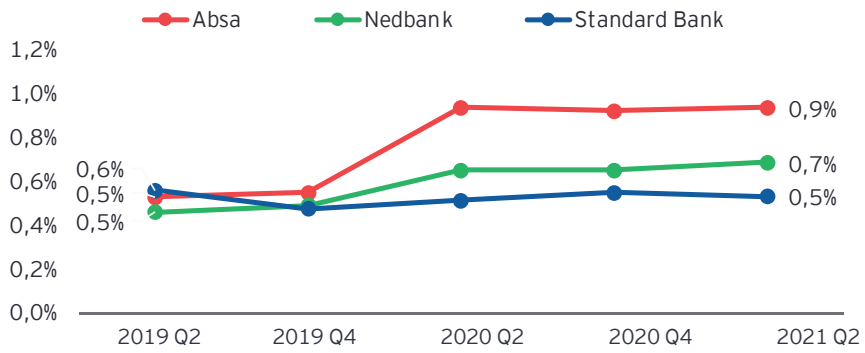
EY has created a first ever South African sustainable finance index to benchmark the banks' sustainable performance against its peers to highlight the best practices and also the areas for improvement. Some focus areas included diversity across the banks' hierarchy, emissions and resource reduction targets laid out by the banks, salary gap and linking the executive compensation to sustainability targets by the bank to increase focus on the agenda. Look out for further details of this publication on **ey.com**

Appendix

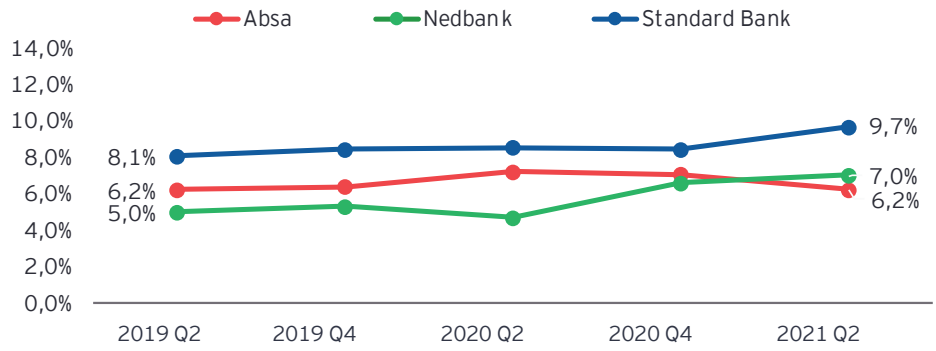
Further ECL analysis

ECL coverage ratio movements (by Stage)

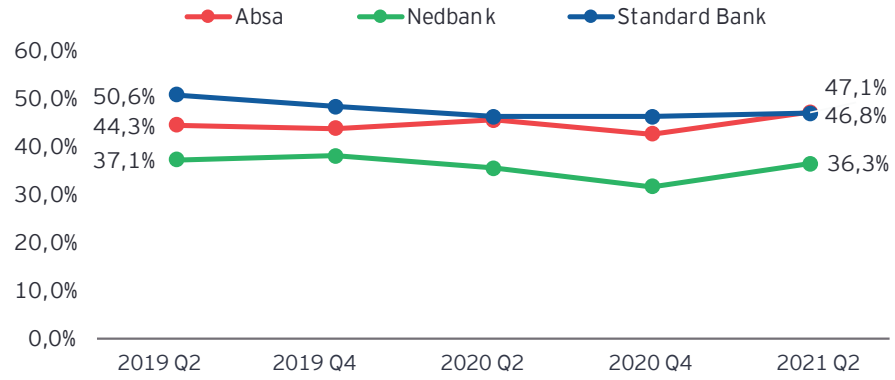
Change in Stage 1 ECL Coverage Ratio - 2019Q2 - 2021Q2*



Change in Stage 2 ECL Coverage Ratio - 2019Q2 - 2021Q2*



Change in Stage 3 ECL Coverage Ratio - 2019Q2 - 2021Q2*



Source: Absa, Nedbank, Standard Bank and FirstRand Annual & Interim Reports
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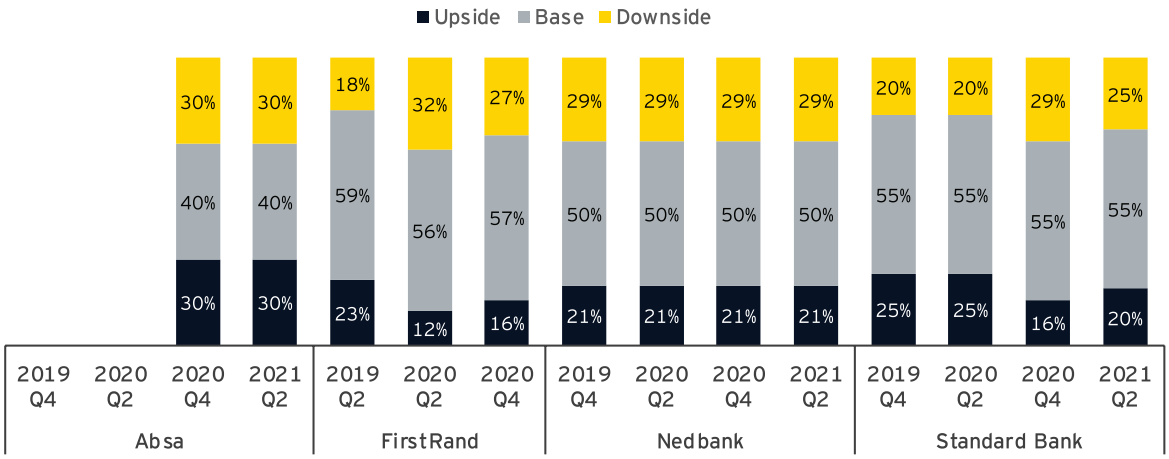
Stage 2 & 3 coverage ratios have been impacted by changes in portfolio distributions

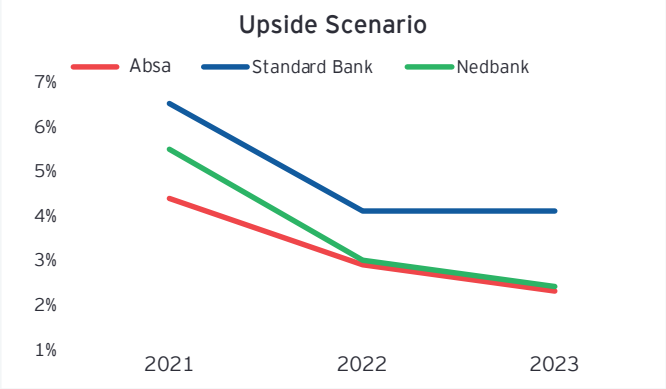
- Stage 1 coverage ratios have remained stable from 2020 Q2 to 2021 Q2 across all the banks. Notably, Nedbank's coverage ratios increased across all stages between 2020 Q4 and 2021 Q2.
- Increases were observed in the Stage 2 coverage ratios for Standard Bank and Nedbank, however, Absa's coverage ratio decreased from 6.6% to 6.2% over the same period. This may be explained by the model enhancements applied by Absa, as explained above.
- An increase in the Stage 3 coverage ratios was observed for Nedbank and Absa. All 3 banks reported similar Stage 3 coverage ratios during 2021 Q2 when compared to the 2020 Q2 period.

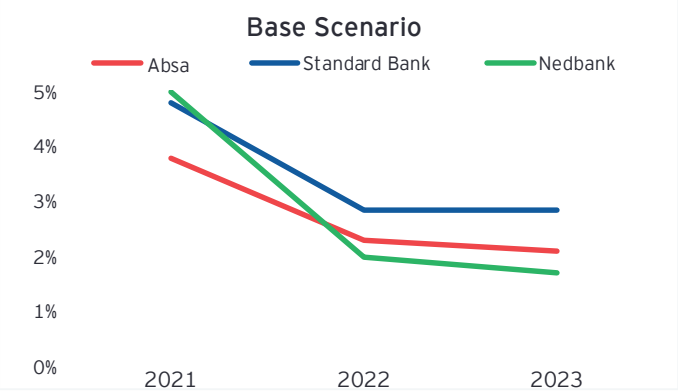
ECL coverage ratio movements (by Stage)

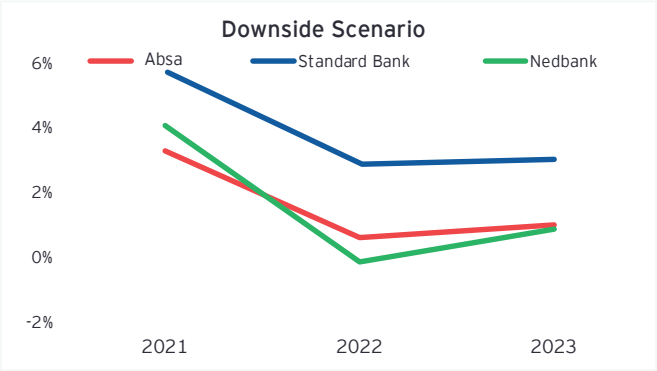
Change in Macroeconomic Scenario Weightings*



Comparison of Real GDP Growth Forecasts – 2020 Q4







Macroeconomic outlook improvements observed from 2021 Q2

- Banks have made revisions to their macroeconomic scenarios from 2019 Q4 to capture the economic environment.
- Nedbank has not changed the scenario weightings since 2019 Q4.
- An increase in the upturn scenario weighting was observed for Standard Bank between 2020 Q4 and 2021 Q2, whilst a decrease is observed in the downturn scenario weighting. This may be indicative of a more positive economic outlook.

Source: Absa, Nedbank, Standard Bank and FirstRand Annual & Interim Reports
*FirstRand's is excluded from the analysis as their 2021Q2 results will only be released in September 2021.
Absa's scenario weighting were only disclosed from 2020 Q4.

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About this report

EY Global Banking and Capital Markets Benchmarks analyze the financial performance of South African banks.

Database and Report: The deck covers 3 South African banks – Absa Group Limited (Absa), Nedbank Group Limited (Nedbank) and Standard Bank Group Limited (Standard Bank). The analysis presented helps identify trends about the financial performance of the banks and compare them against their peers. The report will be updated to include the year end results of FirstRand Limited in due course.

Period comparison: All information is sourced from publicly available banks' financial statements.

Methodology and notes:

- IFRS numbers are used across banks to facilitate like for like comparison. Thus, normalized numbers have not been used.
- We have used calculated CIR ratio across the report which is calculated as : operating expense / total revenue
- Stage 2 exposure: Gross Stage 2 loans / Gross total loans
- Stage 3 exposure: Gross stage 3 loans / Gross total loans
- Stage 3 ECL coverage: Stage 3 impairments allowance / Stage 3 loans
- Wherever data is not reported by the banks, ratios such as credit loss ratios and CIR for FY20 are EY calculated
- There could be a variation in reported CIR ratio at the banks basis the difference in calculation methodology.
  - For e.g. at Absa: Calculated CIR ratio takes into account the IFRS numbers while the reported CIR considers the adjusted numbers for Barclays separation.
  - For e.g. at Standard Bank, reported CIR only considers banking activities and our calculated CIR incorporates the insurance and investment management segments in income and expense calculations.

Abbreviations

- **FirstRand:** FirstRand limited
- **Absa:** Absa Group limited
- **Nedbank:** Nedbank Group limited
- **Standard Bank:** Standard Bank limited
- **NII:** Net interest income
- **non-II:** Non interest income
- **NIM:** Net interest margin
- **CIR:** Cost to income ratio
- **ROE:** Return on equity
- **COE:** Cost of equity
- **NPL:** Non-performing loans
- **ECL:** Expected credit losses
- **CLR:** Credit loss ratio
- **bps:** basis points
- **p.p.:** percentage points
- **RWAs:** Risk weighted assets
- **CET1:** Common equity tier 1

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