Press release – 11 September 2020

In the eye of the storm

SA's major banks navigate a crisis of unprecedented pace, scope and impact

Combined headline earnings of R14.6 billion declined 65.5% against 1H19, combined ROE of 5.4% (18.5% at 1H19), net interest margin of 392 bps (432 bps at 1H19), credit loss ratio of 232 bps (78 bps at 1H19), flat cost-to-income ratio of 55.1%

The major banks' results for the period ended 30 June 2020 reflect the impact of the profound public health, social and economic strain brought about by the COVID-19 pandemic and resulting stresses to the operating environment. Against unprecedented levels of market turbulence and operating uncertainty, key themes emerging from the results include:

- **The major banks entered the crisis with resilient balance sheets, sound capital and liquidity levels and strong franchises.** These foundations helped anchor the course 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 depressed economic 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 headline earnings and depressed ROEs. Although subject to significant estimation uncertainty, PwC's research suggests that South African economic output could take between 2-7 years to return to 2019 levels.
- **While different banking segments and products reacted with different levels of acuity to crisis conditions,** 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 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,** foundational capabilities were leveraged to facilitate customer experiences through online channels as lockdowns rapidly accelerated digitisation of banking services – ranging from collection capabilities, transactional channels and 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, amongst others.
- **Tight cost control and intense management of discretionary spend** represented a key 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 fortitude.
- **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.

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PwC's Major Banks Analysis highlights key themes from the combined local currency results of Absa, FirstRand, Nedbank and Standard Bank.

External environment: The economic premise on which 2020 began in South Africa was deeply challenging. Commencing on the back of the slowest level of economic activity since the global financial crisis, the domestic economy registered a second technical recession in less than two years in Q4-19. By the time Q1-20 concluded, a global crisis of unprecedented pace, scope and impact was underway, engulfing economies and financial markets worldwide in a severe and synchronised downturn.

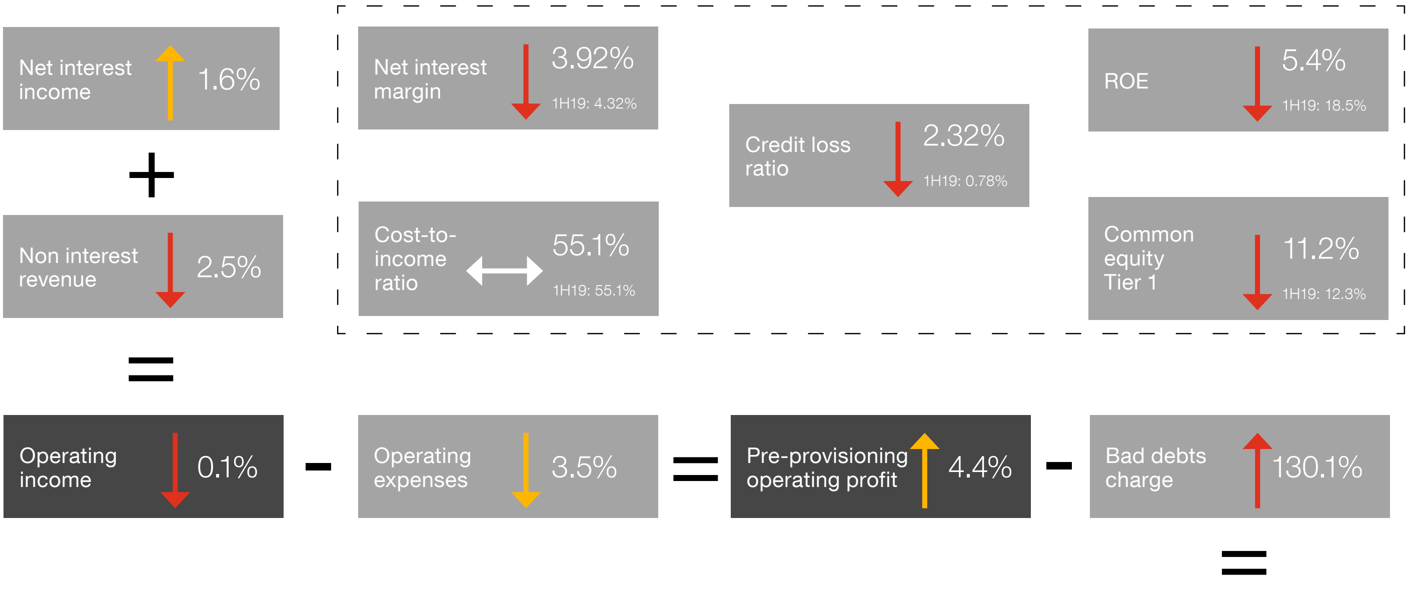
There is debate amongst risk professionals as to whether the COVID-19 pandemic reflects an unforeseeable cataclysm or a biological inevitability of unknown timing. In contrast, there is no debate regarding the devastating scale – yet to be fully measured – resulting from the pandemic-induced economic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

South African GDP contracted by 51% in Q2-20 on an annualised basis, representing a quarterly decline of a scale that dwarfs the annualised slowdown of 6.1% recorded in Q1-09 during the global financial crisis. By the time government restrictions were imposed in March, the unemployment rate was at 30.1%, a 17-year high and is expected to register at significantly elevated levels for 2020.

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

Results highlights: Costa Natsas, PwC Africa's Financial Services Leader noted:

> "The major banks' results for the six months to 30 June 2020 are heavily impacted by the dire human, social and economic costs caused by the COVID-19 pandemic. While the scale and scope of these challenges are unprecedented, operating conditions were already constrained as the year began given a benign domestic economic climate and structural challenges that extended recessionary conditions into Q1-20. This set of major banks' results reflect these challenges – amplified by the effects of the pandemic and resultant containment measures.



1H20 versus 1H19

Highlights from the major banks results include:

- Combined headline earnings fell 65.5% relative to 1H19 (65.1% against 2H19) driven by a steep increase in the combined credit impairment charge of 130% (112% against 2H19).
- 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 CET1 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 14.8% (15.7% at 2H19), well above regulatory required levels.
- Given the front-loaded nature of expected credit loss estimation under IFRS 9, the combination of markedly deteriorated economic outlooks, worsened customer risk profiles and pandemic-induced social containment measures resulted in the combined bad debt charge increasing 2.4 times relative to 1H19. These elevated impairment levels were last seen during the global financial crisis. Increased impairments deteriorated the credit-loss ratio to 232 bps (78 bps at 1H19 and 83 bps at 2H19).
- Unsurprisingly, credit demand was nuanced across customer segments and geographies. National lockdown measures and acutely depressed household and business confidence levels combined to constrain loan disbursements in the retail and business banking segments.
- From a corporate perspective, client-driven loan growth was evident through, inter alia, facility draw-downs 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 converted with a weaker ZAR/USD exchange rate. Altogether, gross loans and advances grew 8% against 2H19 – a credible achievement given lockdown constraints.
- Retail, business and corporate deposit balances increased in aggregate during the lockdown period as customers held additional liquidity to support uncertain cashflow demands, driving total deposits to increase 9.5% against 2H19. Some banks observed healthy growth in call, savings and investment products.
- Strong migration to digital channels which aided transaction volumes during the lockdown period was not enough to translate into meaningful fee and commission income growth, resulting in non-interest revenue contracting 2.5% (down 5.9% against 2H19).
- Disciplined cost control in response to revenue pressures reflected in the combined cost-to-income ratio remaining flat against 1H19 while operating costs fell 3.5% (down 2.9% against 2H19).
- Pre-provision operating profit 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).

Francois Prinsloo, Banking and Capital Markets Leader for PwC Africa says:

> “In a period of intense distress, the major banks quickly galvanised their focus towards the safety and adaptation of their workforces, ensuring operational stability and maintaining balance sheet resilience, while providing customer support through relief measures and partnering with government to protect the economy. As they’ve done this, return to growth strategies and adapting to a post-crisis world remain on the minds of bank management teams.

The Outlook: As many contemplate how the pandemic will play out, while managing the fluidity of the situation, some commentators observe that any attempt at predicting when and how economies – and bank profitability – might return to pre-crisis levels is not an exercise in forecasting, but 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 macro forecasts, particularly as the effects of the crisis and its second-order effects extend beyond 2021.

The annual 2020 SA GDP forecasts of the major banks range from a decline of between 7% – 8.5%.

Rivaan Roopnarain, PwC Africa Banking and Capital Markets Partner notes:

> “Aided by their investments in technology and focused efforts in enhancing customer experiences and offerings over recent years, the major banks have been purposeful in their responses to navigating the crisis. At the same time, these results reflect balance sheet strength, resilient operations and strong, trusted banking brands that were able to withstand severe economic shocks.

In recognition of the wholly uncertain operating environment, the major banks have all withdrawn pre-crisis medium term financial targets. 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 redesigned strategies for a ‘post-COVID 19’ world – or at least one in which the current pandemic has rescinded to more stable virology. Doing so will require striking the difficult balance of risk, strategy and resilience in an unprecedented climate.

Aiming for renewal and revival – not just survival – may be where leading banks will focus their strategic lenses as they navigate, recover and restore their operations through the current crisis.

We believe the banks that will best navigate through and emerge from the current crisis 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 a reimagined strategy. Strategies predicated on customer-centricity, responsiveness to demographic shifts and evolving customer expectations while still maintaining pace with technological change are those that will best provide a foundation for success.

Ends.