

# THE BANKING COUNCIL

South Africa

## APPENDIX A

### CAN COMMERCIAL BANKING IN SOUTH AFRICA EARN A SATISFACTORY ROE?

33333

#### INTRODUCTION

Branch banking, which takes in the savings and deposits of the public, handles their transactions, and makes loans, is under severe pressure at present, especially as far as the four major banks are concerned. This sector of banking is commonly referred to as "commercial banking". If the full cost of capital used in commercial banking activities is taken into account, the Return on the Shareholders' Equity ("ROE") on that portion of the major banks' business is inadequate and dilutes their overall results. The overall ROE and capital ratio of the major banks at the present time is set out in Table 1.

**Table A1: The ROE and capital ratio of the major banks, 1998**

<i>Name of Bank</i>	<i>ROE</i>	<i>Inflation adjusted ROE</i>	<i>Capital ratio</i>
ABSA	18.9%	11.2%	9.1%
SBSA	18.1%	10.4%	11.2%
Nedcor Bank	23.4%	15.7%	10.7%

\* Due to the FNB / RMB merger and hence the creation of FirstRand Group, the FNB figures are not comparable for 1998.

(Source: Annual Financial Statements - 1998)

The shareholders will be looking at the "real" return that they are getting on their capital, net of inflation, and they also compare the returns with the sort of return that they could earn on their capital in other industries with a similar risk profile. Perhaps the closest example would be the Retail Sector, in which Pick n Pay earned an ROE of 31% last year and Shoprite an ROE of 32%.

In order to achieve an acceptable level of ROE on the commercial sector of their business, the major banks are therefore faced with two options: to either **Increase** their net interest income or their transaction charges; or to **reduce** their operating costs or their bad debts.

For a variety of reasons, neither is likely to happen unless the banks develop very focused strategies to serve the markets in question profitably, or they exit some of the less profitable segments of that market.

### **WHY IS ROE SO IMPORTANT?**

Over the past few years, the management teams of the big banks have become increasingly concerned about the need to increase the ROE. Any decision to operate in a particular market depends, crucially, on whether or not a business can earn a satisfactory - and sustainable - return on shareholders' investment.

Where money is already invested, shareholders have the option, if they feel that they are getting an inadequate return, of selling their shares, and that will tend to depress the share price. This makes it all the more difficult, and expensive, for the bank to raise new capital when it is required. A bank must (by law) hold a minimum ratio of capital to total assets, so, if a bank is not to contract in real terms, new capital will always be required. Without a strong banking industry, South Africa cannot participate effectively in the global village, nor raise the capital internationally that is vital for our continued economic growth.

### **HOW DIVERSIFIED IS A BANK'S BUSINESS?**

Banks can be in a variety of different businesses. One of the more common categorisations is into two main areas:

**Commercial banking** is that portion of a bank's business which involves deposit-taking from, lending to, and handling the transactions of the general public and corporations. Because it takes deposits, a bank has to comply with the Banks Act and maintain a high ratio of capital to total assets. Although the capital is required to protect the depositors, it has to be calculated at the rate of 8% on "risk-weighted" assets - international best practice, however, dictates a rate more like 12%. Since the commercial bank does all of a bank's lending to the general public and corporations, the bulk of its capital is related to its commercial banking activity. Currently, more than 85% of the commercial banking in South Africa is done by the four major banks. It's worth noting that, apart from the convergence between the old building societies and banks in the late 1980s, no new banks have entered this market on any scale in the last 40 years.

**Investment and Merchant Banking** describes that portion of a bank's business which does not involve deposit taking or lending to the general public or corporations. Because the total value of assets involved here is much lower, so is the related capital.

### **WHY IS COMMERCIAL BANKING LESS PROFITABLE?**

Historically, commercial banking in South Africa has suffered from high cost ratios due to its dependence on large branch networks, combined with rising staff and information technology (IT) costs. Furthermore, commercial banking has been reliant on margin income as its main source of revenue. This has been exacerbated by the fact that a large proportion of the funds held by the banks to finance the loans they grant, is short-term, with wholesale characteristics. Those funds are generally more expensive and re-price more quickly than retail deposits. Some banks have initiated successful restructuring programmes diversifying revenues and reducing costs. But by and large commercial banking is still operating at a significantly lower ROE than investment and merchant banking.

In November, 1998, KPMG obtained figures from the four major banks distinguishing between "lending" and "non-lending" activities, and did calculations of the performance of those different businesses. The Banking Council requested KPMG to make those calculations available for the purposes of this report.

### **HOW DOES ONE MEASURE A BANK'S PERFORMANCE?**

KPMG confirm that the most significant performance measure is ROE, as it focuses on management's ability to generate profits per Rand of shareholders' equity. They further advise that the minimum return expected by shareholders can be estimated by using the Capital Asset Pricing Model (CAPM) which specifies the relationship between risk and required rates of return on assets when they are held in well-diversified portfolios. The calculated return is the minimum return required to persuade investors to purchase the share, or to hold it. The required rate of return equals a "risk-free" rate plus a "risk premium".

The "risk-free" return is a satisfactory return on the actual money that is invested by the shareholders. They could have put their money "**risk-free**" and easily liquidated into RSA stocks (which are tradable and in which there is no risk) at a return of approximately 15% over the last couple of years.

The "**risk premium**" is the "profit" over and above the risk-free return that the shareholders expect to get. This "**risk premium**" is the return for taking risk that they would not take if

they invested their money in RSA stocks. According to a recent study by KPMG, the estimated benchmark of the risk premium for the banking industry in South Africa is between 4 and 6%. So the required minimum ROE of a bank in South Africa is the aggregate of the risk-free return and the risk premium, and is therefore between 19 and 21%.

### HOW DO SA BANKS COMPARE WITH OVERSEAS BANKS?

The overall ROE and the actual capital ratios of three major banks are reflected in Table 1 on page 1.

Bearing in mind that the international benchmark for a bank's capital ratio is more like 12%, the four major banks are barely meeting the minimum ROE expectations of their shareholders.

Comparisons can be drawn with banks in other countries - developing and developed.

**Table A2: ROE & Capital Adequacy ratios – developed & developing countries**

<i>Country</i>	<i>ROE</i>	<i>Capital Ratio's</i>
USA	15%	12.0%
Canada	17%	10.0%
United Kingdom	20%	12.3%
Australia	15%	9.8%
Botswana	39%	
Kenya	36%	
Ghana	75%	
Zimbabwe	37%	
Mauritius	14%	
Namibia	28%	
Nigeria	41%	

*(Source: 1998 Financial Institutions Performance Survey, KPMG - Australia)*

When drawing comparisons, it should be borne in mind that the "risk-free" return in those other countries is dependent on the prevailing rates of interest in those other countries. So for example, the prevailing rates of interest in the developed countries is of the order of 5%, and therefore the risk premium that is being earned in those countries is in the range of 10 to 15%. That has to be compared with the risk premium of 4 to 7% in South Africa. The

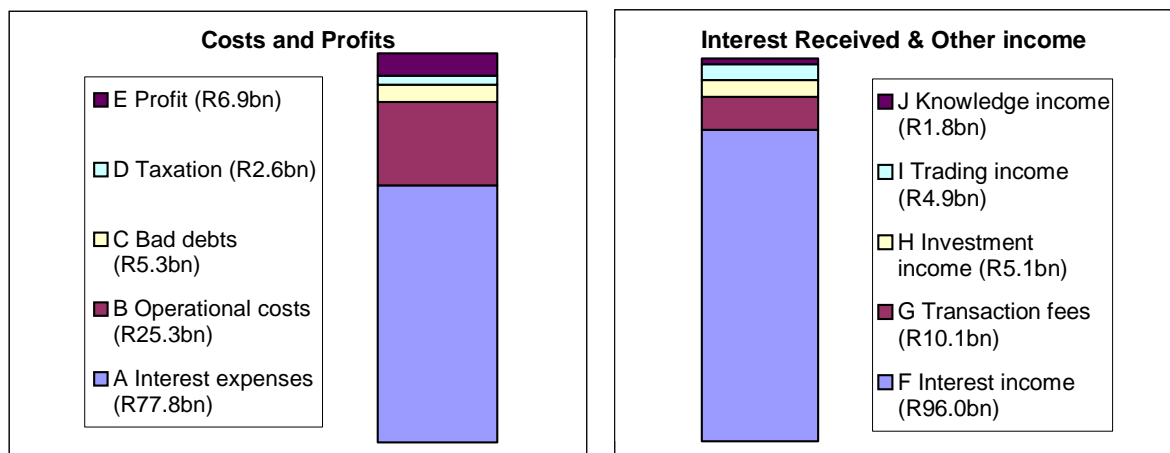
same calculation similarly depletes the apparently high rate of return in the developing countries.

Shareholders also look at the real rate of return on their investment, and because of our high rate of inflation (7.7%) relative to that in the developed nations (2-3%), South African banks don't score well on that comparison either.

The KPMG study also found that, taking into account the full cost of capital utilised, the calculated loss for commercial banking activities of the four major banks was R181m in 1997. In their investment and merchant banking, however, they made R2.6bn in that year.

This is really significant. Obviously this analysis by KPMG is dependent on figures furnished by the major banks. But it corresponds reasonably closely with our own analysis done on the basis of the audited returns of all the banks for the year ended December, 1998 to the Registrar of Banks in terms of the Banks Act.

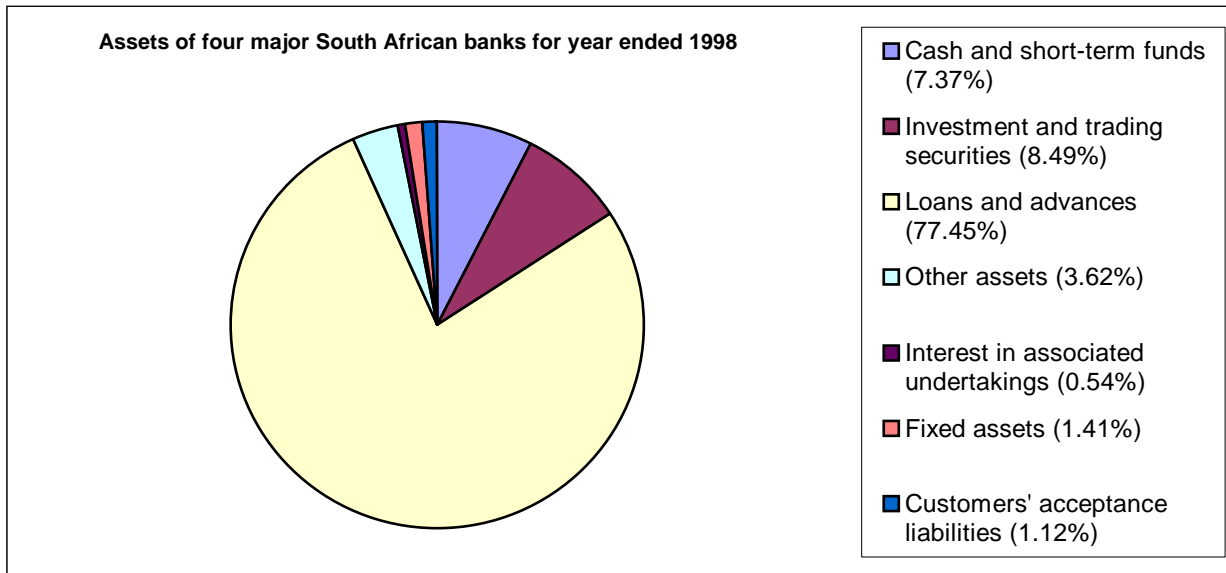
**Diagram A3: Revenue and expenses of the banks, 1998**



Source : Registrar of Banks DI 200 Returns

The actual make-up of the assets of the four major banks at the end of 1998 is as follows.

**Diagram A4: Assets of the four major banks, 1998**



Source : Registrar of Banks DI 200 Returns

Investments and trading stock make up only 8.5% of the total assets, where loans and credit granted to the public and corporations make 77.5% of the total assets. So the vast majority of the capital (and its related cost) is allocated to support the commercial banking business.

It is also clear from Diagram A3 that the aggregate of interest income and transaction charges of the banks (R106 bn) does not cover their interest costs, operating costs and bad debts (R108 bn). Those are the components of commercial banking.

So, our major banks are under considerable pressure to do something about the drag which retail banking constitutes to the rest of the business.

### **HOW PROFITABLE IS THE REST OF THE BUSINESS?**

It should be borne in mind that there are different segments within the different businesses of a bank, and those different segments themselves have different profitability profiles. Within the commercial banking business, the corporate and high-value personal markets are much more profitable than the low-value markets. That is mainly because the average balance on an account (whether deposit or loan) is much bigger in the corporate and high-

value personal markets, and so the net interest income on the account is also bigger and more than covers the cost of administering the account.

That is not true in the lower-value markets where the average balance on an account is frequently inadequate to cover the costs of administering it, let alone to make a contribution to the costs of the transactions on the account. It should be borne in mind that if no interest income was earned by the banks, the transaction charges would have to be more than four times higher than they are for the banks to make the same profit.

The return of a bank can be broken down into the following elements :

	Interest income
• Add :	Transaction fee income
• Less :	Operating costs
• Less :	<u>Bad debts written off</u>
	<u>Profit (before tax)</u>

While each of these elements is dealt with individually below, they are all interrelated. Although this submission addresses the question of transaction charges, the different elements cannot be dealt with in isolation. If the interest income were higher, it would not be necessary to charge so much for transactions to make the same profits. Likewise, if the operational costs or the bad debts were not so high, the charges could be reduced.

## WHAT IS DRIVING THESE OTHER ASPECTS?

### Interest income

The interest income is defined as the difference between the interest earned and the interest paid by a bank. This is traditionally the most significant component of earnings generated by the four major South African banks.

**Table A5: Interest income as a % of total income**

<i>Name of Bank</i>	<i>1998 %</i>	<i>1997 %</i>
ABSA	61.20	65.87
FNB	**	51.63
SBSA	53.00	54.53
Nedcor Bank	54.80	57.71

\*\* Due to the FNB / RMB merger and hence the creation of FirstRand Group, FNB figures are not comparable for 1998.

(Source: *Banking Survey Africa, 1998, KPMG and Annual Financial Statements - 1998*).

Bank margins should reflect the risks that banks are exposed to. Notwithstanding the South African banking sector's first world status, it operates in an emerging market and is exposed to additional types of risks therefore comparisons should be made on this basis.

SA's status as an emerging market with a non-investment grade (BBB+) sovereign credit rating indicates that risks are inherently higher in this market than those of a 'AAA' status. A 'risk premium' is therefore required when investing in developing countries like ours. So it is not appropriate to compare the margins of South African banks with large US or European banks. If one compares South Africa with other emerging markets like Argentina, India and Mexico then South Africa finds itself at the lower end with margins, averaging just below 4%.

**Table A 6 : Interest margins - South Africa's major banks**

<i>Bank</i>	<i>%</i>
ABSA	3.4
FNB	4.0
SBSA	4.2
Nedcor Bank	3.4
Average	3.7

(Source: Composition of income statement survey - 1998, KPMG)

**Table A 7 : Interest margins - comparative countries**

<i>Country</i>	<i>%</i>
Argentina	5.0
India	3.5
Mexico	4.4

(Source : Bank of International Settlements)

**Table A 8 : Interest margins - other African countries**

<i>Country</i>	<i>%*</i>
Botswana	8.8
Ghana	10.6
Kenya	6.9
Mauritius	4.6
Zimbabwe	7.7

\* Calculated using total average assets

(Source: KPMG Africa)

**Table A 9 : Interest margins - developed countries**

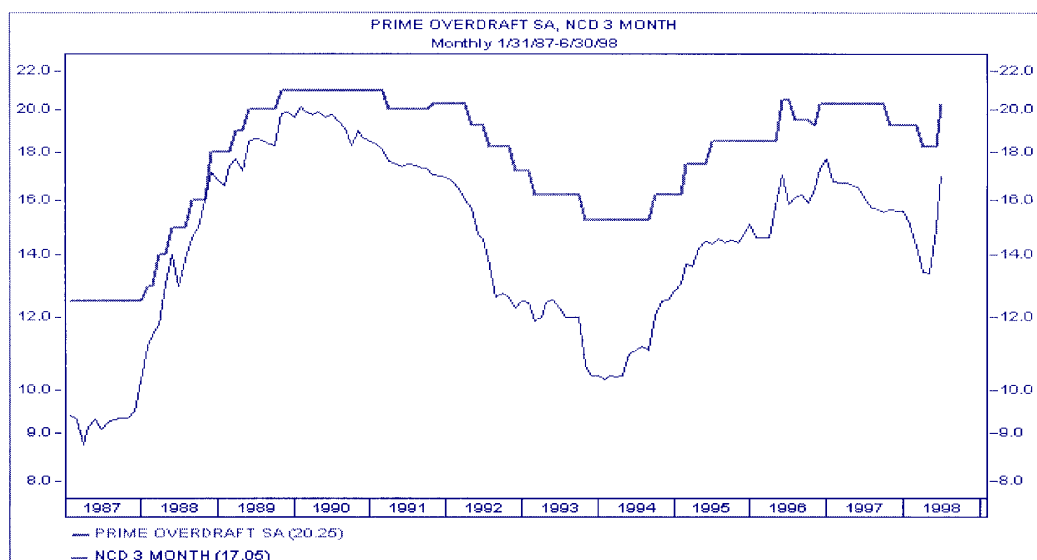
<i>Country</i>	<i>1997 %</i>
USA Supra-regional banks	4.5
Canada	2.3
United Kingdom	2.5
Australia	3.4

*(Source: 1998 Financial Institutions Performance Survey, KPMG - Australia)*

Other points to take into account when considering the size of the interest margins of South African banks are:

- South African banks get the majority of their funds from the wholesale market. Those funds re-price more quickly than retail funds and tend to be a more volatile and expensive source of funds than deposits. This phenomena results from the shortage of retail deposits brought about by poor domestic savings as well as attractive alternative investment options available to investors (especially when the impact of taxation is taken into account). Retail cheque and savings accounts earn a very low rate of interest, but they make up a very small portion of the total funds of the banks. So the benefit to the banks of the low rate of interest paid on those accounts is minimal.
- As movements in deposit rates generally precede any movements in lending rates, margins tend to narrow during periods of rising interest rates, but widen when interest rates fall. This can be seen in the gap between the prime lending rate and the three-month NCD borrowing rate of the banks. Note how the margin tends to widen at the bottom of the interest rate cycle and narrows at the top. Contrary to popular belief, the banks do not benefit when interest rates are high. To the contrary, the margins narrow and borrowers are more likely to default under pressure of the high interest rates, and so bad debts increase. This should also be borne in mind when comparisons (which are favourable to the South African banks anyway) are drawn with the margins of banks operating in low inflation countries like the USA and the UK.

### Diagram A 10 : Comparison of Prime Overdraft Rate with 3 Month NCD Rate



Source : KPMG

- The upward pressure that is exerted on deposit rates during times of strong credit growth causes interest margins to narrow. This is due to the increasing demand for bank deposits to fund the strong growth in credit. Despite attempts by the SARB to curb high credit growth, the demand for credit in South Africa remains high.
- Another important factor influencing bank margins is the regulatory environment. The two regulations affecting interest margins are the liquid asset requirement and the cash reserve requirement:
  - A bank is required to hold liquid assets equal to at least 5% of its total liabilities less capital and reserves. Liquid assets include notes and coins, gold coin and bullion, clearing account balances, treasury bills, RSA government stock, securities of the Reserve Bank and Land Bank bills. These items generally yield a lower rate of interest than the banks' other assets. Any increase in the liquid asset requirement results in even lower interest income; and
  - A bank is required to deposit cash equal to 2.5% of its total liabilities interest free with the Reserve Bank. In determining the amount of the cash reserve, a bank is entitled to set off the amount of vault cash that it holds.

According to a KPMG study, the cost of these prudential requirements is estimated to be between 0.5% and 0.6%, so the margin without these costs would be approximately 3.1%.

## IS THERE SCOPE TO INCREASE THE INTEREST MARGIN IN ORDER TO REDUCE TRANSACTION CHARGES?

Not really. The interest margin is determined in a very competitive international market. If the South African banks were out of line for any period of time, they would find that they would either make losses or that they had lost their business to some other players. It is very significant that SA Home Loans has come into the high-value market for home loans with very strict loan conditions to maintain high account balances and to restrict bad debts. . Moreover, apart from the competitiveness of the market, there is strong public resistance to any increase in the margin,.

## CAN SOMETHING BE DONE ABOUT OPERATING COSTS?

The cost to income ratio has become an important measure of bank efficiency.

**Table A 11 : Cost/income ratio - South Africa's major banks**

	<i>1998 %</i>	<i>1997 %</i>
ABSA	65.40	68.24
FNB	**	63.77
SBSA	62.30	63.37
Nedcor Bank	56.90	58.67

\*\* Due to the FNB / RMB merger and hence the creation of FirstRand Group, FNB figures are not available for 1998.

(Source : Banking Survey, Africa KPMG - and Annual Financial Statements - 1998).

**Table A12 : Cost/income ratio - developed countries**

<i>Country</i>	<i>%</i>
USA	62.0
Canada	64.0
United Kingdom	55.5
Australia	63.2

(Source : 1998 Financial Institutions Performance Survey, KPMG - Australia).

While South African banks have been focusing on bringing their cost to income ratios in line with those of the banks in the more developed countries, there are a number of specific factors that contribute to their high cost structures:

- The average income per capita of \$3,500 per annum in SA is relatively low compared to developed countries. For example the GDP per capita in the USA is \$27,000 per annum. The net interest income is determined by multiplying the total amount involved by the difference between the rate of interest paid and the rate of interest received. If an amount of say R100,000 were in 120 deposit accounts and 4 loan accounts, then the bank would incur the costs of administering 124 accounts. But if that amount is in 15 deposit accounts and 1 loan account, then the bank incurs the cost of administering 16 accounts to make the same interest margin. So, because of the low GDP per capita in South Africa, South African banks incur the costs of administering a large number of accounts to earn the same margin income as they do, for example, in the USA administering only a few accounts.
- South Africa is regarded as having one of the highest crime rates in the world. This has had a direct effect on banks, which have experienced an increase in the number of cash heists, robberies and white-collar crime. In addition, the cost of maintaining adequate security at outlets throughout the country runs into millions each year. Fraud and robberies are costing the banks well over R1 billion per annum.
- The major banks maintain extensive branch networks in order to conduct their commercial banking business. This is mainly because of the geographic spread of their customers, and the very different customer segments that have to be served through that network. Moreover, the function of paying the wage and salary earners of South Africa has largely been passed over to the banks. This has much to do with the reluctance of the employers to perform that function in the light of the cost and danger of moving and handling cash. The result is that the banks have had to increase their infrastructure to cope with the peaks at the end of each week and at the end of the month. The rest of the time that costly infrastructure is under-utilised. As a result, the volumes in many of the branches at off-peak times are totally inadequate to justify the cost of providing the services, and economies of scale are not achieved.

**Table A 13 : Number of branches, service branches and agencies**

<i>Banks</i>	<i>Local Branches</i>
ABSA	1 090
FNB	690
SBSA	852
Nedcor Bank	465

(Source: *Banking Survey Africa 1998, KPMG*)

**Table A 14 : Number of ATM machines**

<i>Banks</i>	<i>ATM's</i>
ABSA	1 696
FNB	1 532
SBSA	2 099
Nedcor Bank	1 000

(Source: Banking Survey Africa 1998, KPMG).

- This extensive distribution network is dependant on complex technology and systems, the vast majority of which is imported and, as a result of a deteriorating exchange rate, is increasingly expensive. For example, since January 1998, the Rand has declined by approximately 29% against the British Pound and 27% against the US Dollar.
- Efficiency of staff – Staff efficiency in South African Banks is questionable compared to their overseas competitors. As highlighted below, a significant portion of the bank's costs are related to staff costs.

**Table A 15 : Staff costs as a % of total costs**

<i>Banks</i>	<i>%</i>
ABSA	49.7
FNB	53.4
SBSA	50.0
Nedcor Bank	47.0

(Source: Annual Financial Statements - 1997)

- Banks still operate in a comparatively high inflation environment. That translates into continuously and rapidly escalating salaries, and a whole host of administrative costs. Even if there is no increase in the volumes handled by the banks, the operational costs are likely to go up at much the same rate as inflation. The consequence is that the transaction charges have to go up to cover the increase. The interest margin does not go up merely because costs have inflated.

- As an indicator of how costs have inflated, one of the major banks experiences the telecommunications costs reflected in this table:

**Table A 16 : Telecommunications costs of one of the major banks**

<i>Cost</i>	<i>Jan 1995</i>	<i>Jan 1996</i>	<i>Jan 1997</i>	<i>Jan 1998</i>	<i>Jan 1999</i>
% Increase in telecommunications costs	11.5	15	12	10	8

*Source : The Banking Council.*

- In addition the bank's telecommunications costs are 40% higher as a result of having to duplicate its lines in order to cater for line downtime in Telkom. As part of that additional cost, it has to carry the costs of 25% duplication on ISDN lines between main centres and 30% duplication of all other lines. Despite that additional cost which goes into the cost of maintaining the network, it still suffers fairly high and unsatisfactory network down-time because of Telkom failures.

### **WHAT ARE THE BANKS DOING TO CONTAIN COSTS?**

One of the biggest drives of the major banks over the last four years has been to bring the costs of branch banking down. Branches have been closed, administration systems have been computerised and centralised, as have credit granting systems. Wherever possible staff has been reduced, and this is particularly noticeable in the branches. South African banks are renowned in the world for their use of modern technology to provide banking services for low-income communities and they have won a number of prestigious awards, including no less than three Smithsonian Institution Awards.

### **WHAT ROLE DO BAD DEBTS AND LOSSES PLAY?**

High real interest rates in South Africa have an adverse effect on bad debt. This is a severe problem for the major banks and they have been keen to avoid increasing interest rates despite the upward market pressure on those rates. For instance, at the height of the emerging market crisis last year, banks provided some relief to home owners by allowing the differential between the higher prime rate and the mortgage rate to widen to two percentage points.. Household debt in South Africa as a percentage of personal disposable income is approximately 70% (1993-54%). Consequently, high interest rates result in a higher default rate that in turn has a negative effect on the bottom line.

The extent of bad debt write-offs by banks is measured by the bad debt ratio :

**Table A 17 : Bad Debts - South Africa's major banks**

<i>Bank</i>	<i>%</i>
ABSA	0.60
FNB	0.94*
SBSA	0.55
Nedcor Bank	0.52

(Source : Banking Survey Africa 1998, KPMG).

\* A significant portion of the FNB relates to their furniture financing operations which were subsequently disposed of.

**Table A 18 : Bad Debts - comparative countries**

<i>Country</i>	<i>%</i>
Argentina	1.8
India	0.7
Mexico	1.1

(Source : Asli Demirguc-Kunt and Harry Huizinga : Determinants of Commercial Bank interest margins and profitability : Some international evidence)

**Table A 19 : Bad Debts - developed countries**

<i>Country</i>	<i>%</i>
USA	0.80
Canada	0.30
United Kingdom	0.40
Australia	0.22

(Source: 1998 Financial Institutions Performance Survey, KPMG - Australia).

South African banks tend to experience higher levels of bad debts than the developed countries. There are a number of factors specific to South Africa which aggravate the level of bad debts and losses:

- A significant proportion of the population is unemployed or is vulnerable to retrenchment.
- South Africa continues to be a relatively high inflation and high real interest rate environment.
- There are some communities where non-payment of service charges, rates and loan instalments has become endemic. There are well in excess of 31,000 non-performing

loans in the low income housing market. Apart from not recovering interest on those loans, banks also have to carry the cost of security, service charges and rates.

## **THE CONCLUSION**

KPMG conclude their report to the Banking Council as follows:-

The results of our study highlights the fact that, after making adjustment for cost of capital, the traditional intermediation function of the banks is not profitable.

The revenues from providing commercial banking services come from the net interest income and transaction charges. But net interest income is substantially determined in the market place, and if anything that margin is going to be further squeezed by the entry of new players like SA Home Loans. And transaction charges are bumping into increasing public resistance to further hikes.

The expenses are made up of the operational expenses of running the branch network and systems, bad debts and the cost of the capital that is employed in doing that business.

Operating costs are determined by forces largely beyond the control of the banks and have a lot to do with the historic development of the banking industry and environment in which they currently conduct this part of their business.

Bad debts are at a higher level than in developed countries, although not as high as in some other comparable countries. But the indications are that there has been a serious deterioration in the level of debt default and of debt write-off in the recent past. So, far from anticipating a reduction in bad debts and losses, it is likely that that figure will increase and negatively impact on the already poor ROE in the sector.

So there is no easy solution to the banks' dilemma in relation to their commercial banking activities. It is not as easy as just pushing up their prices or cutting their costs. They really only have two real options:

- Get out of the market - which none of the major banks has yet done, or
- Develop focused strategies, which improve the profitability of their business in this segment.