



FIRSTRAND

Annex 10 – The economic cycle and its effect on FRB

As with most businesses, banks tend to be “pro-cyclical”. In the upward phase of the business cycle, bank profits tend to rise, whereas in the downward phase, profits tend to fall or become negative.

South Africa has enjoyed a period of economic success following on a period of monetary and fiscal discipline, low and stable inflation and interest rates, a strong and stable Rand and international attention on emerging markets. Prior to this there was a period of high volatility with changing interest and exchange rates. Our view is that the new reality of higher GDP growth, increasing volumes and increases in credit extension and dis-saving in the economy will create new risks and funding will become more expensive. This will affect the profitability of FRB. FRB believes that to be consistent, profits thus need to be looked at over the entire economic cycle, not just in recent history.

Below we highlight aspects of the economic environment that are pertinent to banks, which we split into four major categories:

- Increased consumption (spending)
- Increased borrowing
- Very low savings levels
- Bad debts

1 Increased Consumption / Spending

Increased consumption has been fuelled by real GDP Growth, real disposable income growth, cheaper credit (lower interest rates), higher property prices and a change in the South African demographic. The following charts show a period of positive and steady real GDP growth since 1999, and household spending growth at levels not seen since the mid 90s.

Figure A10.1

Real GDP growth

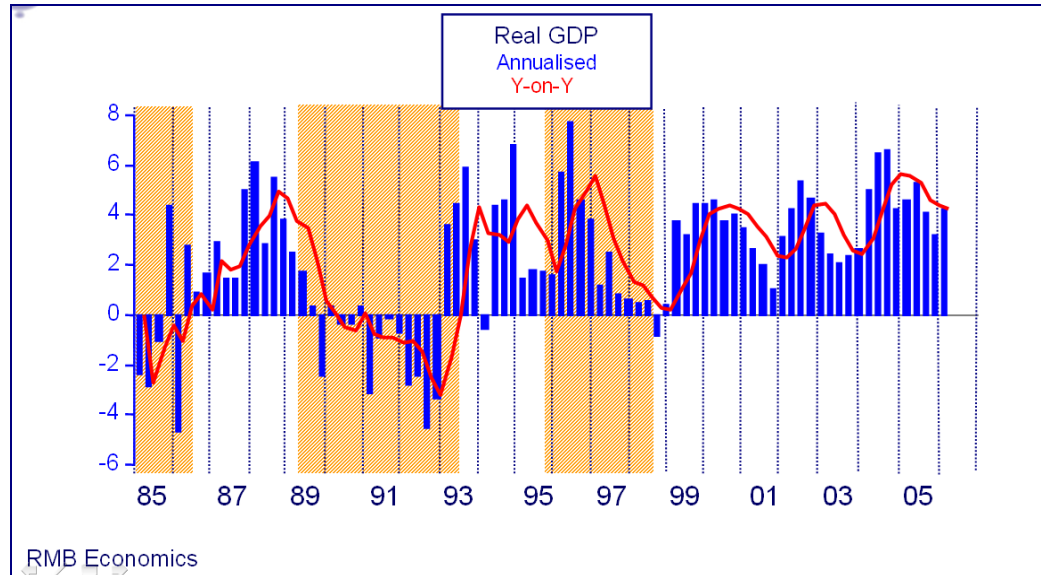
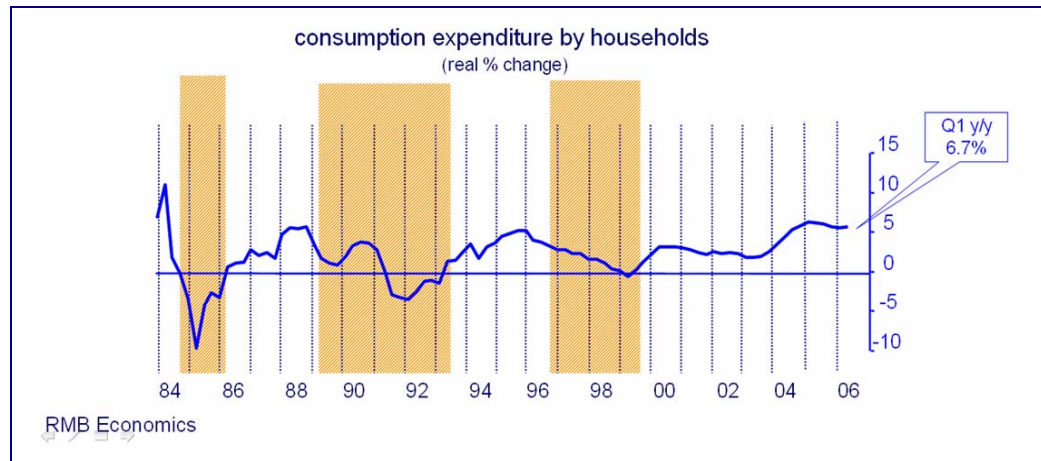


Figure A10.2

Consumption expenditure

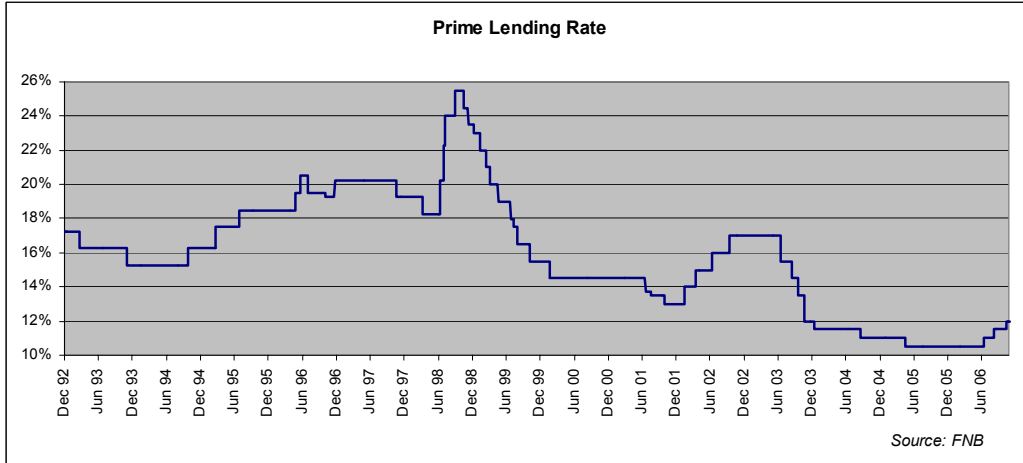


2 Increased Borrowing / the demand for Credit

Falling interest rates make debt more affordable and have a direct impact on the demand for credit. The chart below shows the prime rate of interest since December 1992. Since December 2003, interest rates seem to have stabilised. All else being equal, lower interest rates will lead to increased demand for credit.

Figure A10.3

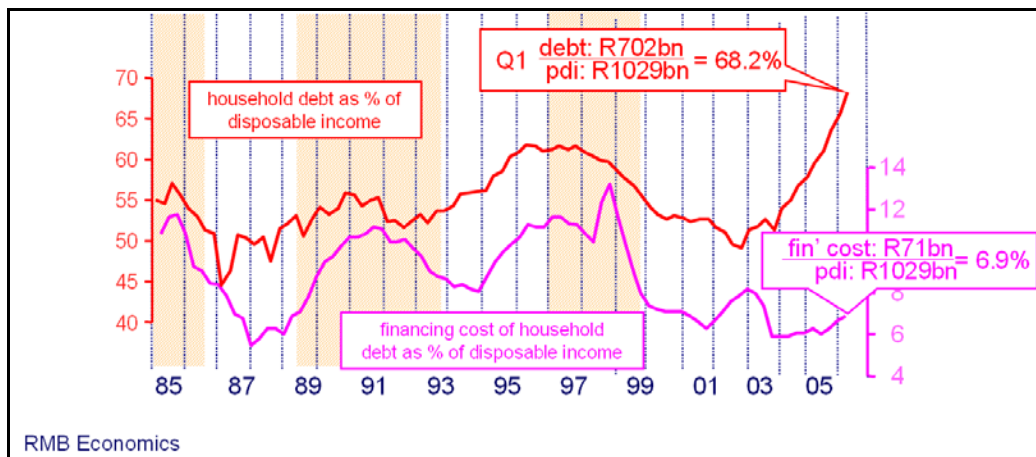
Interest rates since 1992



The following chart shows the impact of the growing demand for credit as measured by the percentage of income that households are spending on debt financing, as well as household debt compared to disposable income. These levels impact directly on the balance sheets of business that extend credit such as banks and retailers. We can see that debt rates have increased substantially since 2001 to current levels, which are unprecedented in recent history.

Figure A10.4

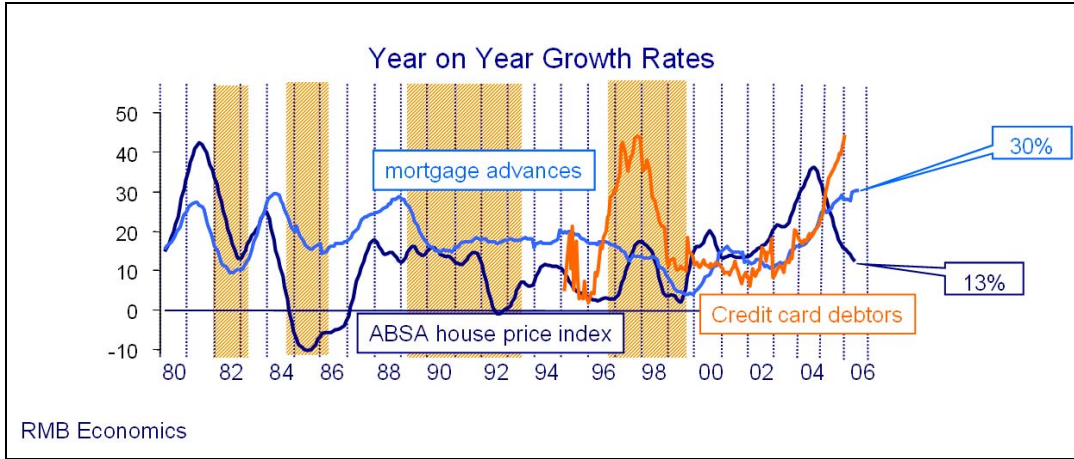
Debt and financing as proportion of income



The extension of credit can be seen in the growth rates in the various types of advances made by banks. Since 2002 both credit card debtors and mortgage advances have increased substantially.

Figure A10.5

Lending rates

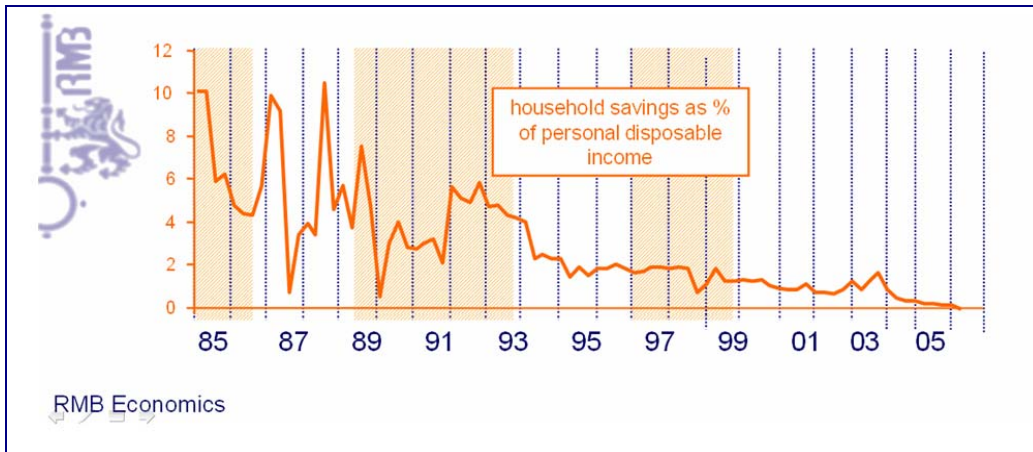


3 Low Savings Rate

The graph below illustrates how critically low household savings has become, to the point of being negative. Apart from the impact on the economy, low savings among consumers will force banks to become more reliant on (expensive) funding in the professional market.

Figure A10.6

Household savings rate



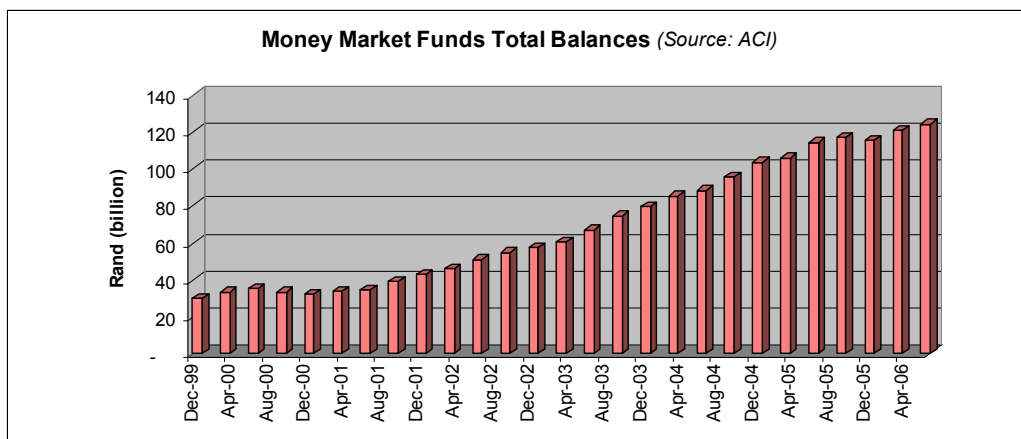
The poor savings culture in South Africa and a propensity to buy on credit has led to advances far outgrowing deposits. This has resulted in the bank having to fund asset growth with funds sourced from the professional market (for example, by issuing FRB paper). This type of

funding is more expensive than retail deposits, and as funding gets more expensive, so interest margins are reduced. This then leads to an increase in the non-interest to net-interest mix. This is a trend set to continue unless the savings and spending behaviour of consumers changes, though it may be curbed somewhat by rising interest rates.

Retail deposit growth tends to be limited to the higher income segments of the economy, but the low interest rate environment is creating a search for higher yielding income products. An analysis of the collective investment (unit trust) industry clearly shows that higher income investors are putting their short term money into such products as money market funds and other income funds (see chart, below). The impact of taxation of interest is clearly felt here too, where wealthier individuals seek tax-free income investments such as high income and high dividend funds.

Figure A10.7

Money market funds



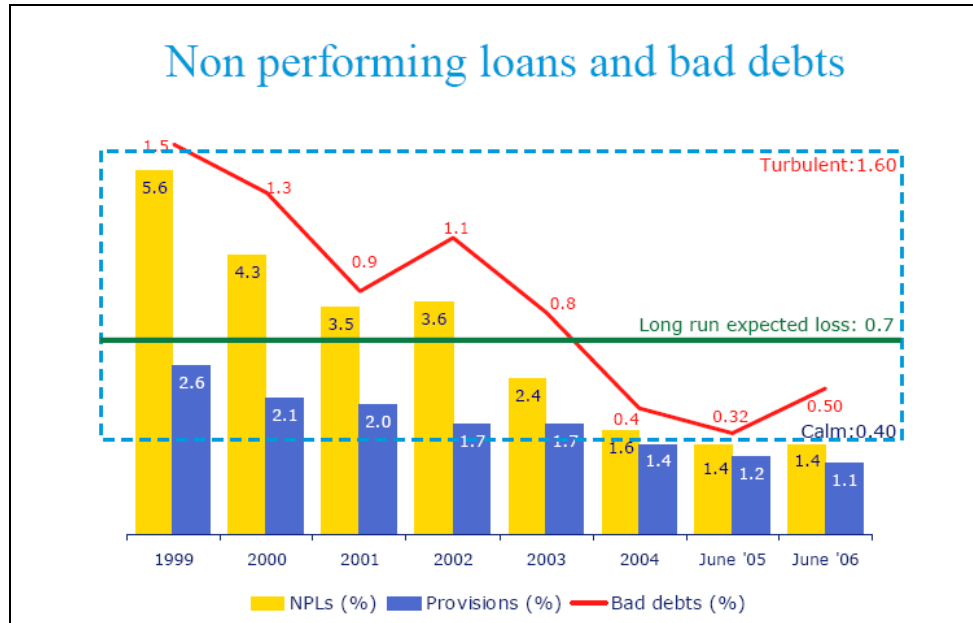
In addition are Government's retail bonds which are similar to banks' fixed deposits, these had attracted R1.4b of deposits by July last year (2005). Competition in the deposit space is leading to a reduction in interest margin for banks which is also set to continue.

4 Bad Debts

The following chart indicates how non performing loans and bad debts are currently below the long run average, which is largely due to the low interest rate environment. However, with rates rising FNB is expecting bad debts to increase which is beginning to occur already.

Figure A10.8

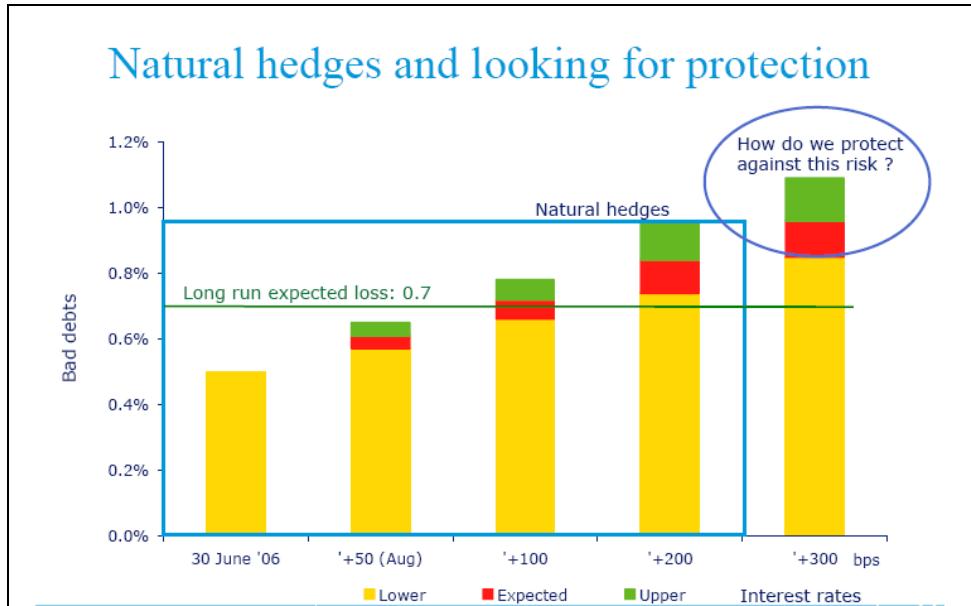
Bad debt analysis



The chart below shows FRB’s view of the expected impact of rising interest rates on bad debts. The “+100” increase was seen in October 2006, and the consensus opinion is currently for an additional 50bp increase in December 2006. Clearing this poses significant challenges for FRB going forward.

Figure A10.9

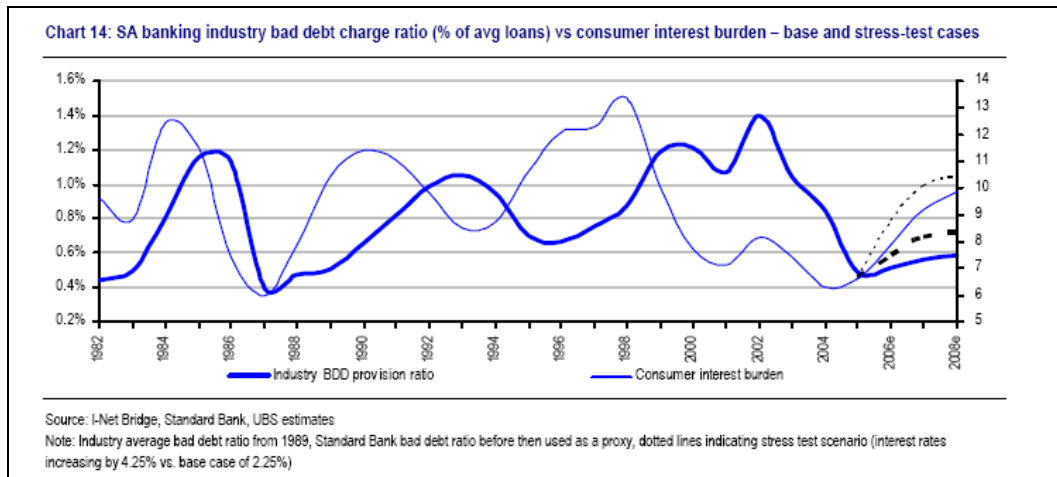
Interest rates and bad debts



UBS Warburg corroborates this view, setting out in the following chart the impact of rising interest rates (“consumer interest burden”) on bad debts, the consumer interest burden and their expectations going forward.

Figure A10.10

Impact of rising interest rates



5 Impact of economic developments on FRB

Banks have seen, overall, a growth in their balance sheets, lower net interest margins due to aggressive competition, and increased non-interest revenue driven by higher volumes of transactions.

This has come at a time when efficiencies such as economies of scale have been realised in the banking industry due to consolidation. Additional volume on a solid infrastructure has allowed banks to benefit from additional volumes, despite steep competition and rising costs.

Future developments in banking may however be more challenging and banking returns will reflect this. It is thus essential to consider banking returns over the entire economic cycle and on a forward looking basis, not just in the recent period.