

Return on Equity (ROE)

ROE is made of two distinct parts, namely: Return-on-Assets (ROA) and Gearing.

ROE	=	ROA	x	Gearing
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Or

<u>Return</u> Equity	=	<u>Return</u> Assets	x	<u>Assets</u> Equity
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We draw attention to the component parts of ROE because gearing has a substantial impact on ROE and because it is a separate management function.

Gearing is of particular importance to banks, because of the uniqueness of their capital structure. Banks obtain funding from many depositors, rather than just from traditional suppliers of capital. Banks earn low margins on their assets, and these margins are leveraged by the existence of depositors.

The level of gearing is limited by regulation in the form of the capital adequacy ratio which dictates the type and amount of capital that must be held in relation to risk-weighted assets. This is done primarily for the protection of depositors. The South African Reserve Bank (SARB) regulations are based on international Basel I principals, and currently require tier 1 and 2 capital to be a minimum of 10% of risk-weighted assets.

The FirstRand Banking Group is capitalised at the higher of economic and regulatory capital (inclusive of an appropriate buffer). Economic capital is the amount of capital which the FirstRand Banking Group holds to give comfort to stakeholders (shareholders, counterparties and depositors, rating agencies and regulators) that it will be able to discharge its obligations in accordance with a high¹ degree of certainty even under stress conditions, and would continue to operate as a going concern entity. Economic capital is broadly based on the advanced approaches of Basel II.

Capital adequacy is done at group level, as well as at each of the operating entities within the Group. The following targets are documented in the approved FirstRand Capital Management Framework:

- FirstRand Bank Limited – 11% to 11.5%
- FirstRand Banking Group – 12% to 12.5%

¹ The “bottom up” statistical economic capital calculation is done at a 99.9% confidence interval.

Basel II, which will be operational in South Africa from 1 January 2008, is a fairly substantial change in the way regulatory capital is calculated. In essence, it requires a far more detailed approach to measuring risk and to calculating risk-weighted assets. The amount of capital that FirstRand Bank considers to be prudent under the Basel II regime of risk-weighted assets works out to be between 8% and 10%. Basel II requires a minimum of 8% but some regulators will apply higher percentages. In South Africa the SARB currently requires 10% under Basel I and is considering requiring a % *higher* than 10% under Basel II. It is important to consider the impact of these capital requirements on ROEs.

Consider the following scenario. A bank has risk-weighted assets of R1000, a minimum capital adequacy ratio of 10% and profits of R25. That bank would carry R100 of capital and would have an ROE of 25% (if all that capital was ordinary equity).

If the capital adequacy requirement were increased by the regulator to 12%, profit would need to increase 20% to R30 to achieve the same ROE.

If the capital adequacy requirement were reduced by the regulator to 8%, profit could reduce by 20% to R20 to achieve the same ROE.

Therefore the high (and potentially higher) capital adequacy ratio in South Africa has a major impact on returns to shareholders, and ultimately to consumers in the prices that the bank sets.

It is also important to note that FirstRand Bank Limited (the South African registered bank) and the Banking Group have made significant strides in terms of its capital management through careful structuring of its capital:

- In October 2004, FirstRand Bank raised R3b in non-redeemable non-cumulative preference shares
- In October 2005, FirstRand Bank raised R1b in subordinated debt followed up with a further R3b in June 2006.
- The BEE share trust loan of R2.1b was transferred from FirstRand Bank to FirstRand Limited in December 2005, providing capital relief to the regulated entity.
- During March 2006, the Banking Group securitised R2b of instalment finance assets originated by Wesbank.

The above capital management initiatives have allowed the bank to optimise returns to shareholders while simultaneously reducing the total cost of banking to consumers.

There are clearly two distinct elements of return to shareholders which comprise Return on Assets (ROA) and gearing. ROA is therefore a measure of profitability which allows us to compare companies with different levels and types of gearing without having to consider the impact of regulators or balance sheet management.

Cost to income ratios are a measure of efficiency which banks use internally, it is generally assumed to represent the level of costs incurred to generate income. Clearly due to differing costs, international comparisons of this measure are not usually appropriate, in section 3.2 we identify some of the specific costs of being a bank in South Africa outlining why this is the case.

The Net Interest Income and Non Interest Revenue (NII:NIR) ratio can also be examined to give an indication of the diversity of revenue. It is important to consider the ratio of these two forms of income both when looking at profitability over time, as the mix changes and when looking at profitability between countries, where the ratio varies.

Annex 8 shows an international comparison of revenues, costs and profits as a proportion of assets. This method of comparison takes out the effect of differing capital adequacies or gearing across different nations.

Section 3.3 of our report highlights the problems of drawing conclusions from profitability analysis. This annex identifies the dangers of focusing on some of the traditionally used measures in the industry, especially when making international comparisons.