



FIRSTRAND

Annex 8 – Measurement of relevant banking metrics

Despite our reservations regarding simple profitability analyses outlined in section 3.3 of the main submission, in this annex FRB provides some alternative measures of returns compared to the calculations done in Falkena to illustrate how sensitive such analysis is and that Falkena's inferences regarding profitability can be overturned on a reasonable re-adjustment of the data. The measures presented in this annex refer to accounting returns on capital, not economic returns which are discussed in the main report.

The annex presents analysis of non interest and net interest revenues for both developed and developing countries, cost ratios, returns on assets, data which shows the sophistication of the financial sector as a whole, a re-assessment of returns on assets across countries and ROEs across South African industry.

When comparisons of cross country profitability were made in the Falkena report, data from the publication: The Banker was used. The Falkena report justified the use of this one unadjusted source on the basis that it would "standardise" the data. However it is in standardisation that problems of comparability arise. We wish to draw attention to the following problems with the data used by Falkena:

- Only the top 1,000 banks are included, by tier one capital, in US dollars. The smallest bank by tier one capital has US\$216 million of tier one capital (and about \$5.4 billion of assets). So these are not small banks. Though this concept impacts all countries, it would have a greater impact on countries whose total tier one capital is smaller or who have many banks.
- The regional summary data included in the 2006 report (pages 189 to 213) uses the average of individual banks' ratios to calculate the pre-tax profits as a percentage of capital of individual countries. Averages, rather than weighted averages (weighted by the size of the bank, by tier one capital) are misleading for the purposes of this type of analysis.

- Banks generally have a mixture of activities which include amongst others: retail banking, investment banking, private banking, wealth management (and advice), asset management, stock-broking and assurance. The Banker data has aimed to include only the banking business where groups engage in bancassurance. However, it is evident from the South African companies included that this approach has not been consistently applied, probably due to the fact that prior to International Financial Reporting Standards, wholly owned subsidiaries did not prepare consolidated annual financial statements. For example, Standard Bank Group is used instead of Standard Bank of South Africa Limited.
- Tier One capital as a base is problematic because, although The Banker will have applied the same formula to calculate tier one capital, different countries have different rules for calculating tier one capital, and will structure their capital accordingly. This ratio is very sensitive to the denominator of Return on Equity.
- Although companies had differing year-ends, a single exchange rate was used to convert currencies to US\$. This would have some impact on the relative sizes of banks and their rankings, particularly those with volatile currencies.
- A further point made by the Falkena report is that relative to non-bank South African firms, banking industry returns are not particularly variable over the economic cycle. Citigroup¹ argue that this may be due to (accounting) smoothing, especially in the provisions line. The introduction of AC133 may cause a marked increase in variability going forward using the Falkena measures of returns.

These criticisms are additional to those made in the main report regarding whether profitability analysis itself can form a valid basis for a finding of anticompetitive behaviour. Despite these reservations we present further information on some relevant banking metrics, which were discussed in annex 7.

1 Net Interest and Non Interest Revenues

There has been a trend by financial institutions to pursue diversity in their income streams. This is evident in the fact that many financial institutions engage in the full spectrum of financial services. While banks may have traditionally engaged in the primary business of borrowing and lending, today, their revenue streams are more heavily weighted toward non-interest revenue.

The move toward Non-Interest Revenue has seen benefits to consumers and more transparent pricing. A more precise allocation of the interest burden is beneficial for economic growth because it means that funds are allocated more efficiently to consumers including businesses.

¹South African Banks. 30 November 2005. CitiGroup Global Markets

This is apparent in South Africa when one looks at the interest rate charged on mortgage loans. The prime rate of interest is the variable rate to which homeloans are linked. The variable rate quoted to customers is then percentage points above or below prime (for example, prime plus 2%). In the past, prime was the rate offered to the bank's best (lowest default risk) customers yet today, these customers are priced close to prime-2.

The move towards non interest revenue also emphasises the need to look at all elements of the pricing structure when making international comparisons.

Citibank Analyst, Henry Hall confirms in his report on banks how interest spreads in South Africa have declined over time. The following two figures illustrate how South African interest rates and lending margins have declined over time.

Figure A8.1

South African interest spreads

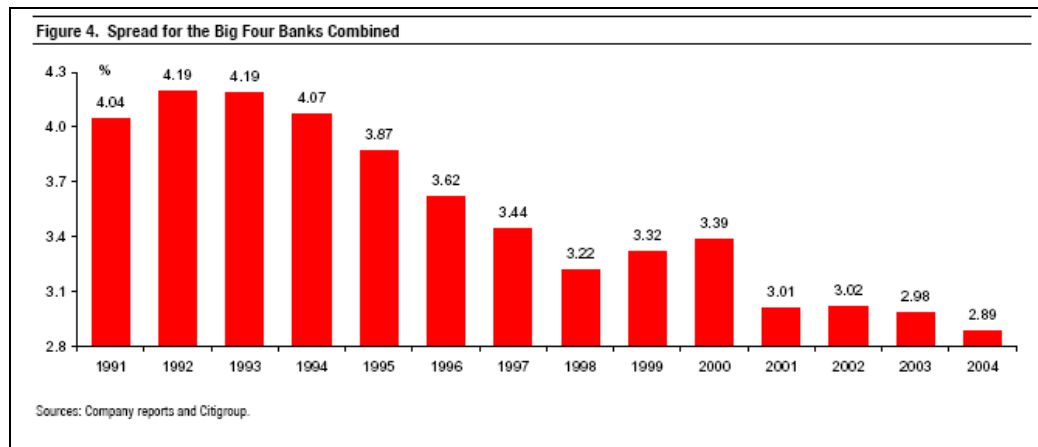
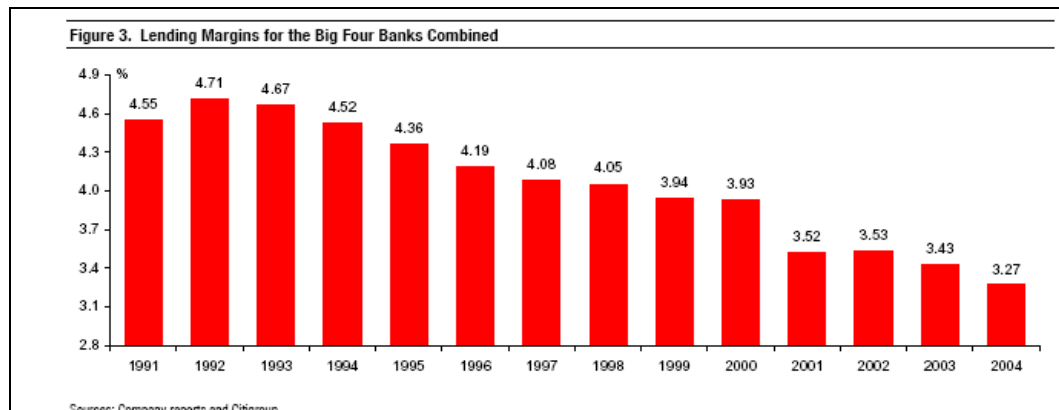


Figure A8.2

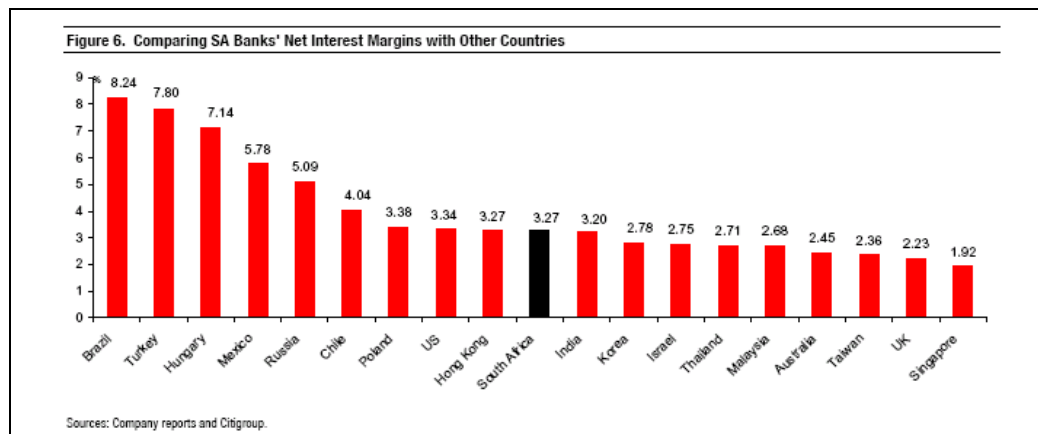
South African lending margins



The figure below illustrates that, in international terms, net interest margins with other countries are low, especially when compared to developing countries, with whom South African might reasonably be compared.

Figure A8.3

International comparison of net interest margins



2 An alternative analysis of returns

The below analysis uses data from actual company results sourced from JP Morgan SaVanT for financial years ended in 2004. The country ratios have been derived by summing the income statement or balance sheet items for the banks within each country to arrive at a country total. Ratios are then calculated using country totals (e.g.: Total revenue earned by banks in the UK divided by total assets of banks in the UK = average Revenue/Assets ratio for UK). We have used FirstRand Banking Group data rather than a South African Average.

The figure below shows FirstRand Banking Group compared to 30 countries both developing and developed. The following figure shows FRB compared to a range of developing countries

Figure A8.4

Non interest and net interest revenues

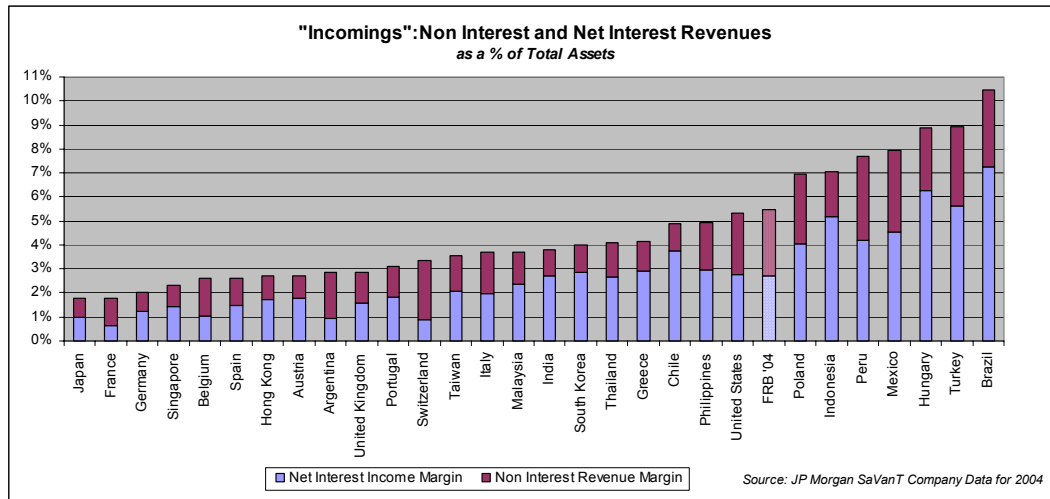
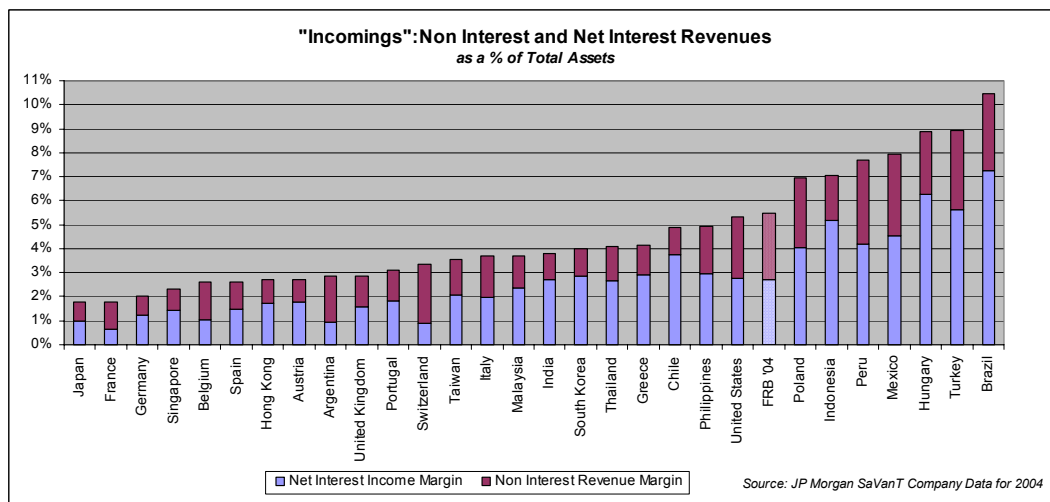


Figure A8.5

Non interest and net interest revenues – developing countries



The analysis shows:

- Total revenue margin (Revenue/Assets) is relatively high against these comparative countries, which include a mix of emerging and developed economy countries. However, against emerging market peers only, the margin is below average.
- Net interest margin is just below the average of all the countries, and substantially lower than that of the emerging markets.

- Non-interest margin appears to be higher than both the all country and developing country averages. This is due to South Africa having a higher ratio of non-interest revenue to total revenue compared to both country sets. Overall, however, total revenue is not high against its peers.

The following two tables show the breakdown of the “Outgoings” compare for FirstRand against other country averages. Outgoings are equivalent to Revenues but are broken down into where those Revenues go (i.e.: to Costs, Provisions for bad debts, Taxes and shareholder profits). Again FRB is shown against a set of 30 countries and then against developing economy countries only.

Figure A8.6

Operating expenses, loan provisions and profits as proportion of total assets

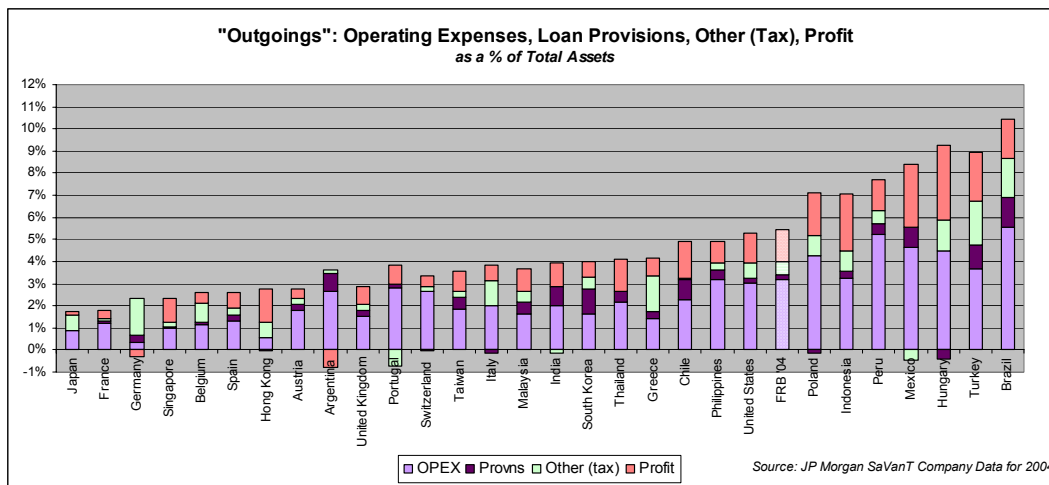
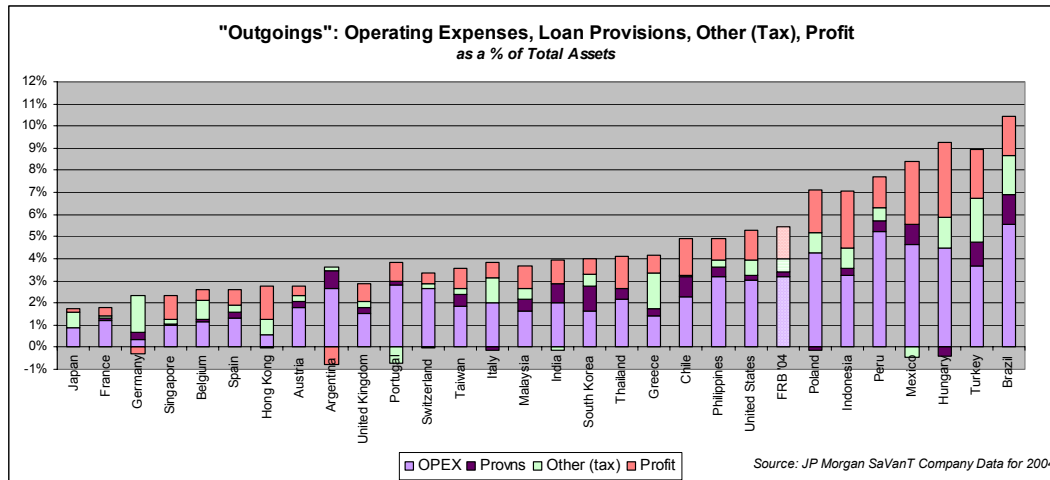


Figure A8.7

Operating expenses, loan provisions and profits as proportion of total assets – developing countries



The analysis shows:

- Operating Expenses (OPEX) is above the average of the all-country data set, but at the average of the developing economy countries. This is to be expected as the impact of servicing a developing economy impacts directly on the costs of running a bank. Examples of this are discussed elsewhere in this report but would include the costs associated with a cash-based economy, a low usage of cheaper electronic channels and a preference for labour-intensive branches, etc.
- The “Other” comprises mainly tax but would also include such items as associate earnings and extraordinary items. This figure is line with both country set’s averages
- Provision for doubtful debts is at the all-country average and below the developing country average. This is due to South Africa being at the bottom of its bad-debt cycle and doubtful debts are expected to increase. The long run expected loss for FRB on bad debts is 0.7%, and was only 0.41% in 2004.
- The Profit figure, which is Reported Net Income after tax, as a percentage of assets (or ROA), is just below the developing country average, and above the all country average. This is to be expected as developing economies, including South Africa require a premium above developed economy returns to accommodate additional country, currency and inflation rate risk.

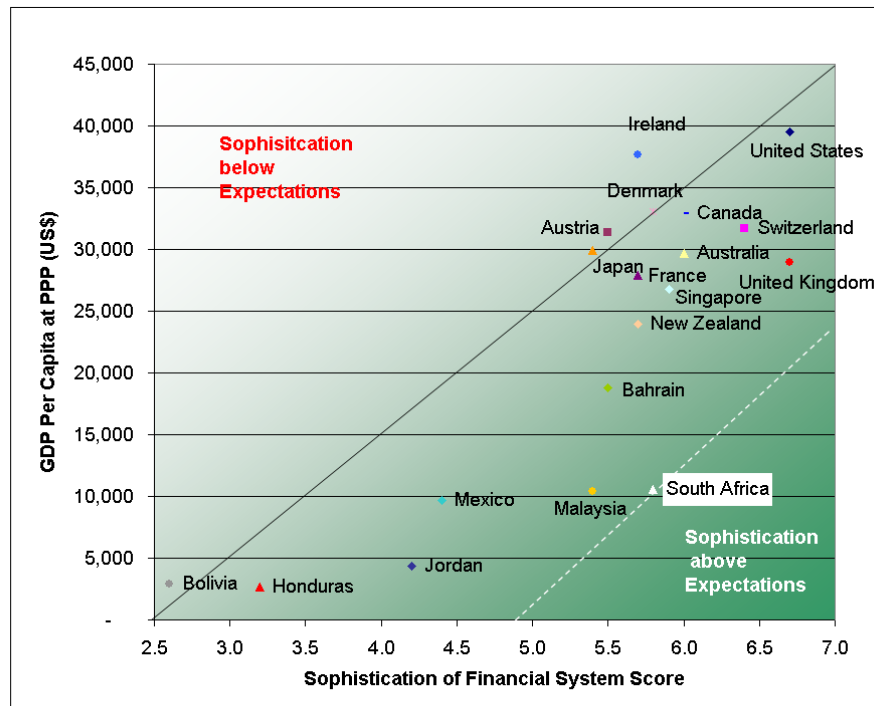
3 Sophistication of the South African Financial Services Environment

We note that in the annual Global Competitiveness Report conducted by the World Economic Forum, the sophistication of banking in South Africa is highly regarded and suggests that the solutions (at a high level) delivered by the banks in South Africa are likely to be superior to many comparable developing countries.

The figure below shows GDP per capita and the sophistication of the financial system; South Africa scores similarly well on the Soundness of Banks score.

Figure A8.8

GDP per capita and sophistication of financial services



South African financial institutions are providing a service which is above that which is expected based on its economic conditions. It is important that the Competition Commission bears this success in mind whilst it considers the effectiveness of competition within the industry.

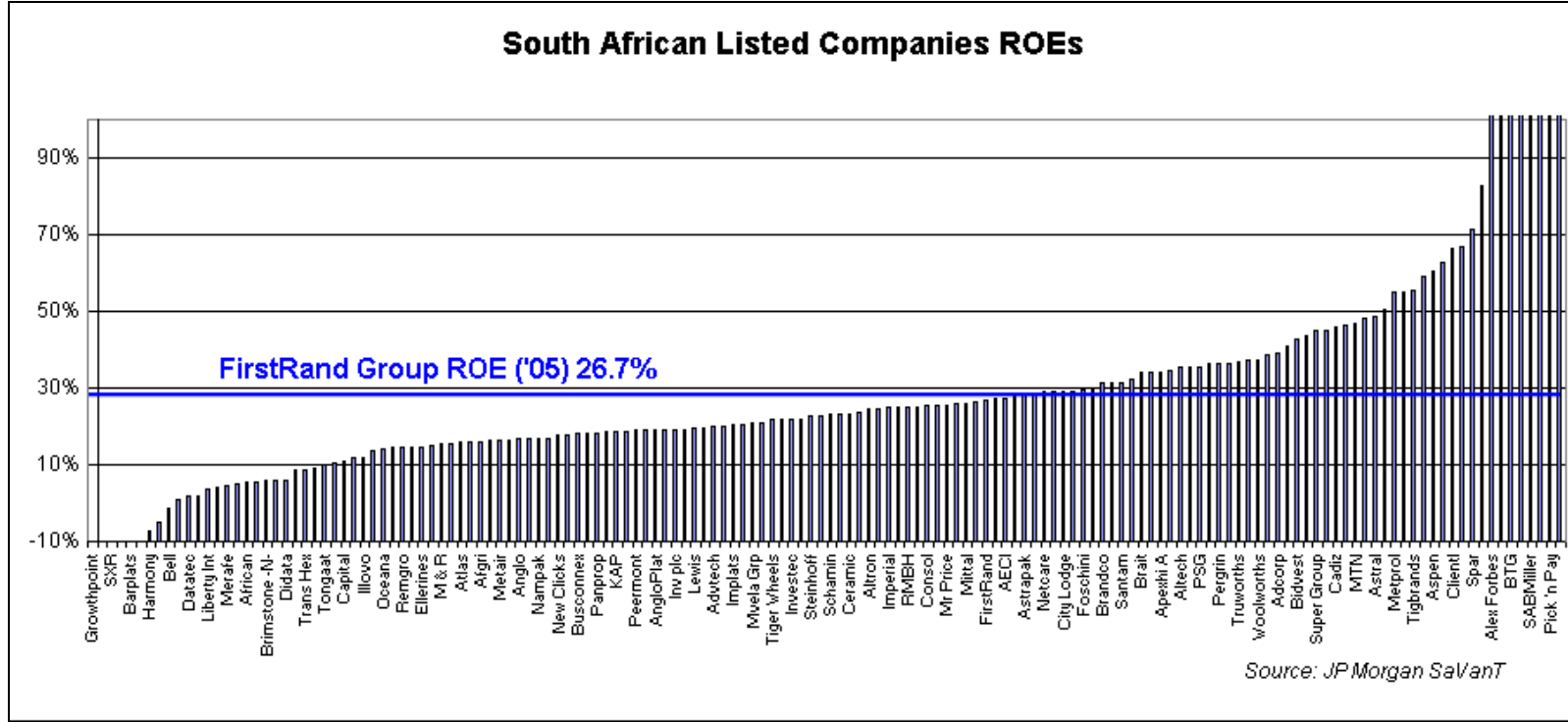
4 Cross Industry Comparisons

Additionally in looking at profitability Falkena carries out a comparison of banks to other industries in South Africa. This analysis needs much further consideration before any useful

conclusions can be drawn. We would expect that different firms and industries would earn different returns regardless of the competitiveness of particular industries due to their differing costs of capital. Without an analysis of FRB's cost of capital there is little more that can be said.

For information we provide the ROAs of South Africa's Top 100 JSE listed shares by market capital. This illustrates the wide level of returns that are in seen in South Africa, emphasising the complexity of the comparison, this very simple analysis shows that the profitability of FirstRand cannot be considered high in the light of South African industry as a whole.

Figure 9: South African Listed Companies' ROEs



5 Conclusion

As outlined in this Annex and in Section 3 of the main report we believe that profitability analysis is complex especially in relation to international comparisons which add further layers of difficulty. It could be argued that the comparisons presented in this annex fall foul of the same issues.

FRB would, however, draw attention to the following findings

- Measures of South African banking profitability and efficiency are not out of line with the relevant comparator group of developing countries
- Net interest margins in South African have fallen almost consistently since 1992 bringing benefits to consumers
- FirstRand profitability does not appear to be out of line with measures of returns across South African industries.
- The diversification ratio is relatively skewed to non-interest, but this does not have a negative impact due to the much lower net interest margin and low overall margin. Furthermore, the National Credit Act will impact the non-interest margin and diversification ratio.