South Africa
Outlook Report

2011 Outlook: South African Banking Sector

Rating Outlook

STABLE

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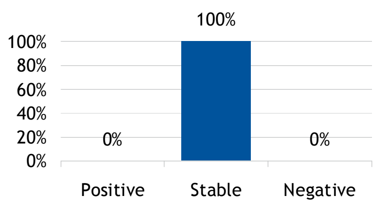
Related Research

Applicable Criteria
- *Global Financial Institutions Rating Criteria (August 2010)*
- *National Ratings Criteria (January 2011)*
- *Short-Term Ratings Criteria for Corporate Finance (November 2010)*

Other Research
- *Global Economic Outlook (October 2010)*

South African Banking Sector Rating Outlooks



Rating Outlook

Stable Outlook for the South African System: Fitch Ratings expects the major South African (SA) banks will continue to deliver acceptable levels of core earnings in 2011. However, earnings growth for these banks in 2011 is expected to be constrained by ongoing elevated impairment charges, weaker revenue streams and muted loan growth. Basel III is unlikely to have an immediate impact on financial performance, although higher capital and liquidity requirements could in the medium term lead to pressure on margins and lower return on equity.

Economic Environment Expected to Improve: Overall levels of economic activity should begin to improve in 2011 driven by a low interest rate environment and spending by key state-owned infrastructure companies. However, these improvements could be negatively affected by reduced export demand from certain European markets. Fitch expects South Africa to report GDP growth of 3.4% in 2011.

Low Growth/Low Interest Rate Challenges: In the context of relatively subdued levels of economic activity, the agency expects the major SA banks will increasingly focus their attention on managing operating costs while revenues remain under pressure.

Credit Growth to be Muted: While there is evidence that loan growth may have returned, slow deleveraging in the consumer sector means loan growth in 2011 will be low. The agency expects overall levels of consumer indebtedness to remain relatively high in 2011.

Asset Quality Indicators Should Stabilise: On balance, Fitch expects the major SA banks' asset quality indicators to stabilise in 2011, with certain banks expecting slight improvements. These gains will largely be achieved on the back of improving retail asset quality and further write-offs. The agency expects SA's wholesale sector should remain resilient in 2011; however, certain industries could be negatively affected by the strengthening of the local currency.

Funding Expected to be Sound in South Africa: Stable inter-bank and wholesale funding markets are expected for 2011, assisted by foreign-exchange controls. This provides a closed rand system, with low levels of reliance on foreign funding to support domestic banking activities.

Acceptable Levels of Capitalisation: In anticipation of regulatory reform, Fitch expects the major SA banks to continue to improve overall levels of capitalisation through the retention of earnings, while low levels of credit growth will constrain the growth in risk-weighted assets. The sector is well placed for Basel III.

What Could Change the Outlook

The outlook for the South African banking sector could turn negative if there is a significant deterioration in the domestic operating environment that leads to weakened financial performance, asset quality and levels of capitalisation.

Key Issues

SA Major Banks' Ratings Table

	Ratings							
	Short-Term	Long-Term FC	Long-Term LC	Individual	Support	Support Rating Floor	National Long-Term	National Short-Term
Absa Group Ltd	F1	A	A	C	1		AAA(zaf)	F1+(zaf)
Absa Bank Ltd	F1	A	A	C	1		AAA(zaf)	F1+(zaf)
FirstRand Bank Ltd	F2	BBB+	BBB+	C	2	BBB-	AA(zaf)	F1+(zaf)
Investec Limited	F3	BBB		C	5	NF		
Investec Bank Limited	F3	BBB		C	2	BBB-	A+(zaf)	F1(zaf)
Nedbank Group Ltd	F2	BBB	BBB	C	2		AA-(zaf)	F1+(zaf)
Nedbank Limited	F2	BBB	BBB	C	2		AA-(zaf)	F1+(zaf)
Standard Bank Group Ltd				C	5			F1+(zaf)
The Standard Bank of SA Ltd	F2	BBB+	BBB+	C	2	BBB-	AA(zaf)	F1+(zaf)

Source: Fitch

Outlook: Fitch expects the SA banking sector's recovery in earnings in 2011 to remain tepid while the global and domestic banking environment remains challenging. The South Africa Reserve Bank (SARB) is forecasting GDP growth of 3.4% for 2011 and 3.6% for 2012. In the context of this, Fitch expects overall levels of credit growth to remain low on the back of weak credit demand from retail and wholesale customers.

Although the SA corporate sector has remained relatively resilient with very few significant defaults to date, the tough operating environment and strengthening of the rand (ZAR) will continue to place additional pressure on counterparties in certain industries. Simultaneously, the ongoing process of deleveraging SA consumers will take time which, together with weak property markets, could mean that retail impairments may remain elevated.

Capital Adequacy: Fitch considers the major SA banks to be conservatively capitalised and with core Tier 1 and Tier 1 capital ratios that comfortably comply with the Basel III requirements. Fitch does not expect that the enhancements to the Basel II framework and Basel III amendments will materially affect the core Tier 1 capital ratios of the major SA banks.

However, overall levels of capitalisation need to be viewed in the context of relatively high loan/value ratios (LTVs) for home loan portfolios and low coverage ratios on defaulted home loans. Fitch estimates that the core Tier 1 capital ratios of SA's major banks could decline by 120bp-180bp if the coverage ratio for their defaulted residential mortgage portfolios increased to 50% from a current estimated average of 20%.

Financial Performance: Despite the difficult operating environment, the well-established franchises of the big four SA banks supported an acceptable level of core earnings. However, their financial performance indicators were negatively affected by significantly higher retail impairment charges, tighter interest margins and higher operating costs. Fitch considered that the high level of non-interest income served to diversify the income sources, and supported a core level of earnings.

Asset Quality: Fitch expects asset quality indicators to remain high while economic activity remains subdued. NPLs are also expected to remain at elevated levels while defaulted consumer loans remain in the debt counselling process. A significant deterioration in the major SA banks' asset quality indicators occurred during the downturn. This was mainly on account of rapid deterioration in retail asset quality, with residential mortgage delinquencies rising rapidly. Fitch notes that most major SA banks' home loan portfolios have relatively high LTVs, with several of them having significant components of their home loan portfolios at LTVs of above 90%.

Funding: Although SA banks are significantly reliant on wholesale deposits and money market funding sources to fund their operations, SA's foreign-exchange controls ensured that funding from these sources remains fairly stable. This is due in part to SA's low savings rate, with close to 50% of total deposits having a contractual maturity of less than one month.

Liquidity: In the context of relatively high loans/deposits ratios, Fitch considers overall levels of liquidity to be moderate.

Fitch expects the major SA banks will be unable to meet the current Basel III liquidity requirements. This is on account of the relative small size of SA's capital markets and the limited number of qualifying liquid assets, which may mean that SA's major banks may need to hold higher amounts of government securities. At the same time, SA banks do not benefit from a deposit insurance scheme and therefore banks are unable to classify retail deposits into a stable funding category.

Fitch also notes that SA banks receive a significant component of their funding from professional money managers, with regulations precluding investments for more than 12 months, while the average maturity cannot exceed 90 days at any point. This accentuates the liquidity mismatch with a significant component of these funds being used to finance long-term assets such as home loans. In the context of the above, Fitch anticipates structural reform of SA's funding markets.

- Sophisticated and well developed banking system operating in an emerging market environment
- SA banks held up well during the global credit crisis with no single institution requiring state support
- Sector dominated by "big four" banks
- South Africa appears to be the preferred base to expand regionally

2010 Review

Competitive Environment

At end-December 2009 the four large domestic banks controlled a high 84.2% of the country's total banking assets. SA's fifth-largest bank, Investec Bank Limited ('BBB'/Stable) represented 6.4% of the country's banking assets. This results in high barriers to entry for foreign and other smaller banks. Competition between institutions is intense, with each bank's strategy driven by a combination of organic growth within the domestic market and further development of their pan-African franchises.

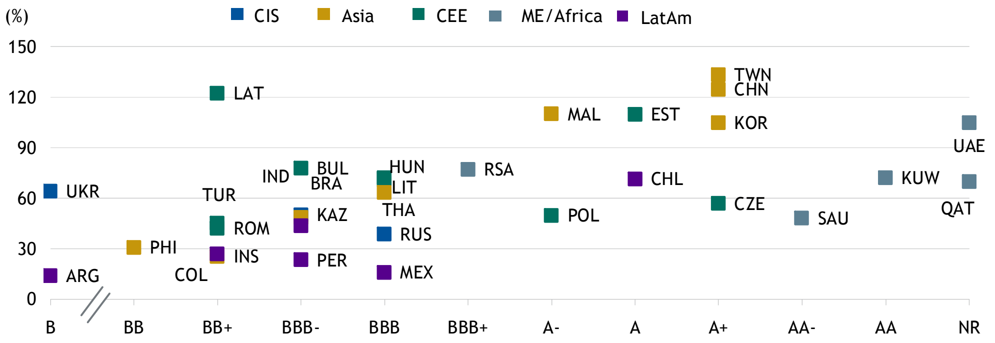
Penetration rates in SA's banking sector are moderate to high and this is evidenced in a loans/GDP ratio of 77.0% at end-H110, which compares well with other emerging markets (see Chart 1). The abbreviations for the countries in Chart 1 are included in Annex 1. However, the banking sector continues to be faced with a sizeable unbanked adult population in SA. The 2010 Finscope South Africa Survey results suggest that the unbanked adult population of SA has reduced to 32% in 2010 from 54% in 2004. Most of this improvement has been brought about by the introduction by the banking sector of a low-cost savings account called Mzanzi during 2004. Although SA's unbanked population represents a growth opportunity, further penetration into this market is likely to be constrained by the country's high levels of unemployment and weaker levels of economic activity. Fitch expects that SA's smaller banks, such as African Bank and Capitec, may experience higher levels of competition as the SA's major banks begin to target entry-level customers.

Over the years, all the major SA banks have grown and established international franchises. With the exception of the Standard Bank Group Limited (Standard, 'F1+(zaf)'), the international franchises of the SA banks do not represent a significant component of their balance sheets — for example, Nedbank Group Limited's (Nedbank, 'BBB') stands at 8.7% of total assets and Absa's at 2.3%. Standard's international operations represented 27% of its total assets at end-December 2009, with 73% of these assets represented by assets outside Africa.

More recently, the major SA banks have increasingly focused on countries in Africa outside SA. This is largely in response to renewed interest in the continent as financial institutions begin to follow their SA wholesale customers north of the border, but it is also as a result of increasing trade with China and India. For the moment, Standard has a head start, with operations in 15 African countries. Although Absa has operations in Mozambique and Tanzania, its parent, Barclays has operations in nine other African countries. Absa intends to establish a presence in three new markets — Angola, Namibia and Nigeria — while rolling out Absa's investment banking and insurance products to Barclays customers in markets where Barclays already has a presence. Nedbank has operations in five African countries, and in 2009 the bank continued to develop its alliance with Ecobank Transnational Incorporated of Togo, which allows Nedbank customers to a combined Nedbank-Ecobank network of 33 countries in west, central, east and southern Africa. FirstRand Limited, the parent company for FirstRand Bank Limited (FirstRand Bank, 'BBB+') has operations in six African countries.

International banks are increasingly viewing SA as the preferred base for expanding into Africa. In light of this, the agency considers that is highly likely that the major SA banks will remain acquisition targets for international banks — HSBC Holdings PLC's (HSBC, 'AA') recent moves for Nedbank is evidence of this. However, a key acquisition hurdle will be government and regulatory approval.

Chart 1: Loans/GDP Ratios and Sovereign Ratings



Sovereign ratings indicated are long-term foreign currency IDRs at 15 Nov 10. End-H110 loan data except IND (30 Sep 10). 2010F GDP for all markets
Sources: National banks and bank regulators, Fitch calculations and estimates

- SA's major banks at fairly conservative levels of leverage
- Overall levels of Tier 1 capital for the sector continued to improve in 2008 and 2009 in anticipation of regulatory reform
- Additional capital requirements for Basel III not material for SA banks
- Appropriate capital adjustments for high LTV and low coverage ratios on defaulted home loans

Over the years, a feature of the SA banking sector has been a strong linkage between SA's large insurance companies and the country's major banks. However, these entities appear to be becoming less integrated. For example, FirstRand Limited is in the process of unbundling Momentum Group Limited (Momentum, 'AA-(zaf)')and merging its subsidiary with another local insurer, Metropolitan Life Limited (Metropolitan, 'AA-(zaf)'); also, Old Mutual Plc (Old Mutual, 'BBB+', 'RWP') recently announced its intention to dispose of Nedbank to HSBC (although the transaction was not completed) and Sanlam Limited (Sanlam, 'AA-(zaf)') disposed of its stake in Absa to Barclays in 2005. The trend appears in line with international developments brought about by the global credit crisis, with international banks increasingly moving away from the bancassurance model in an attempt to reduce potential risks of contagion.

Capital Adequacy

At end-June 2010, the major SA banks' Tier 1 ratios ranged from 11.5% to 13.1% compared to a minimum regulatory requirement of 7%. Consequently, leverage ratios for the SA banks are fairly conservative, with the SARB reporting a sector financial leverage ratio of 15.38x at end-June 2010 (December 2009: 15.67x). The SA banks implemented Basel II in January 2008 with the SARB allowing most of the major banks to apply the advanced internal ratings-based approach in assessing credit risk. According to the SARB, banks that used the IRB approach for calculating the minimum capital requirements for credit risk represented 84.3% of the banking sector's gross loans and advances at end-December 2009(December 2008: 84.4%).

Low growth means SA banks should continue to accumulate capital in the medium term. The sector is well positioned when it comes to Basel III.

Table 1: Capital Adequacy

	Absa		FirstRand Bank		Nedbank		Standard		South Africa
Year-end (%)	Jun 10	Dec 09	Jun 10	Dec 09	Jun 10	Dec 09	Jun 10	Dec 09	Current reg.
Core Tier 1	11.90	11.50	11.24	n.a	9.90	9.90	11.00	11.00	5.25
Tier 1	13.10	12.70	12.24	10.95	11.50	11.50	11.80	11.90	7.0
Total	**15.80**	**15.60**	**14.44**	**13.15**	**14.80**	**14.90**	**14.60**	**15.10**	**9.5**[a]

[a] Excludes Pillar 2b add-on

n.a - not available
Source: Fitch, banks

Profitability Outlook

As in 2010, Fitch expects an improvement in profitability in 2011 with lower impairment charges being the primary driver. As a result of the low credit growth and low interest rates, revenue growth will be muted with a big focus on managing costs. Those banking groups with sizeable international operations will also be affected by the strengthening ZAR.

Impairment charges to average gross loans for the four major banks ranged from 1.24% to 1.45% in 2010. Impairment charges for the sector have started to decline from a 2009 peak that represented nearly 50% of pre-impairment operating profit during 2009. Most of these impairment charges arose from distressed SA consumers following record levels of indebtedness and a challenging operating environment. Fitch notes that a significant component of the retail impairment charges arose from defaulted home loans.

The rapid decline in interest rates has caused interest margins for most of the major banks to contract. This was largely on account of repricing mismatches and the negative endowment impact of lower interest rates on capital. At the same time, the global credit crisis and consequential impact on liquidity caused interest spreads on wholesale funding to move out.

Non-interest income represents a high percentage of SA banks' total revenues and in most of the major banks it represented more than 45% of total revenues. In spite of the global credit crisis, the non-interest income for the sector held up fairly well despite certain of the SA's major banks being negatively affected by write-downs of private equity and associate investments and losses arising from equity trading positions.

Table 2: Peer Group Performance

	Absa		FirstRand Bank		Nedbank		Standard	
Year-end (%)	Jun 10	Dec 09	Jun 10	Dec 09	Jun 10	Dec 09	Jun 10	Dec 09
Assets (ZARm)	718,204	717,740	582,353	560,822	590,847	570,703	1,315,044	1,339,800
Equity (ZARm)	59,297	56,490	34,447	33,387	42,010	41,498	98,503	93,866
ROAA	1.15	1.00	1.02	1.01	0.80	0.96	1.05	0.86
ROAE	14.32	13.85	17.71	17.75	11.18	13.82	14.50	12.95
Cost/income	55.30	52.05	62.53	59.75	56.90	55.09	63.02	60.27
Net int. margin	3.41	3.13	2.25	2.32	3.03	3.12	2.28	2.44
Non-int inc/tot. inc	46.24	47.79	64.78	64.26	43.24	42.01	58.54	54.97
Impairment charges/average gross loans	1.45	1.69	1.28	1.58	1.44	1.52	1.24	1.89
Impairment charges/pre-impairment op. profit	40.27	51.50	41.38	45.53	52.85	52.14	28.8	42.06

Source: Fitch, Banks

- Significantly slower credit growth during 2009 with certain major SA banks' loan books contracting
- Home loans originated with high LTVs
- New macro-prudential limit of 25% of liabilities could lead to increased exposure to foreign assets

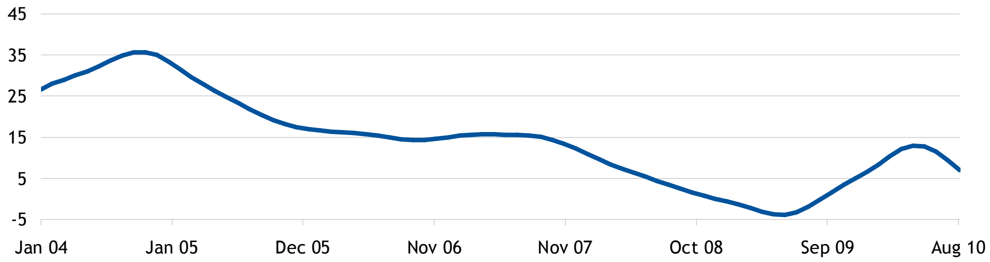
Credit Risk

While there is evidence of loan growth having returned, slow deleveraging in the consumer sector means growth in 2011 will be low. Retail loans represent approximately 50% of SA major banks' loan books at end-2009 with home loans a significant component of total retail loans. According to the SARB, home loans, lease and instalment debtors and commercial property mortgages represented 40.1%, 12.1% and 11.1% respectively of SA banking sector loans (excluding inter-bank placements) at end-2009. Wholesale and loans to small and medium-sized businesses make up the remainder. Foreign-currency loans represented approximately 5.5% of banking sector assets.

A feature of SA's major banks' home loan portfolios is the relatively high LTVs. Home loans approved at 90% to 100% and in excess of 100% LTVs are not uncommon. For example, 43% of Standard's personal and business banking home loans had LTVs in excess of 90% at end-2009. This compares with 20% of Absa's home loan portfolio having LTVs in excess of 90%, while Nedbank had 55% of its mortgages originated at LTVs in the range of 81%-100% and 10.6% of mortgages with LTVs in excess of 100%. Although the growth in property prices has slowed since 2005 (see Chart 2), with a slight decline of approximately 5% in 2009, property indicators are now starting to show signs of a recovery.

Chart 2: Absa House Price Index

Houses of 80m² to 400m², up to ZAR3.1m



Source: SARB Financial Stability Review

Given the concentrated exposure to SA consumers, concentrations to single obligors are considered to be low, with the largest 20 non-bank exposures ranging from 8% to 14% of the major SA banks' gross loans. However, concentrations to certain wholesale sectors exist, with mining being a key example.

- Rapid deterioration in asset quality indicators to end-2009 a function of distressed SA consumers
- Defaulted home loans the most significant contributor of weakened asset quality
- Wholesale sector delinquencies remain low although default risk remains high
- Restructuring of home loans prevalent

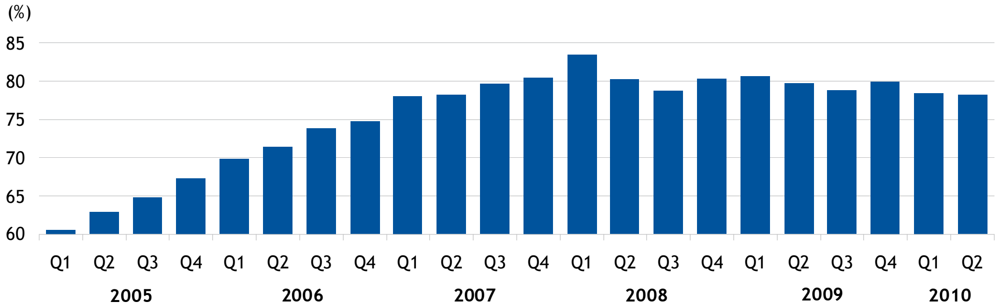
Asset Quality: Stabilised But NPLs Expected to Stay at Elevated Levels

NPLs in the system appear to have peaked. The decline from current levels is likely to be gradual due to the high level of consumer indebtedness. In contrast, the wholesale sector remained fairly resilient, with low levels of delinquencies. The major SA banks reported coverage ratios of between 36% and 41% at end-2009, which Fitch considers to be low. This is largely on account of an average coverage ratio of 20% for defaulted home loans.

During this recession, most of the major SA banks resorted to the restructuring of retail loans as a credit management tool. This arose particularly in response to the rapid inflow of non-performing loans but also as a result of the National Credit Act which permits defaulted consumers the opportunity to enter a debt counselling process. During the debt counselling process, banks are prevented from realising collateral until such time as a loan is restructured or there is a court decision. In some respects, this has weakened the enforceability rights of the banks. As a result, most of the major SA banks have begun to pro-actively restructure the arrears balances of consumers before they become a default (ie, at 90 days). The agency notes that pre-NPL restructuring was most prevalent at Absa and Standard during 2008 and 2009, with home loans being the single largest category. During 2009, Standard and Absa restructured 3.9% and 3.2% of their gross loans respectively, with a significant component of these restructures represented by pre-NPLs.

In June 2007, SA implemented the National Credit Act (NCA). The purposes of the Act included: the promotion of responsible credit granting and use; the regulation of credit information; the prohibition of certain unfair credit and credit-marketing practices; and the provision of debt re-organisation in cases of over-indebtedness. Fitch considers the implementation of the NCA to have been a key risk mitigant, which caused the rapid rate of consumer credit growth to slow at the height of the economic cycle. Although Fitch notes that the SA banking sector has experienced significant weakening in asset quality since 2007, the agency considers the introduction of the NCA prevented asset quality indicators from deteriorating to even weaker levels (see *Asset Quality*).

Chart 3: Ratio of Household Debt to Disposable Income



Source: SARB Financial Stability Review

Table 3: Asset Quality Measures

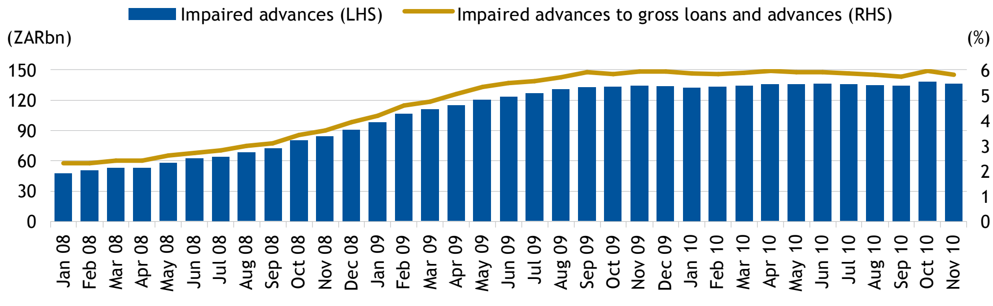
	Absa		FirstRand Bank		Nedbank		Standard	
Year-end (%)	Jun 10	Dec 09	Jun 10	Jun 09	Jun 10	Dec 09	Jun 10	Dec 09
Gross impaired loans/gross loans	7.56	6.98	4.95	5.68	6.15	6.03	7.54	7.39
Impairment reserves/ gross impaired loans	36.84	36.46	39.49	40.49	38.74	36.23	40.10	40.91
Specific reserves to impaired home loans	19.2	20.5	19.7	17.8	22.4	18.8	19.1[a]	18.1[a]

[a] Ratios for mortgage loans
Source: Fitch, banks

Fitch estimates that certain of the major SA banks had approximately 20% of their NPLs in debt counselling at end-2009.

- Relatively high loan to deposit ratios indicative of moderate levels of liquidity
- SA's banking sector is structurally reliant on wholesale funding
- The SARB intends to consult with the National Treasury and Financial Services Board on the impact of Basel III liquidity proposals

Chart 4: Impaired Advances



Source: BSD: Selected South African banking sector trends

Funding

SA banks are structurally reliant on wholesale and money market funding sources to fund their operations. According to the SARB, retail deposits represented 22.3% of customer deposits at end-2009, with the remainder sourced from the wholesale sector. The main components of wholesale funding were corporate customer and inter-bank deposits, which represented 42.5% and 13.7% of sector deposits respectively at end-2009.

The increasing reliance on wholesale deposits was largely a function of SA's low saving ratio during a period of relatively strong levels of credit growth (2005–2008) but also as a consequence of the growing emergence of the country's professional money market funds which continued to attract more of SA's "lazy" cheaper retail deposits by offering more attractive returns. A significant number of the sector's funding sources are also at relatively short tenors, with close to 50% of total deposits having a contractual maturity of less than one month. SA's major banks lengthen the tenor of their funding by issuing negotiable certificates of deposit and floating rate notes.

SA banks are not overly dependent on foreign sources of funding and deposits with foreign-currency deposits and foreign-currency funding representing 4.3% of banking sector liabilities at end-2009 (end-2008: 5.1%).

Liquidity

The loan to deposit ratios for SA's major banks vary, with certain banks reporting loan to deposit ratios close to 100%, while other banks' ratios are higher than this. This is largely a function of whether certain wholesale funding instruments, such as negotiable certificates of deposit or floating-rate notes have been separately disclosed and excluded from their deposit bases. Fitch notes that the loan to deposit ratios for FirstRand Bank, Nedbank and Standard could have been higher, if their wholesale funding instruments had been excluded from their deposit bases.

In the context of relatively high loan to deposit ratios, Fitch considers overall levels of liquidity to be moderate. Fitch considers this is due in part to SA's low savings rate, but also as a result of structural wholesale funding issues that affect the market (see *Funding*).

Table 4: Loan-to-Deposit Ratios

	Absa		FirstRand Bank		Nedbank		Standard	
Year-end (%)	**Dec 09**	**Dec 08**	**Jun 10**	**Jun 09**	**Dec 09**	**Dec 08**	**Dec 09**	**Dec 08**
Loan to deposit ratios	147.3	141.5	133.6	132.3	113.1	99.7	93.2	94.0

Source: Fitch, banks

Annex 1

The countries covered in Chart 1 are as follows (the codes used in the charts are shown here in brackets):

- Asia: China (CHN), India (IND), Indonesia (INS), Malaysia (MAL), Philippines (PHI), South Korea (KOR), Taiwan (TWN), Thailand (THA);
- CEE: Bulgaria (BUL), Czech Republic (CZE), Estonia (EST), Hungary (HUN), Latvia (LAT), Lithuania (LIT), Poland (POL), Romania (ROM), Turkey (TUR);
- CIS: Kazakhstan (KAZ), Russia (RUS), Ukraine (UKR);
- LatAm: Argentina (ARG) Brazil (BRA), Chile (CHL), Colombia (COL), Mexico (MEX), Peru (PER);
- Middle East/Africa: Kuwait (KUW), Qatar (QAT), Saudi Arabia (SAU), South Africa (RSA), United Arab Emirates (UAE).