

Sector focus - banking

Prepared by Dr Roelof Botha – 4 February 2011

1 Composition & growth of banking assets

Figure 1 illustrates the composition of assets of South African banks, with mortgage advances and overdrafts being the most prominent.

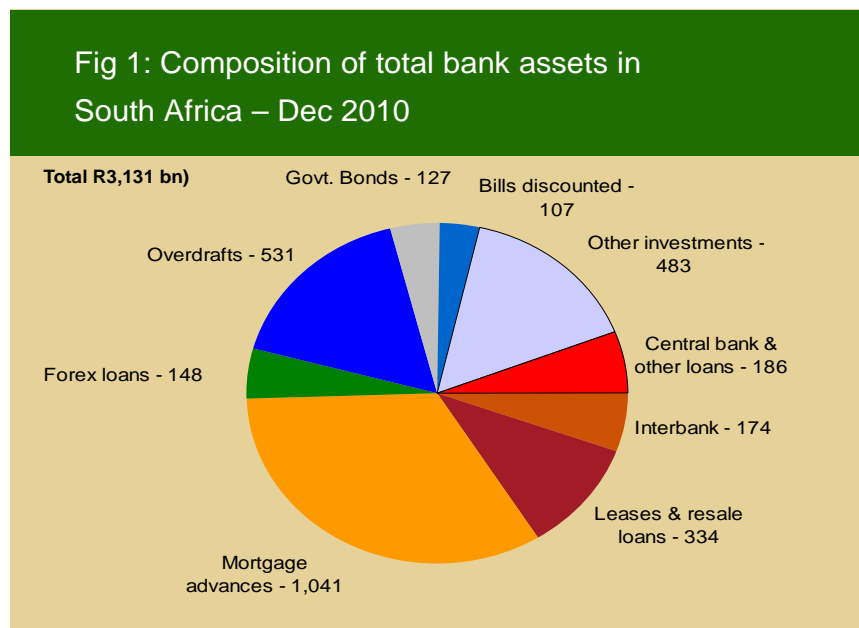


Table 1 depicts the average annual growth rates in the value of South African banking sector assets (in nominal terms), confirming the highly impressive expansion of financial sector activity in the country over the past decade.

Due to the fact that a significant proportion of the South African population does not yet participate in the formal banking sector, combined with sustained increases in real disposable income levels, it is anticipated that the high growth trend in banking sector activity will continue well into the future.

Table 1: Average annual nominal growth in SA bank asset groups (2000 to 2010)	
	%
Loans under resale agreements	28.5
Bills discounted	17.8
Other investments	17.1
Mortgage advances	16.9
Credit card debtors	16.6
Total	14.3
Central bank deposits	13.9
Interbank & intra-group funding	13.3
Government stock	12.7
Instalment debtors & leases	11.4
Overdrafts & loans	10.4
Forex loans	10.2

Figures 2 and 3 illustrate the strong growth (in nominal terms, on an indexed basis) of the four largest classes of assets of South African banks since 2000. The negative effect of the global recession in 2009 can clearly be seen, but a welcome recovery in banking sector activity has since ensued.

Fig 2: Nominal growth in the two largest asset classes of SA banks

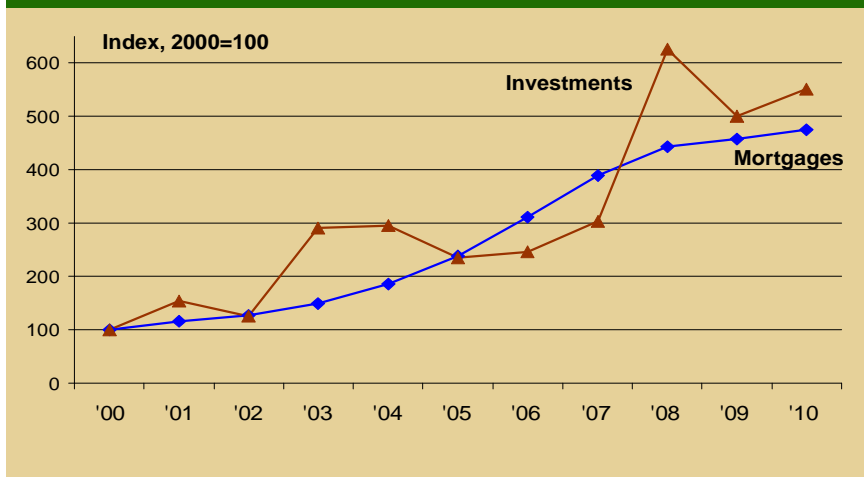


Fig 3: Nominal growth in the 3rd & 4th largest asset classes of SA banks

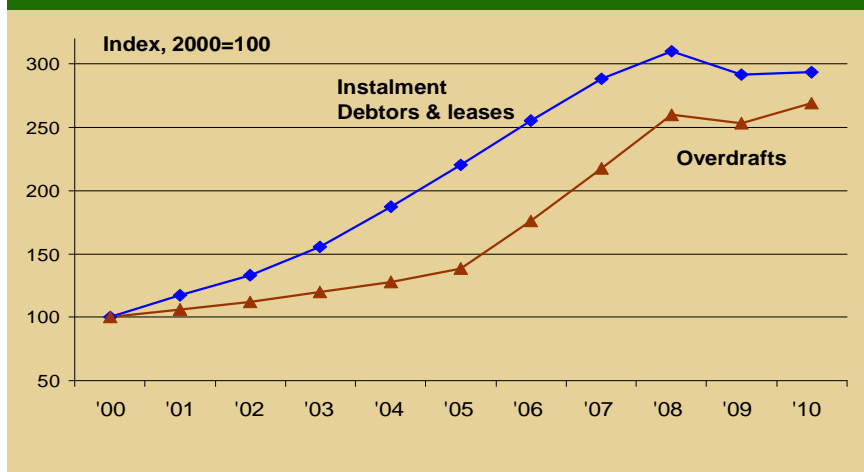
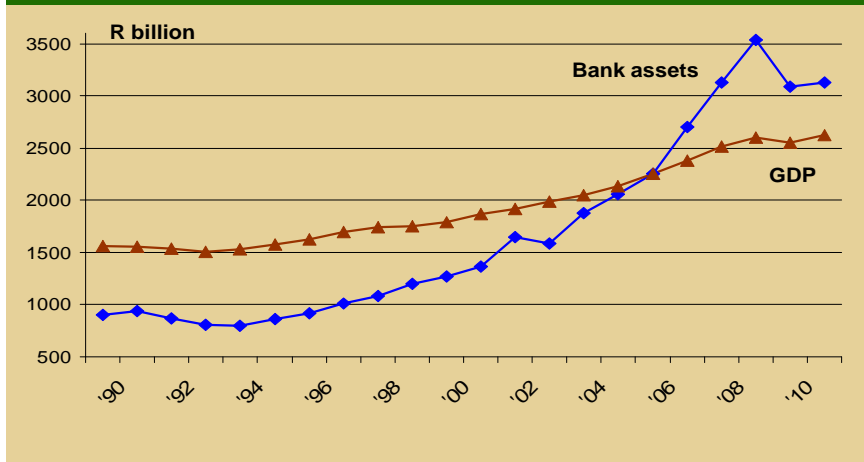


Figure 4 compares the growth performance over the past 20 years of the total South African economy with that of total bank assets. Both sets of values have been adjusted for inflation and are expressed in terms of 2010 prices.

The superior performance of the banking sector over this period is quite clear. Explanations for this trend include South Africa's transition to democracy, which led to a re-adjustment of international trade activity to a structurally higher level as well as the combination of net formal sector employment growth and higher levels of real disposable income *per capita* of households.

Fig 4: Total bank assets & GDP (South Africa) at constant 2010 prices



2 New record low for interest rates

South Africa's monetary authorities have continued to follow the most accommodating monetary policy in almost four decades by a further 50 basis points lowering of the official repurchase rate (repo rate) in November 2010. The repo rate is currently 5.5%, which is the lowest level in 37 years. This translates into a prime overdraft rate of 9%.

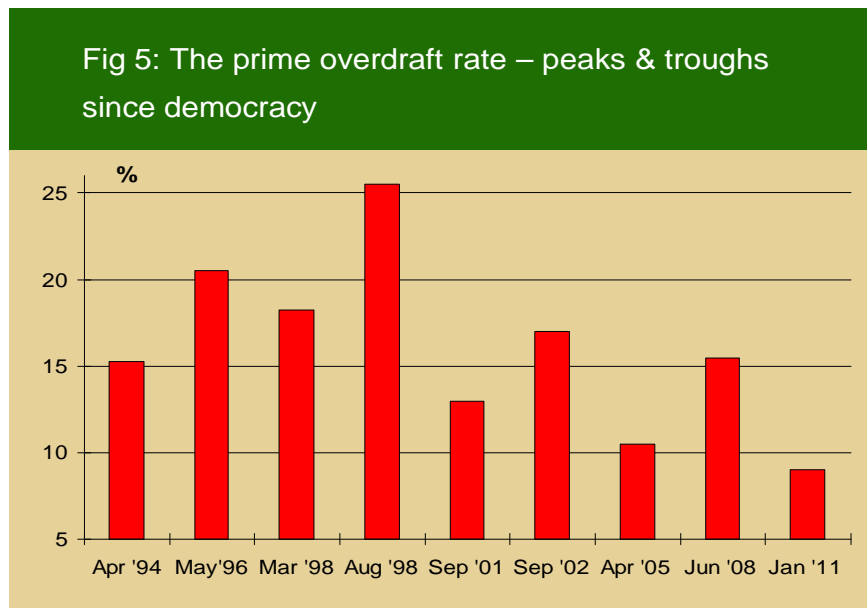
The decision by the Reserve Bank to lower the repo rate to a new record low towards the end of 2010 caught some analysts by surprise, particularly against the background of a relatively swift and strong economic recovery.

An element of justification for the return to a single-digit prime rate may nevertheless be found in the fact that, by international standards, South Africa's money market interest rate remains relatively high in real terms, as illustrated by table 2.

	%
Brazil	4.8
Australia	2.2
South Africa	1.9
Japan	0.1
South Korea	-0.7
China	-0.9
US	-0.9
Russia	-1.0
Euro-zone	-1.2
India	-1.2
Egypt	-1.9
Singapore	-3.4

The second argument supporting the surprising degree of monetary accommodation over the past year is the continued strength of the local currency, which gained more than 40% in real terms against a basket of South Africa's 15 major trading partners (between November 2008 and December 2010).

Figure 5 illustrates a long term downward trend for peaks & troughs in the prime overdraft rate, indicative of structurally lower inflation and a concomitant easier monetary policy stance.



3 Slow recovery of credit extension

Justification for the most accommodating monetary policy in South Africa in almost four decades may also be found in the lethargy of money supply growth and private sector credit extension over the past two years.

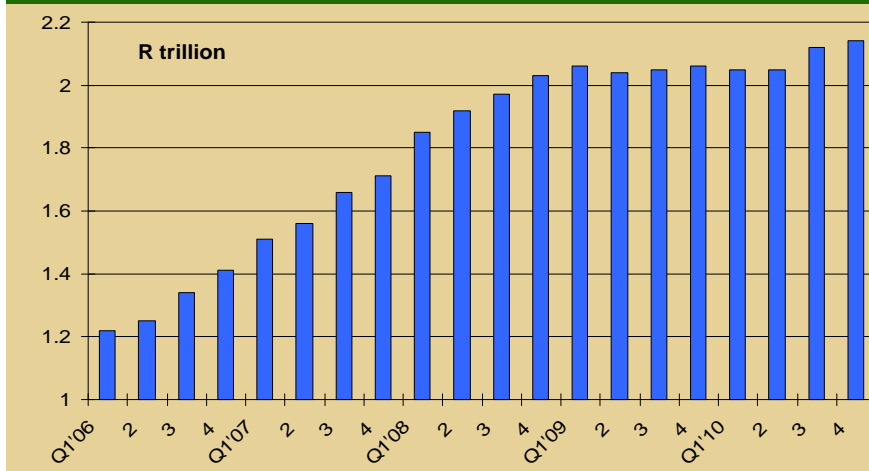
The South African Reserve Bank (SARB) has even expressed its concern at the slow rate of recovery of the economy in a recent policy statement, specifically singling out the “strict lending criteria” applied by banks as a constraint to growth in household consumption expenditure.

Although a welcome return to positive growth in credit extension by the banking sector was made in the second quarter of 2010, the rate of expansion remains rather muted, as illustrated by figure 6.

Slower growth in credit extension by banks started in 2007 and continued decelerating until it reached negative territory in 2009. The stagnation in loan activity by financial institutions was consistent with a fairly dramatic decline in money supply growth during 2009.

The so-called “M3” (the broadly defined money supply) recorded single-digit or negative growth during the whole of 2009 and during the first quarter of 2010. It has now rebounded quite strongly, recording a healthy positive growth rate of 12.9% in the third quarter of 2010.

Fig 6: Total credit extension by all financial institutions



Annualised growth in total loans and advances by banks started to stabilise in the beginning of 2010, after recording an all-time low of minus 2% in November 2009. Significantly, however, the largest category of banks' loans and advances, namely mortgage advances, retained a modest positive growth rate throughout the troubled 2009.

All of the types of bank loans recorded positive growth during the third quarter of 2010. General advances led the rally with an increase of R26.1 billion, followed by mortgage advances which increased by R18.4 billion (over the second quarter).

The main reasons for the lethargy in the demand for credit over the past two years were initially related to the following:

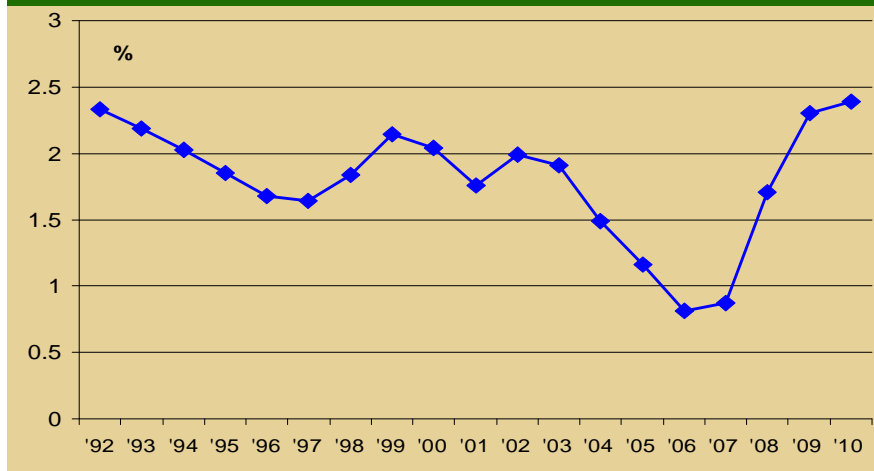
- Negative domestic output growth
- Lower levels of international trade (as a result of the global recession)
- Relatively high interest rates
- Stricter lending criteria by the banks
- A relatively high level of household and corporate indebtedness
- An increase in unemployment

Predictably, this set of abnormal circumstances has led to an increase in credit impairments, as illustrated by figure 7. At a ratio of less than 2.5% of total assets, this is nevertheless regarded as quite low by international standards.

The stubbornness of credit extension to respond to the return to positive real GDP, which occurred as early as the third quarter of 2009, clearly defied the anticipated reverse causalities inherent in several of the above factors, particularly with regard to lower interest rates and a recovery of international trading activity.

According to the SA Reserve bank, the continuation of dampened money market activity was related, *inter alia*, to a low inflationary environment, relatively low returns on M3 deposits and impaired balance sheets in both the corporate and household sectors.

Fig 7: SA banks - ratio of credit impairments to total assets



4 New growth phase for banking sector

Fortunately, the consolidated balance sheet of the country's banks has started a new phase of expansion, mainly as a result of five successive quarters of positive real GDP growth, strong growth in the leading business cycle indicator, a lower interest rate environment and rising levels of income and expenditure by households and the corporate sector.

During the second half of 2010, the equity market also witnessed higher levels of activity, with its value of market capitalisation growing at healthy rates, reflecting the impact of lower bond yields, lower money market rates, higher profit expectations and indications of progress with reducing government's budget deficit.

Banks should be buoyed by the evidence of a sustained and relatively strong economic recovery in South Africa. The International Monetary Fund is forecasting real GDP growth of between 3% and 4% for 2011, a level that should be maintained into 2012.

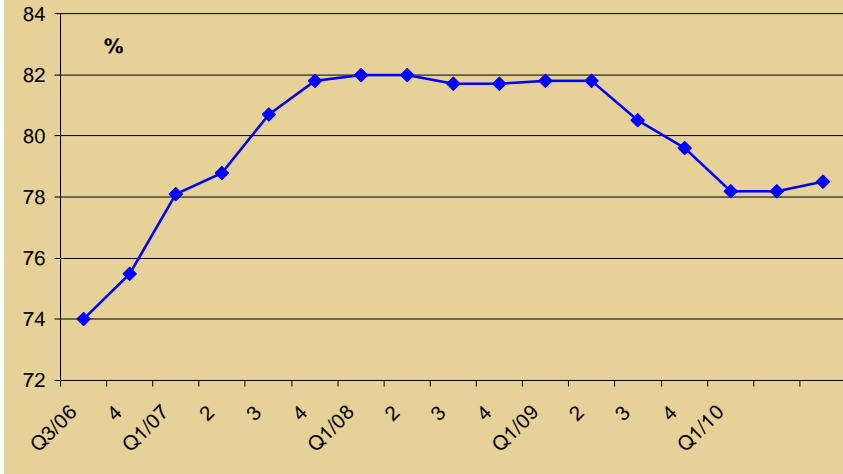
Furthermore, it should be noted that growth in the key banking asset category for mortgage advances has recovered well during the second half of 2010.

After declining to annualised growth rates of below 4% during 2009 and the first half of 2010, the value of outstanding mortgages grew at a rate of 4.7% (annualised) in each of the four months of September to November 2010.

Banks will also be heartened by the fact that the market for new vehicles recovered quite strongly during last year. The number of new vehicles sold remains below the peak recorded in 2007, but recovered well during 2010. The fourth quarter 2010 figure was already 43% higher than the low of the third quarter of 2009.

Another positive development is a clear indication that household debt levels have become less of a concern over the past two years, with the level of debt in relation to disposable income having first declined and then stabilised (see figure 8).

Fig 8: Ratio of household debt to disposable income



The return of formal sector employment creation, combined with a lower interest rate environment, provides ample justification for a modest increase in this ratio over the medium term.

A final and highly significant reason for optimism over the future prospects of banking activity in South Africa is the sound recovery and impressive growth trend line of real disposable income levels, as illustrated by figure 9. These values are expressed in terms of 2010 prices and confirm South Africa’s status as an upper-middle income country.

Fig 9: New record high for real disposable income per capita of households (at constant 2010 prices)

