

Bank credit risk: Making sense of the current credit cycle and outlook

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- Features of the current credit cycle: Three analogies
- FRBG credit experience to date
- Credit outlook: Clouds and silver linings

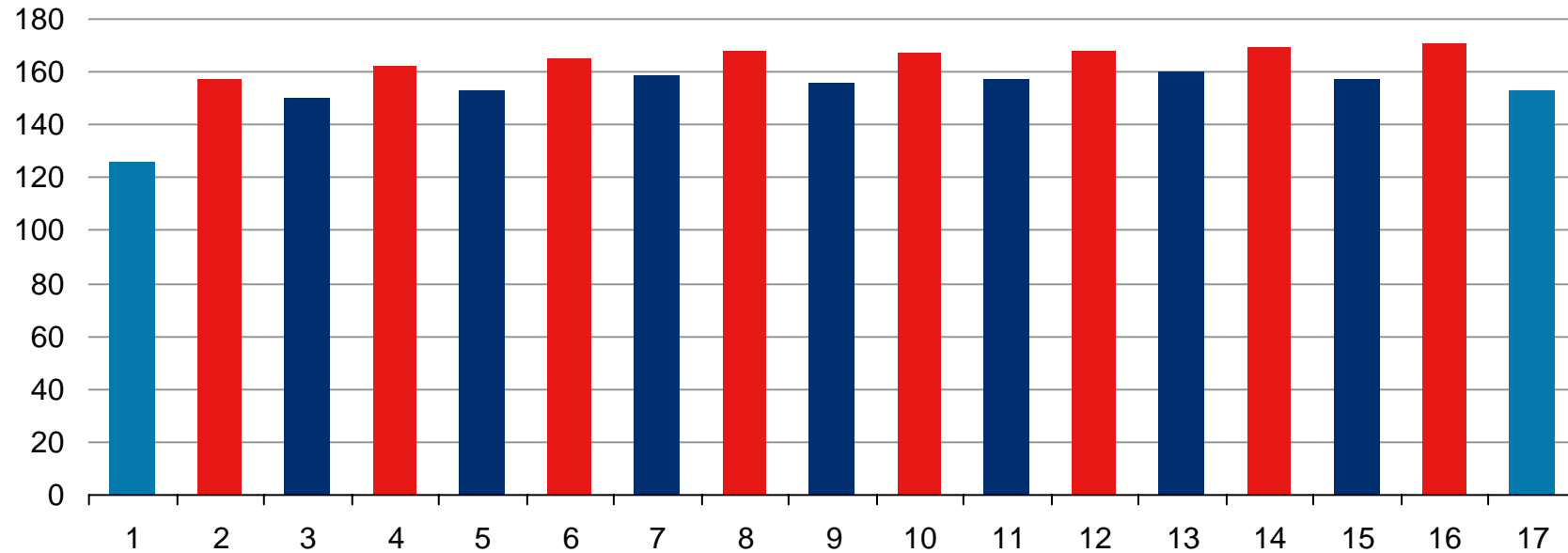
Features of the SA retail credit cycle: Three analogies


Example 1: Strip sets training


Each successive set increases heart rate at a quicker rate of change

Average heart rate (AHR)

bpm



 AHR during warm-up and cool down

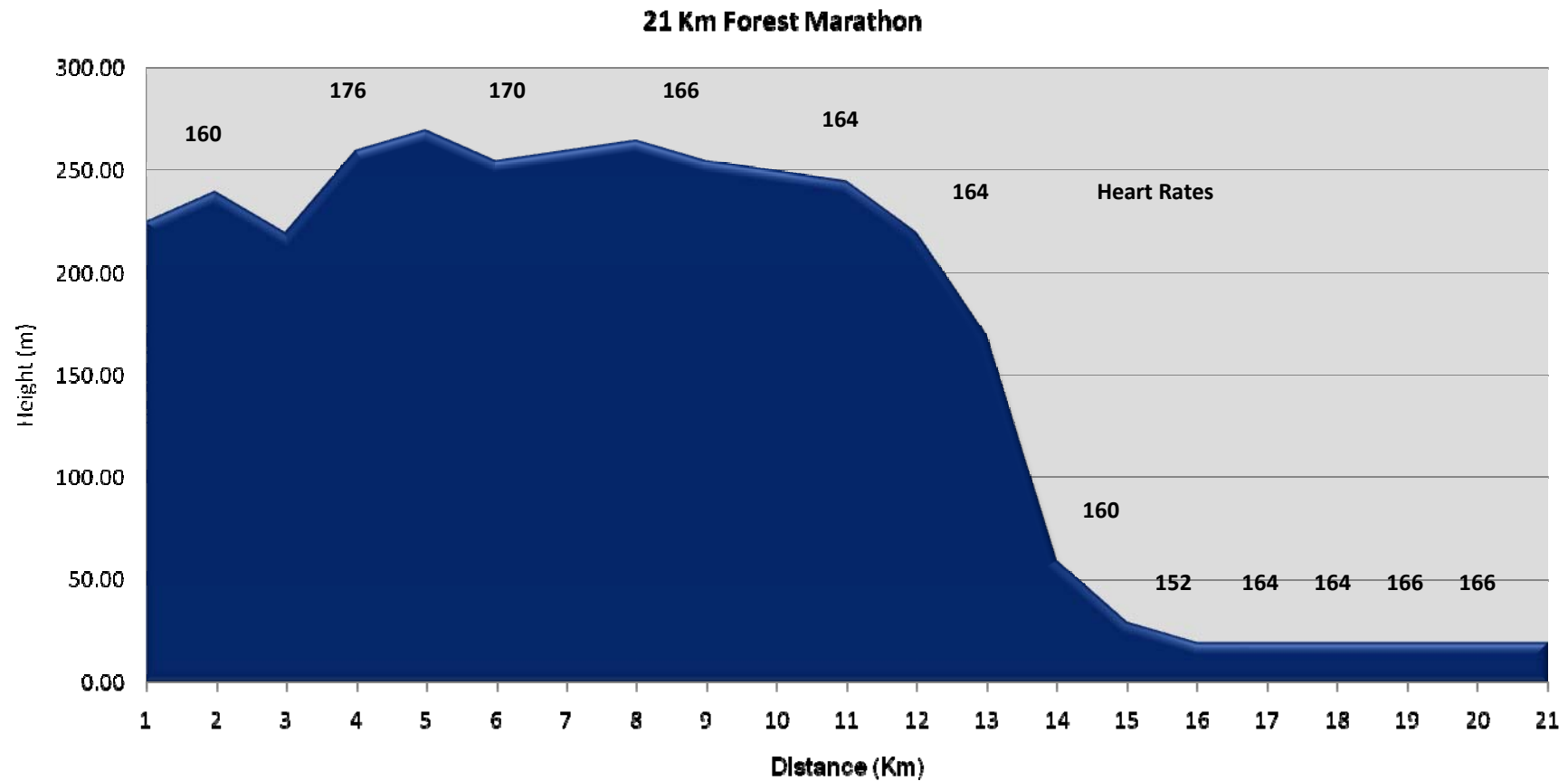
 AHR sprinting up hill

 AHR jogging down hill slowly

Example 2: Descent at the end of a race

The timing of the descent matters – the longer out it is the less immediate is the benefit in terms of decreased heart rate

Example: Knysna half marathon



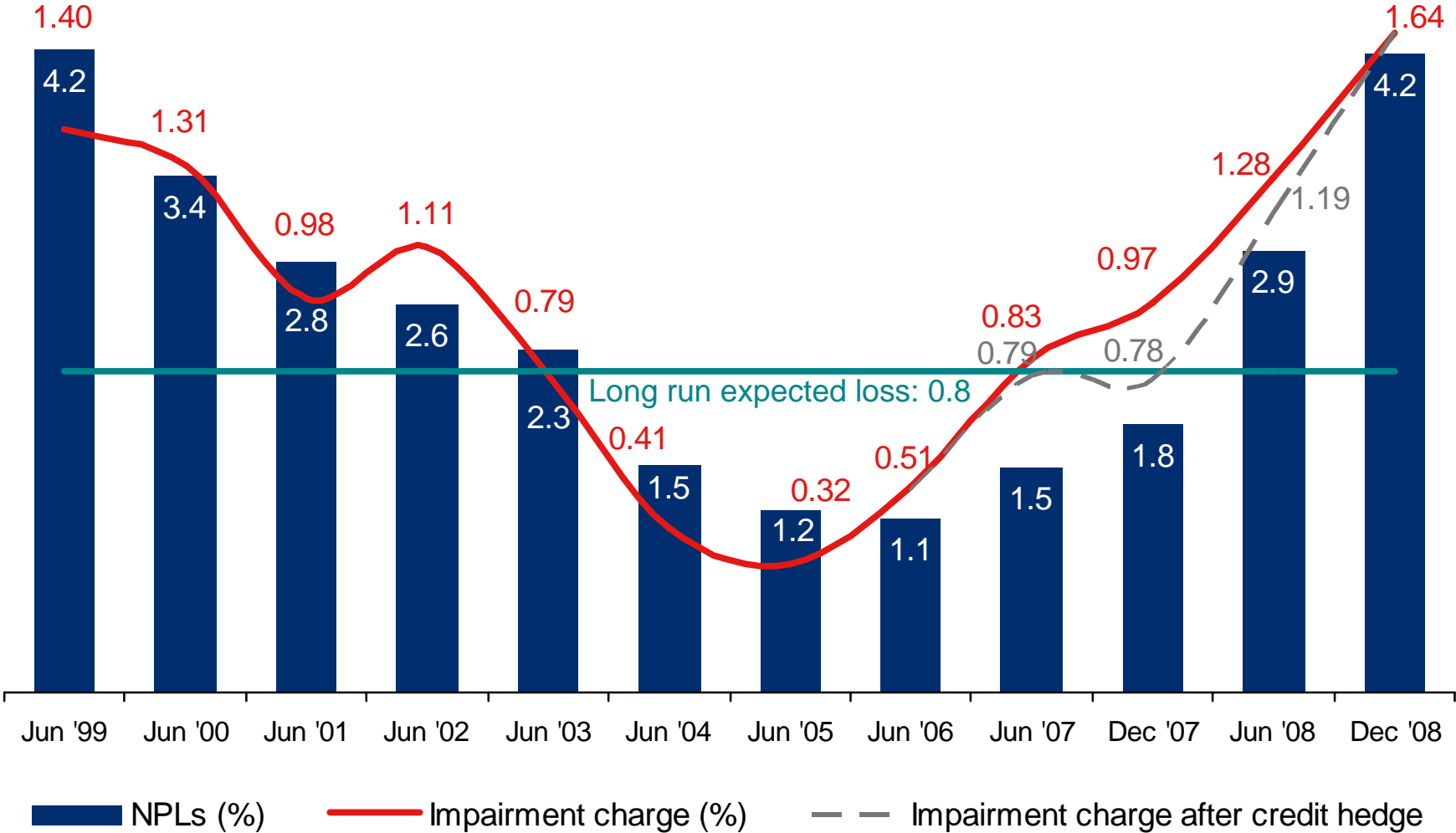
Example 3: Tandem bicycle going up a hill

Partner turning from help to dead weight

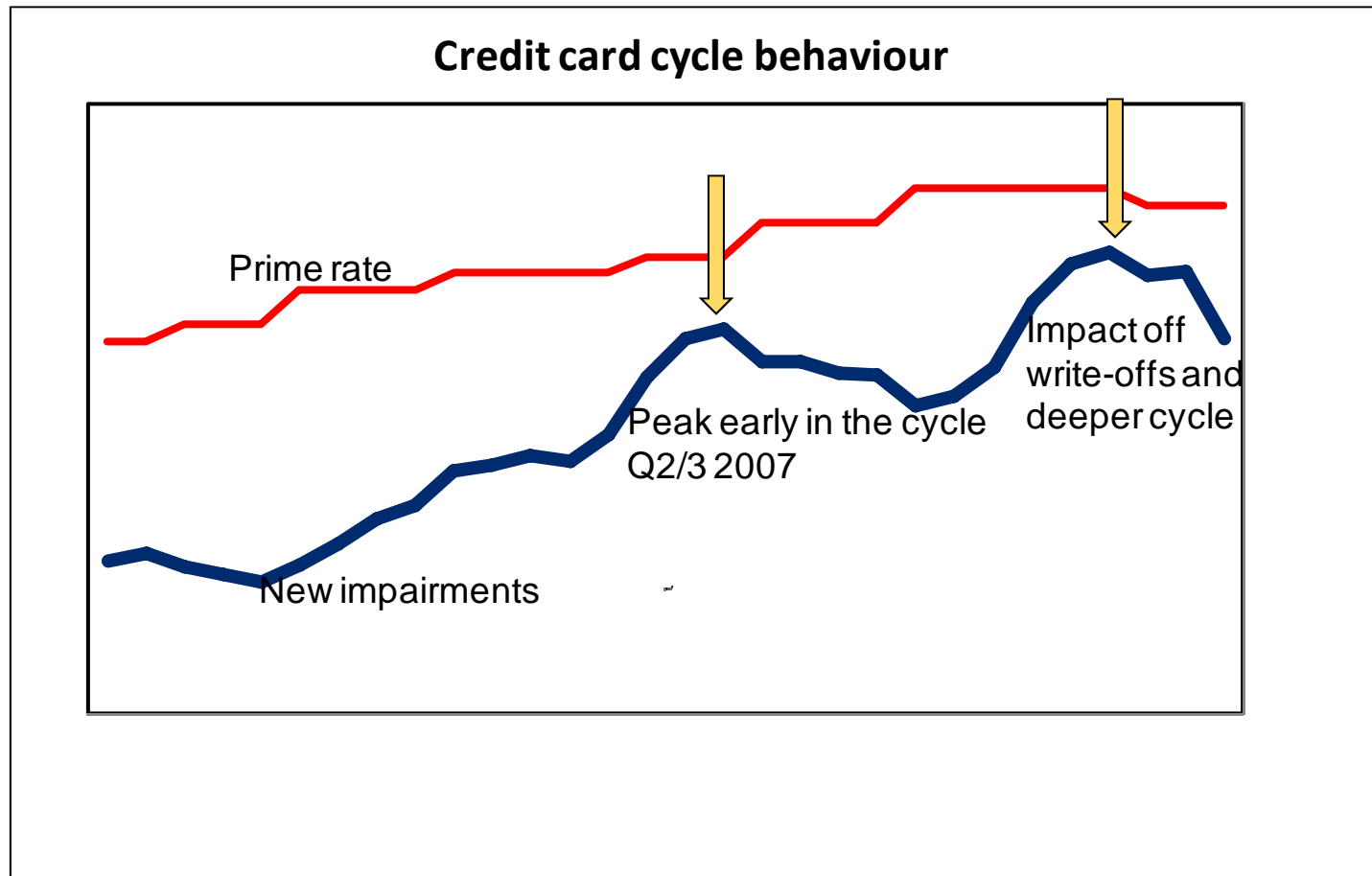


FRBG credit experience in the cycle: Reaction of different parts of the portfolio

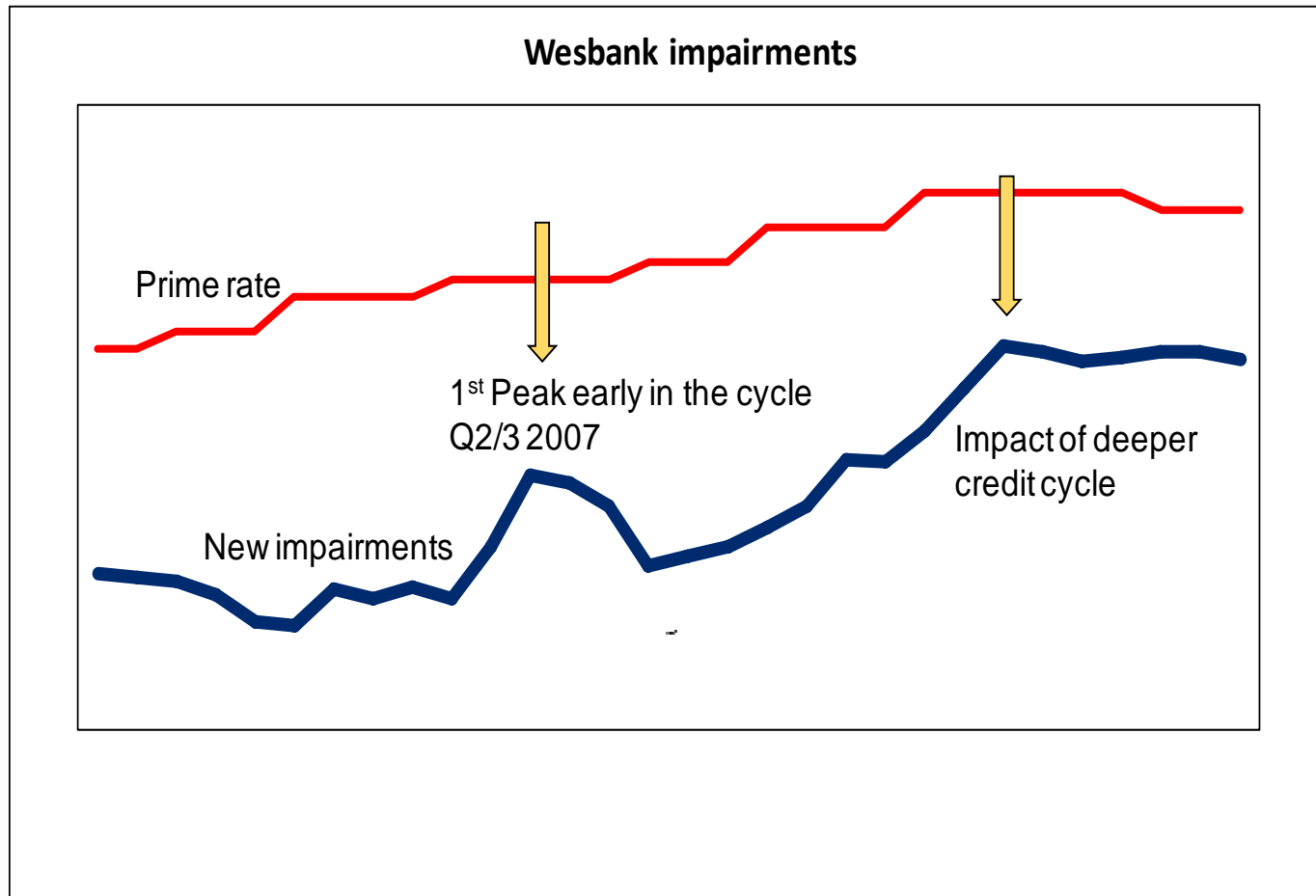
NPLs and bad debts continue upward trend



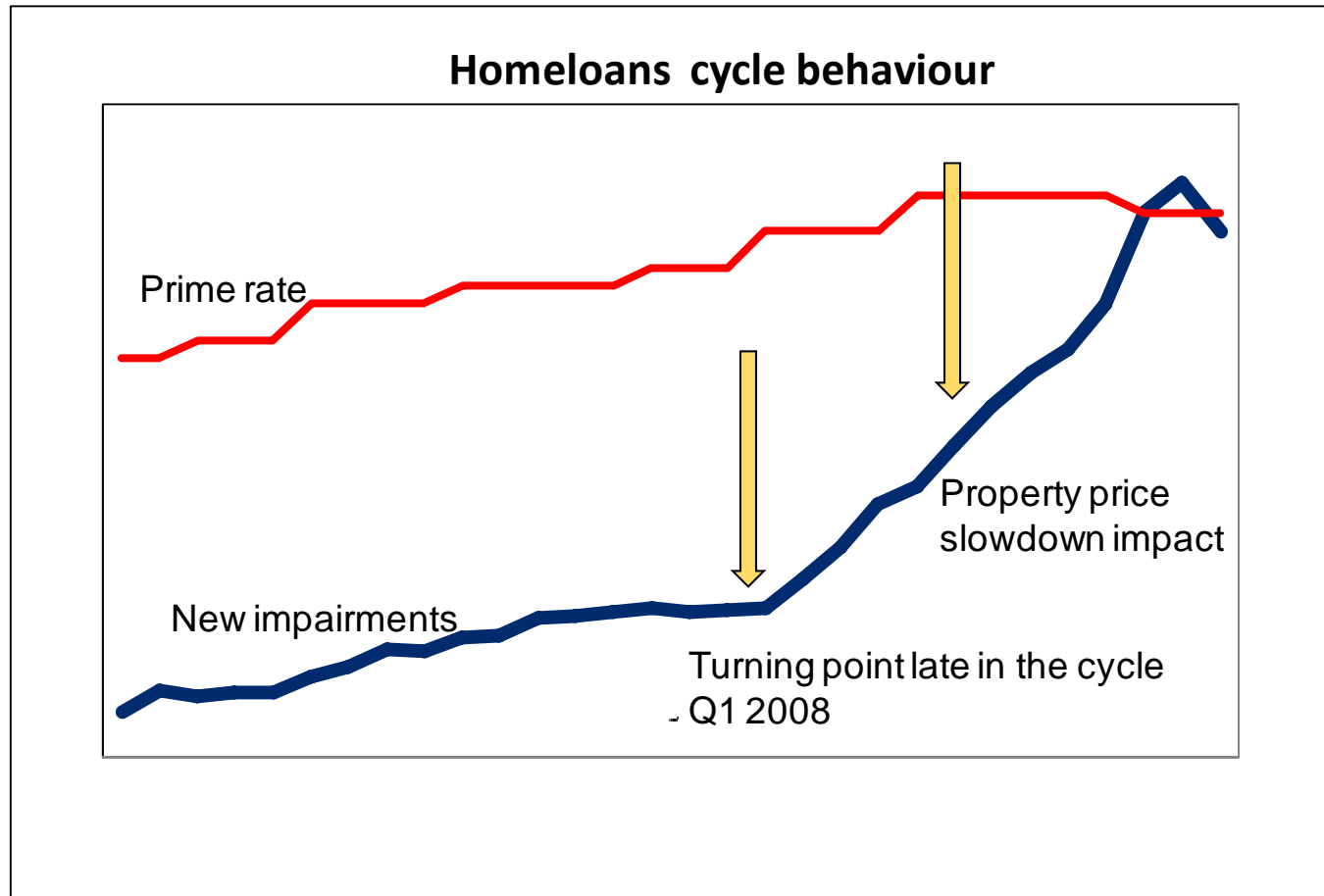
Observation on the product line impact of successive rate increases



Observation on the product line impact of successive rate increases



Observation on the product line impact of successive rate increases



Outlook:
Key clouds and silver linings to consider

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Key clouds and silver linings to consider

- Job losses
- House price developments
- Corporate credit

The macro economic backdrop for the credit cycle

- First impacts
 - High inflation and interest hikes resulting in
 - Lower disposable income
 - Increased consumer defaults
- Next impacts expected
 - Impact of the credit crunch on the real economy
 - Lower GDP
 - Job losses
 - But with some relief
 - Impact of sharp rate cuts
 - Inflation easing

Job losses – the macro data

Unemployment Trends (QLFS)¹

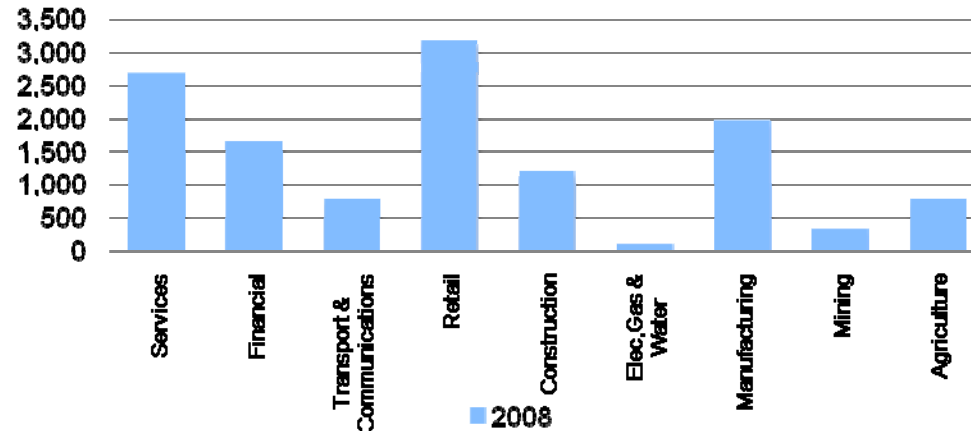


Source: Stats SA

| | 2005 | 2006 | 2007 | 2008 |
|----------------------------|---------------|---------------|---------------|---------------|
| Services | 2,192 | 2,319 | 2,560 | 2,661 |
| Financial | 1,296 | 1,309 | 1,482 | 1,636 |
| Transport & Communications | 616 | 611 | 696 | 774 |
| Retail | 3,024 | 3,055 | 2,935 | 3,164 |
| Construction | 935 | 1,024 | 1,054 | 1,191 |
| Elec, Gas & Water | 100 | 119 | 98 | 86 |
| Manufacturing | 1,706 | 1,737 | 1,757 | 1,944 |
| Mining | 411 | 398 | 432 | 321 |
| Agriculture | 925 | 1,088 | 1,041 | 764 |
| Total | 11,205 | 11,660 | 12,055 | 12,541 |

Source: Stats SA

Employees per Sector (000) - Forecast



Source: Stats SA

How job losses manifest in a portfolio (assume 3% job losses and 0% latent job losses)

- Example: High default portfolio (e.g. card with 10% margin)
 - Assume annual NPL of 12% in distressed market and 70% NPL coverage
 - Charge (pre job losses):
 - $12\% \times 70\% = 8.4\%$
 - Charge (incl. job losses):
 - $15\% \times 70\% = 10.5\%$
 - Relative increase = 25%
 - Absolute increase as % of margin: 21%
- Example: Low default portfolio (e.g. homeloan with 2% margin)
 - Assume annual NPL of 7% in distressed market and 20% coverage
 - Charge (pre job losses):
 - $7\% \times 20\% = 1.4\%$
 - Charge (incl. job losses):
 - $10\% \times 20\% = 2\%$
 - Relative increase = 43%
 - Absolute increase as % of margin: 30%

Low default, low margin portfolios less resilient for job losses.
Need to consider wider factors though (refer next slide)

Assumptions to make to determine impact

- Consensus forecasts vary
 - But 2-3% often quoted as a possibility (250k – 350k)
- Job losses vs banked population
 - Probably reasonable to assume close to a 1:1 relationship
- Job loss demographics
 - Data to date suggest higher incidence of job losses in lower income segments
- Re-employment potential
 - Historically better for higher qualified areas
 - Difficult to track in the credit portfolios
- Job losses vs latent job loss number and defaults in credit portfolios
 - Even benign times have job losses underlying credit results
 - Key question: overlapping or incremental ?

Need to evaluate impact of job losses to benefit from cash flow relief from rate cuts

Outlook:

Key clouds and silver linings to consider

- Job losses
- House price developments
- Corporate credit

How house price movements manifest in bad debts

- Key parameters

- Volume of NPL's
- NPL coverage
 - Loan to value
 - Distress price haircut
 - Time to recovery
 - Level of curing
- Charge
 - (Volume x coverage%)

- Example

- R1bn NPL
- Coverage elements
 - LTV of 100% [R1bn]
 - Haircut of 35% [R0.65bn]
 - 12 months disc. factor
 - 60% curing
- Coverage calc
 - Charge: [R1bn – ((R1bn x 0.65) x 1/1.14)] x 40% = R172m
 - Coverage therefore 17.2%

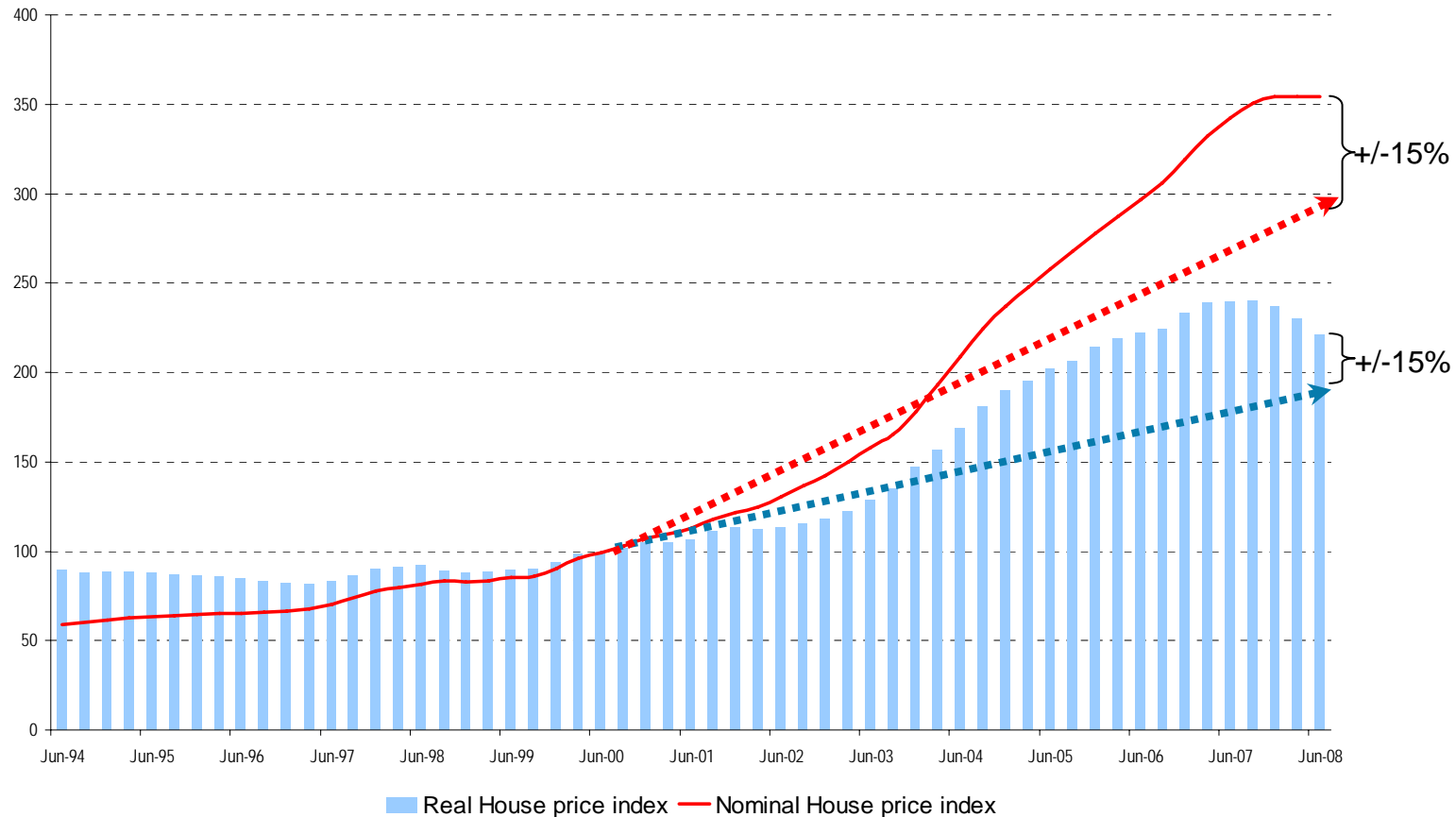
Evolution of normal market prices and distressed prices as % of market price are key factors to consider

Impact of a 10% drop in house prices on the provision

- Example (excluding fall):
 - R1bn NPL
 - Coverage elements
 - LTV of 100%
[R1bn of collateral]
 - Haircut of 35% [R0.65bn]
 - 12 months discount @ 14%
 - 60% curing
 - Coverage calc
 - Charge: $[R1bn - ((R1bn \times 0.65) \times 1/1.14)] \times 40\% = R172m$
 - **Coverage therefore 17.2%**
- Example (including fall):
 - R1bn NPL
 - Coverage elements
 - LTV of 111%
[R0.9bn value of collateral]
 - Haircut of 35% [R0.72bn]
 - 12 months discount @ 14%
 - 60% curing
 - Coverage calc
 - Charge: $[R1bn - ((R0.9bn \times 0.65) \times 1/1.14)] \times 40\% = R195m$
 - **Coverage therefore 19.5%**

Approximately 2.3% increase in coverage required for 10% fall
(13% increase in relative terms)

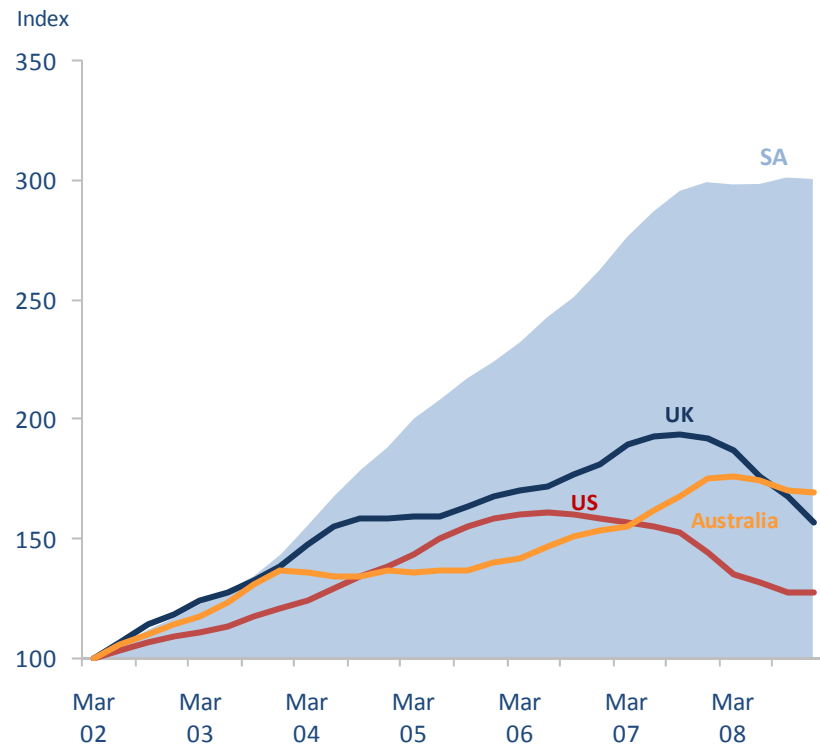
House price development – the simple view



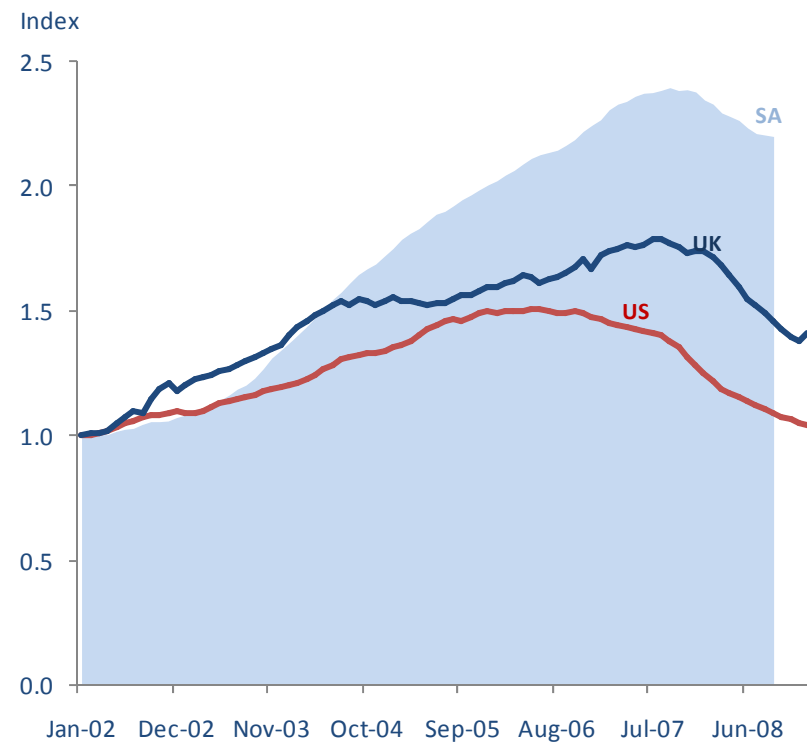
Source: INet & BSM CPM

Nominal and real growth vs global experience

Nominal growth in house prices

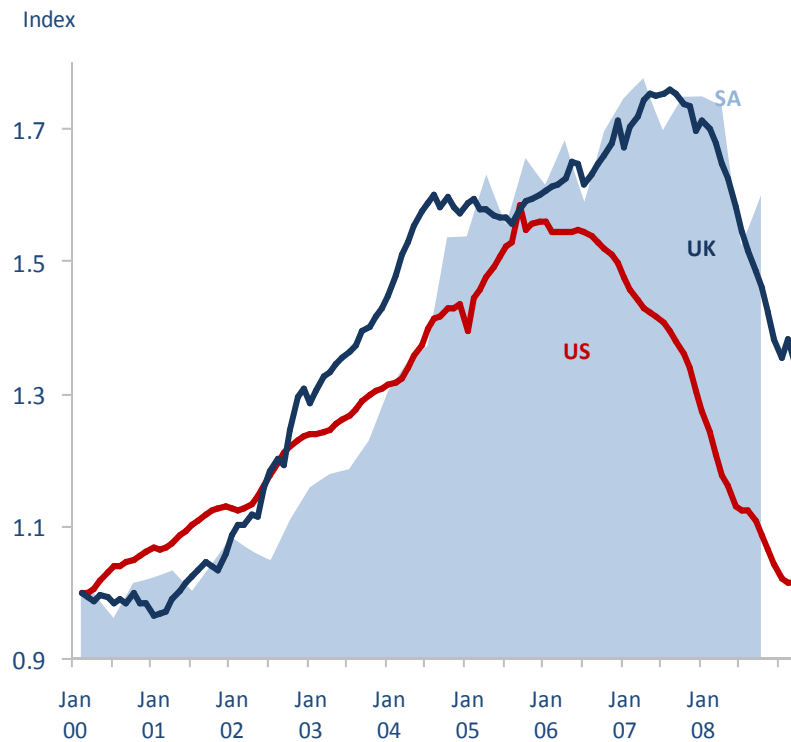


Real growth in house prices

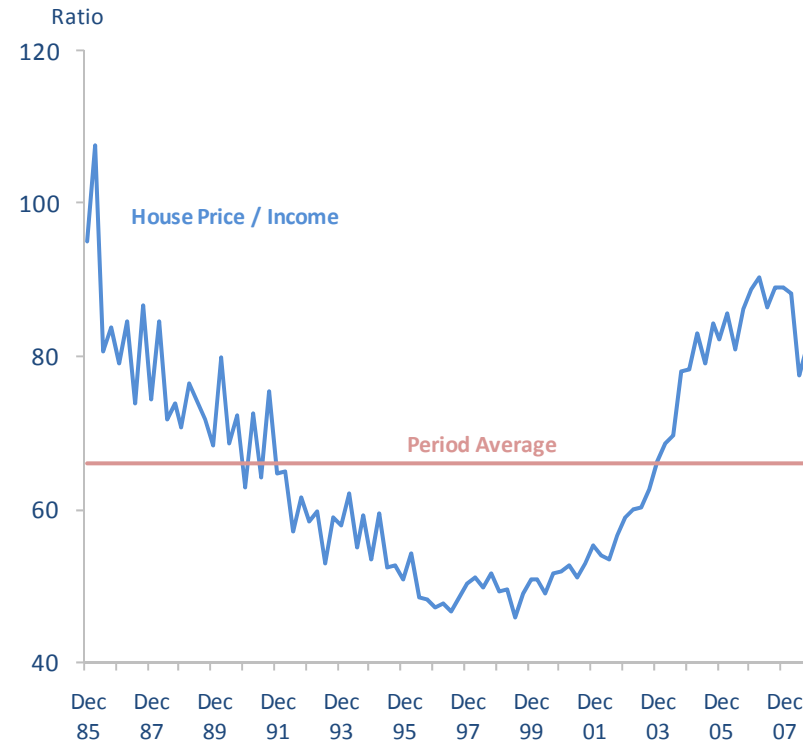


House price : disposable income

House prices to disposable income



SA house price to disposable income



Outlook

- Residential property prices likely to remain under pressure
 - Will put pressure on impairments through lower recoveries
- Rate cuts will provide some cash flow relief and reduce cash flow defaulters

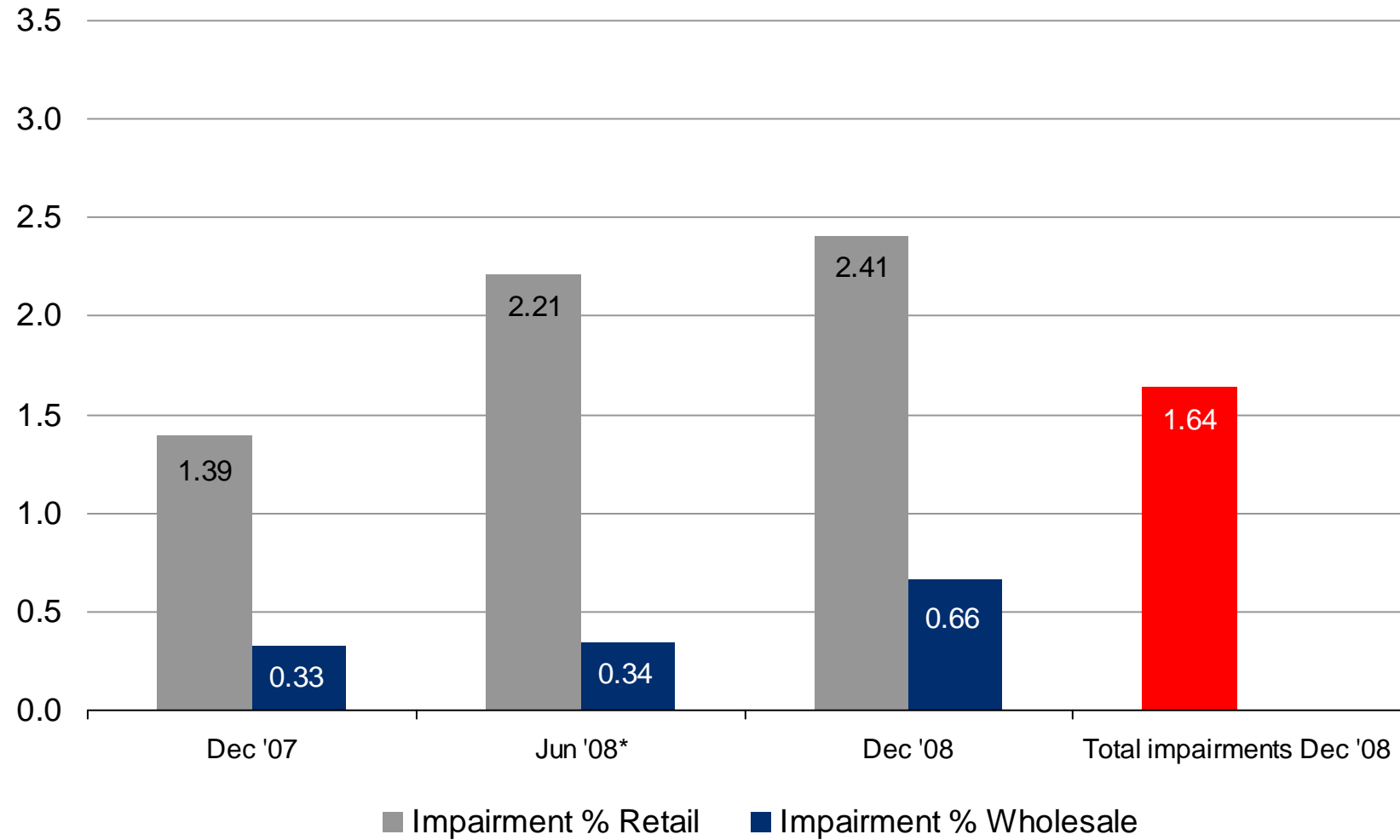
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Migration risk to corporate

Impairment ratio (%)

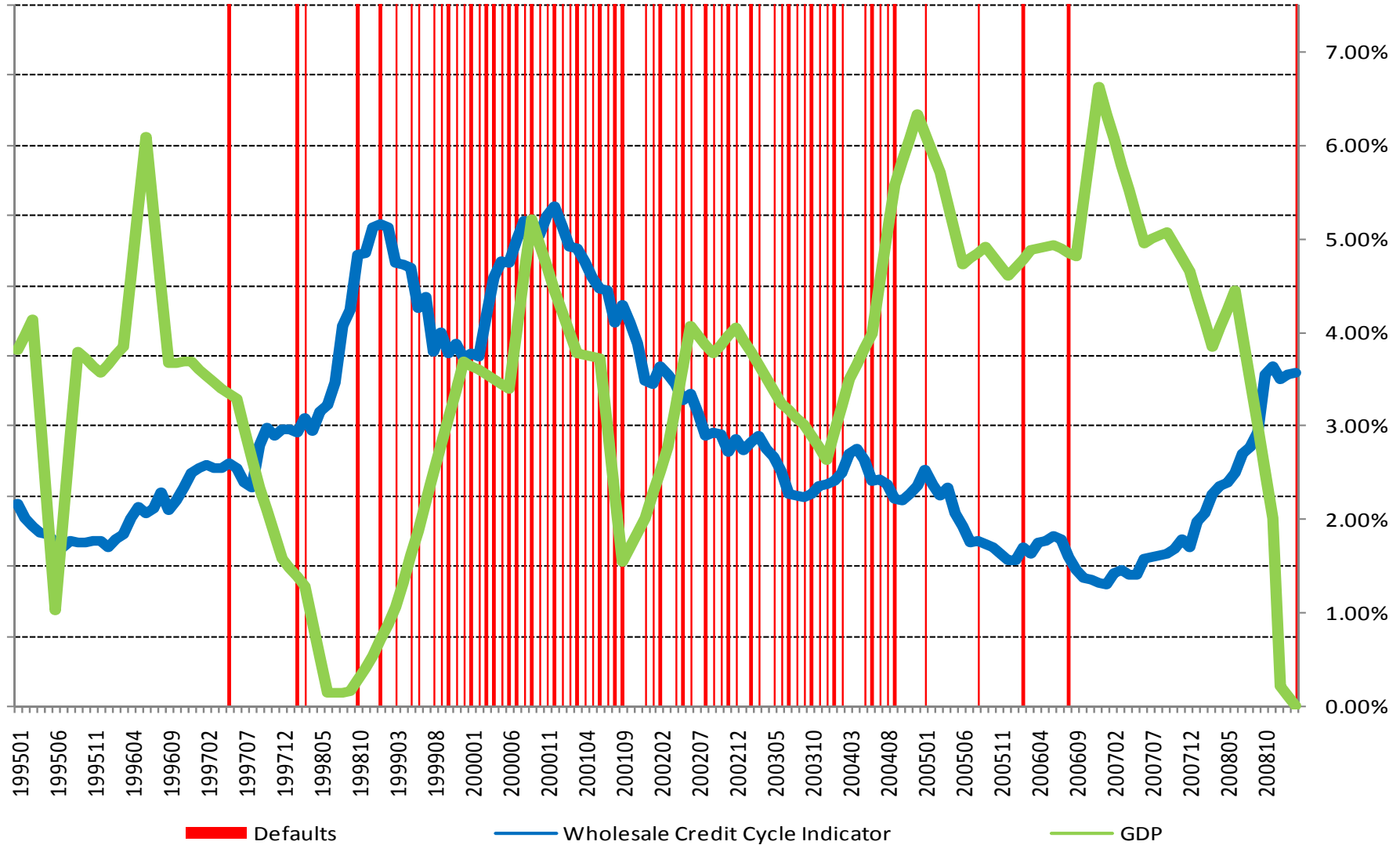


* June 2008 for the 6 months ended

Source: FRBG results presentation

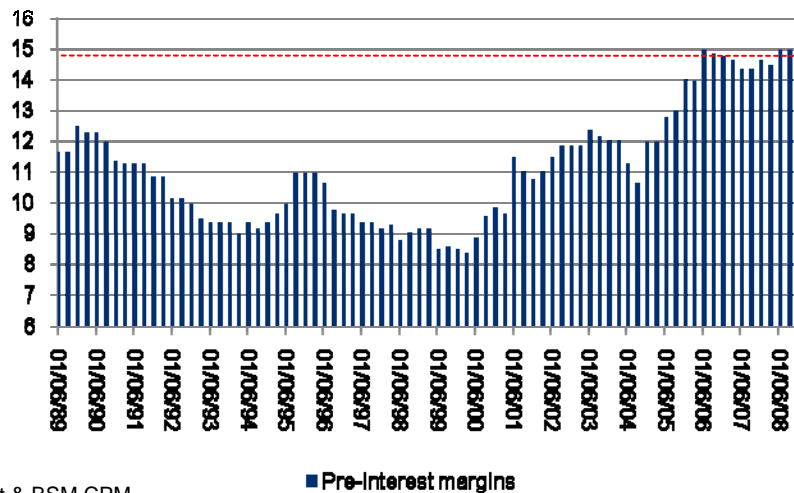
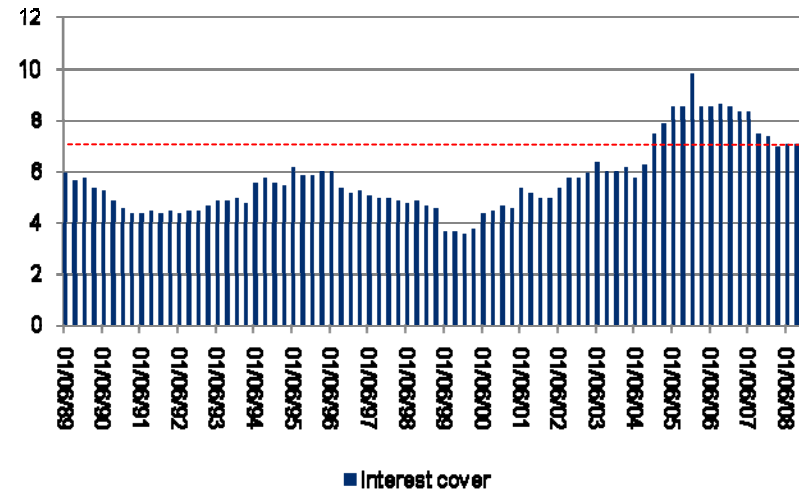
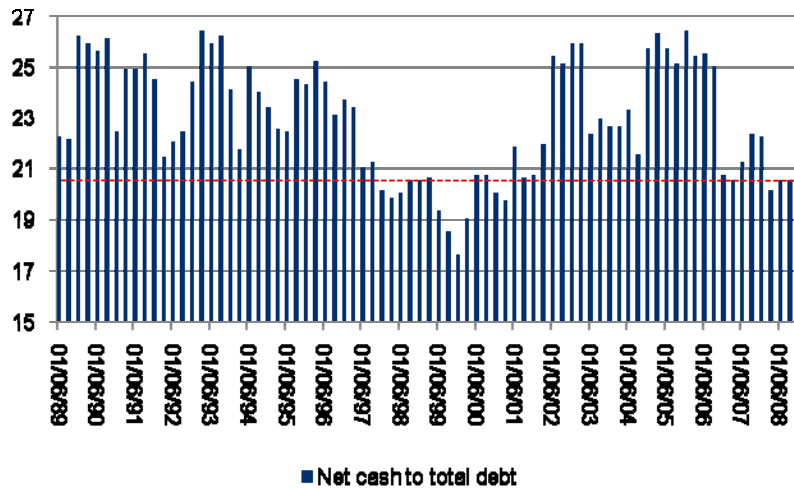
How will it unfold – Corporate ?

RMB Wholesale Credit Cycle Indicator



Corporates however in better health than previous cycles

Key financial ratios of JSE industrial companies



Source: Inet & BSM CPM

Outlook

- Corporate spill-over has already started
 - Key area of pressure is smaller businesses
- Corporate balance sheets in reasonably good health pre-crisis
- Impact of global spill-overs is the main unknown

Conclusion

- Expect retail pressure to remain in the short run
 - Especially for asset backed retail areas e.g. mortgages due to house prices falling
- Rate cuts will provide some cash flow relief
 - But job loss uncertainties likely to mitigate benefits
- Corporate spill-over has started
 - But may be mitigated by the stronger balance sheets
- International spill-over too early to call