The impact of the depreciation of the rand on the South African banking industry

Mr Tucker, the chief executive officer of the Banking Council of South Africa, gave evidence on behalf of the Banking Council. The council represents 43 of the 56 banks and branches of foreign banks registered in South Africa:

1.1 The rapid decline in the value of the rand would have had both positive and negative consequences for each of the banks. While it is possible that some banks derived a net benefit from the depreciation of the rand during the last quarter of 2001, the depreciation of the rand had a severe negative impact on the banking industry as a whole.

1.2 The six major South African banks’ figures were aggregated for the purposes of this analysis:

1.2.1 The higher volatility and wider spreads of the last quarter of 2001, and especially in December 2001, gave rise to higher revenues on foreign exchange dealings than for the remainder of the year. As a result, the average monthly gross revenues of the foreign exchange trading operations were R148 million per month for the first nine months and R288 million per month for the last three months of 2001.

Evidence of Mr RSR Tucker, Record 744-761
The actual forex revenues for the last quarter were R212 million for October, R189 million for November and R461 million for December. Those gross revenues exclude all costs such as IT costs, telecommunication costs, staff costs and the cost of capital.

1.2.2 The same factors that led to higher foreign exchange revenues during the last quarter also led to losses on the fixed income trading desk, that is the desk which trades in interest derivatives of instruments and in bonds. Downward pressure on the value of a currency almost invariably leads to high interest rates and lower bond values. So as the rand depreciated, the margins spread and there was higher volatility. Those very factors gave rise to pressure on the interest derivatives and bond markets, which led to losses.

1.2.3 The average monthly revenue of the six banks from forex and fixed income trading, if the two desks are aggregated, for the first nine months of 2001 was R253 million and for the last quarter of 2001 was R261 million. In other words, during the last quarter of 2001 the six largest banks earned an average of only R8 million more revenue per month from trading in foreign exchange, interest derivatives and
bonds than they did in the first nine months of the year. That amounts to an R3.3% increase on the average revenues for the first nine months.

1.2.4 Those revenues must be measured as a percentage or against a US dollar/rand turnover of approximately USD8 billion a day or USD160 billion a month. If one takes the revenue of R148 million a month, which was the average revenue for the first nine months, that represents less than 0.01% of that turnover. If one takes the average for the last quarter of R288 million per month, that represents 0.016 of a percent of the actual turnover in the market.

1.2.5 Another comparison is that between revenues on foreign exchange trading and the banks’ total revenues. The revenue earned by the six major banks on forex trading compared with the total revenue of the banks, net of interest expenses, represents 4.2% for the first nine months, 4.8% for October, 4.5% for November and 8.3% for December 2001.

1.2.6 Another way of looking at the impact of the depreciation of the rand is on the share price of the major banks. If it had appeared to the market that banks would be able to generate higher returns from a rapid decline in the rand
their share prices would have increased in the last quarter of 2001 to reflect the increased earnings potential. The share prices of the six major banks, however, tended to move lower. For example, Stanbic’s share price was just under R35 at the end of the second quarter of 2001 and by the end of the fourth quarter, the price was down to R31. Investec’s share price was R250 in the second quarter and down to R160 in the fourth quarter. The share prices of the six major banks were below that of the all share index. For example, in the fourth quarter the all share index ran up significantly from an index of just on 100 to an index of just below 130. The bulk of the banks’ index was between 63 and 88.

1.2.7 In July 2001, The Banker, a leading financial services publication, surveyed leading banks internationally and produced a list of the top 1000 institutions. The Banker produced a table showing the comparative of the major South African banks in July 2001 and the same again in January 2002. Stanbic started of at 146 and is down to 199; Nedcor started off at 158 and is down to 219; and BoE started at 455 and is down to 565. The South African banks were probably ranked lower because the effect of the
weaker rand was felt in two ways: they would enjoy reduced access to and higher cost of credit internationally and lower trading volumes and smaller positions in dealings with off-shore counter parties.

1.2.8 Capital requirements. One of the requirements imposed upon banks around the world is that they are obliged to hold capital in a certain ratio to the value of their risk assets. In South Africa the minimum capital requirement is 10%. Between January 2001 and January 2002 the aggregate trading book capital requirement of the four major banks had increased by R2.7 billion principally as result of increased amounts owing by counter parties following the rand depreciation. The cost of the additional capital to the banking industry amounts to about R51.3 million per annum.

1.2.9 Certain expenses incurred by the banks, most notably IT costs, are set in US dollars. Banks are heavily reliant on technology and IT costs comprise a significant portion of expenditure. According to data provided by the six major banks, the banks anticipate an increase of R160 million that is 9% of budgeted expenditure, for every R1 increase in the price of the US dollar. The movement from R9 to
R11.15 to the dollar therefore means an additional cost to the banks of R480 million per annum.

1.2.10 **Capital held by foreign banks**

Foreign banks doing business in South Africa are required to hold capital in South Africa to support their domestic operations. The current capital requirement is R250 million or 10% of the adjusted risk assets, whichever is the greater. In January 2001 the rand value of the capital was R2.3 billion. In January 2002 the rand value was R3.1 billion. Accounting standards may under certain circumstances require the foreign banks to reflect their translation losses in their domestic financial statements. If all of the R2.9 billion held by foreign banks in June 2001 were unhedged, the foreign banks collectively would have reflected a translation loss for that period of about R928 billion in their reporting currencies. If they had hedged, the banks would have incurred hedging costs. On an index of 100 in June 2001, by January 2002, the dollar index was down to 69, the pound was down to 68 and the Euro was down to 67. Depending on the domestic currency of the bank which is holding capital in South Africa, that is the
level of depreciation that it would have suffered on the rand capital that it has to hold.

1.2.11 Share prices and foreign investment

At present about 6% of the share capital in South Africa’s major banks is held by foreign investors. The depreciation of the rand has not been good for those foreign shareholders or for the prospects of attracting additional foreign investors. On an index of 100 in the fourth quarter of 2000 compared with the fourth quarter of 2001, five of the six major banks are on a range somewhere between 38 and 64. That is an indication of the sort of loss in their domestic currency that foreign shareholders would suffer if they realised their share in South African banks.

1.2.12 Bad debts and provisioning

There are two ways in which depreciation of the rand leads to an increase in bad debts for South African banks:-

- imported products may no longer be affordable in the South African economy. The importers of those products will face difficulties or go out of business and the South African banks face a credit risk exposure to those importers which they have financed;
- the increase in the interest rate by the Reserve Bank of 1% in January 2002 results in an increase in all interest rates; that placed additional pressures on borrowers and is likely to result in an increase in bad debts within the banks.

1.2.13 Increased cost of international expansion

In order to better serve their local and international clients, South African banks have been expanding their operations in Africa and other major financial centres. This has now become less viable and more costly as such acquisitions are normally paid for in hard currency.

2 The major banks gave oral evidence before the Commission about the impact of the depreciation of the rand in 2001 on their operations:-

2.1 Absa Bank Ltd ("Absa")

The rapid depreciation of the rand mainly had a negative affect on Absa’s treasury operations. The impact on profitability was mixed. Gains were made on the foreign exchange and gold and currency options desks. By contrast, the interest rate derivatives and local and off-shore funding desks were negatively affected by sharp decline in liquidity.

As a whole, the treasury was adversely affected by the risk to credit lines, as these lines are set within institutional and country risk parameters. Although dollar denominated, these are set with
reference to Absa’s rand based balance sheet. The capacity of these lines was exceeded in rand terms despite the fact that there was still dollar denominated capacity available. This limited the ability of Absa to service normal client needs over the relevant period. Foreign credit lines with Absa were also at risk of being reduced due to the relatively smaller balance sheet in dollar terms.

The value at risk parameters were also exceeded and operational stability was compromised. During December 2001 the capital market yields became unstable, which had a direct impact on liquidity in the market. Absa’s ability to issue longer term instruments was accordingly curtailed.

Capital adequacy ratios decreased due to the negative impact of the rand on Absa’s balance sheet.²

2.2 Nedcor Bank Ltd (“Nedcor Bank”)

The material impact the depreciation of the rand had on Nedcor Bank was:

- profitability: unexpected gains on foreign assets and earnings, plus trading opportunities in a volatile market;

² Evidence of Mr PJB Balt, Group Treasurer, Absa Bank Ltd, Absa Bundle 11
- shareholder value: the value of foreign assets and profits increased in rand terms;
- capital adequacy improved due to the higher value of off-shore assets;
- Nedcor Ltd will experience difficulty in attracting or maintaining foreign investors because of a drop in the value of the shares when converted to foreign currency.3

2.3 *Nedcor Investment Bank Ltd (“NIB”)*

The broad impact of the depreciation of the rand on NIB was:

- the weakening currency resulted in a reduction in the value of NIB’s balance sheet relative to the US dollar based off-shore balance sheets of international banks;
- NIB needs to protect the US dollar equivalent of its balance sheet in relative and absolute terms given the increasing demand of accessing international capital markets by South African banks: this has now become more difficult for NIB as result of the weakening rand;
- NIB generated profits from the declining rand, although the profits were not excessive;

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3 Evidence of Mr M S Parker, Executive General Manager, Treasury, Nedcor Bank, *Nedcor Bundle 22*
- NIB also benefited in rand-terms due to the translation gains made on its foreign currency earnings.  

2.4 FirstRand Bank Ltd (“FirstRand”)  
The bank earned high income from trading margins in foreign currency transactions with customers as a result of increased customer activity and increased volatility in the foreign exchange markets. This increase in profitability will most likely be countered at a later stage by lower income because overall customer volumes would still be constrained over time by what is allowed within Exchange Control Rulings.  
Foreign currency liabilities on the balance sheet will be re-valued at higher rand values, thus resulting in an increased requirement for the bank to hold liquid assets and cash reserves in terms of the Banks Act. Liabilities are increased by the increase in counter-party exposures due to mark-to-market revaluation. This would increase costs and lead to lower profits because of higher costs of maintaining a higher level of cash reserves in respect of which the bank earns no interest. It is also likely that the bank will incur higher cost to hold a higher level of liquid assets.

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4 Evidence of Mr P Lane, Executive Director of NIB with responsibility for the NIB Treasury Division, NIB Bundle 22
The bank’s net asset value in rand terms has increased by the extent to which it has capital held in foreign currency to support its offshore activities.

The rapid depreciation in the rand has reduced the net open position that the bank may hold in foreign currency. This will impact negatively on its business as a market maker thus affecting its ability to service its customers, as well as potential profits.

Existing foreign currency exposures to its customers will have a higher rand value following the rapid depreciation of the rand without a concomitant increase in income. In future, the bank might be forced to reduce foreign currency exposures as measured in foreign currency on its customers whose balance sheets are denominated in rand.

Most of the bank’s systems technology and software expenditure is effectively priced in foreign currencies. The depreciation of the rand will increase those costs substantially over time, resulting in higher banking charges in a developing market, which can hardly afford it.

All assets in foreign currency where the bank is exposed to potential losses, should counterparties not honour their obligations, have been re-valued at the depreciated levels because of the depreciation of the rand, resulting in higher asset or
exposure values in rand terms. As a result, the bank has to hold higher capital in terms of the Banks Act against its assets, which have been re-valued upwards in rand terms. Higher capital requirements result in a lower return on capital, because the same income relates to a greater amount of capital.

The rapid depreciation of the rand has resulted in a reduction of the Group’s net asset value, as expressed in dollars, by about 30% compared to its international competitors.5

2.5 Investec Bank Ltd (“Investec”)

The rapid depreciation of the rand had an overall negative impact on Investec and was the cause of great concern to management and staff.

Given the broad spread of businesses within Investec Group Limited in a variety of different jurisdictions, overall profitability was little impacted by the exchange rate movement.

The impact of the depreciation of a currency on rand liquidity was limited, although adverse interest rate perceptions caused depositors to tend to place funds at the short end of the market.

There was an additional detrimental impact on Investec, given that the unanticipated deterioration in the value of its positions

5 Evidence of Mr JJH Bester, Head of Risk and Audit Services for FirstRand, FirstRand Bundle 9-12
caused an increase in the funding of US dollar margins given as collateral to a number of counterparties with whom the bank had entered into ISDA credit support annexes.

The bank’s operational stability was not affected in any material way by the rand’s rapid fall.

The Group’s capital adequacy was not materially affected, although there was a sharp increase in trading capital required to conduct its foreign currency operations.

In the short term, shareholders’ value may have been enhanced by the increase in Investec’s reserves due to the revaluation of the Group’s off-shore assets, but in the longer term shareholder value may well be impaired in that a volatile and generally weakening currency deters foreign investors from direct investment and from investing in its equities and bonds. This in turn reduced liquidity in South Africa’s various financial markets.6

2.6 Citibank N.A. (“Citibank”) 

The impact on the Johannesburg branch of Citibank (“Citibank SA”) and Citibank was negative. The depreciation of the rand is in future expected to reduce US dollars equivalent revenues in particular from Citibank SA’s account services, payments and

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6 Evidence of Mr RPMA Forlee, Head of the South African Treasury and Financial Markets Operations at Investec, Investec Bundle 10-11
collections and asset-based finance business. Since Citibank SA consolidates its financials in the United States of America, the depreciation of the rand has served to diminish the value in US dollars on rand-based revenues. Citibank SA’s capital adequacy was negatively affected by the rand’s depreciation. Its capital is received in US dollars and converted to rand and is therefore now worth less than it would have been had the rand not depreciated. Any diminution of Citibank SA’s capital base impact negatively upon its parent company, Citibank. The depreciation of the rand affected the administration of Citibank SA in that it set-off pre-existing internal protocols and procedures, provoking reviews of portfolios, thereby increasing the administrative burden on the organisation. Citibank SA did generate profits due to the depreciation of the rand. However, those profits were not excessive as profitability for the forex desk for the year was approximately 6.7% above budget. Gains in respect of forex trading were set-off by losses relating to the depreciation of the rand, such as losses in respect of interest rate products.\(^7\)

\(^7\) Evidence of Mr I Scott, Head of Foreign Exchange Trading, Citibank SA, Citibank Bundle 27
2.7 JP Morgan Chase Bank (“JP Morgan”)

The consequences of the depreciation of the rand for the Johannesburg Branch of JP Morgan were that the rand denominated revenue declined in real terms when reported in US dollars and thereby negatively affected shareholder value. This was off-set to some extent by the fact that about 65% of the Johannesburg offices’ cost were denominated in rand. The notional value of trades by the Johannesburg Branch in rand terms required to generate US dollar returns similar to those obtained prior to the depreciation increased. In the ordinary course this would have required further endowment capital to be injected into the bank from off-shore for capital adequacy purposes. However, this was off-set by the lower trading volumes occasioned by the illiquidity in the market.  

2.8 Deutsche Bank (“DBJ”)

The rapid depreciation of the rand did not benefit DBJ. For 2001, nearly all its revenues were in rands whereas 19% of its expenses were incurred in euros and GBP. The weakening of the rand therefore negatively impacted DBJ’s profits generated in South Africa. In euro terms, with the rapid depreciation of the rand, the

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8 Evidence of Mr JJ Coulter, Managing Director, Head of Investment Banking and CEO of JP Morgan, JP Morgan Bundle 20
capital which the Deutsche Group has invested in South Africa has been significantly reduced in value. The capital adequacy ratio of DBJ has also reduced because the weakening rand increased exposure on certain transactions, therefore requiring that additional capital be placed against those positions.\(^9\)

2.9 **Standard Bank group**

The impact on the Standard Bank group of the depreciation of the rand in 2001 was the following:-

(1) **Overall profitability**

A weaker rand impacts negatively on general consumer and business confidence and consequently on expenditure. This has a negative impact on the lending growth and hence profitability of Standard Bank of South Africa Limited (“SBSA”).

The weakening of the rand increases the cost of imports for most business customers of SBSA; this impacts negatively on profitability and in certain cases on the solvency of customers. This will undoubtedly increase bad debts during the next twelve months.

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\(^9\) Evidence of Morrison, Deutsche Bank Bundle 11
The increased expenditure on information technology and communication due to the depreciation of the rand will reduce the overall profitability of SBSA.

The factors mentioned above will, over time, far outweigh any short term increase in foreign exchange trading profits caused by the volatility of the rand.

(2) **Growth strategy**

The decline in the rand significantly increases the cost of expansion of the Standard Bank group’s activities in Africa and other emerging markets such as Brazil and Russia. The consideration payable for acquisitions and expansion of infrastructure, which is largely US dollar denominated, will significantly increase.

(3) **Capital adequacy**

The trading book capital requirement increased from about R1.5 billion at the end of November 2001 to peak just below R3 billion in December 2001. SBSA’s board of directors was asked in late December 2001 to approve an increase in allocation to R4 billion for the trading book. This reduced the availability of capital in other areas of the bank and caused strains in meeting prudential
requirements for capital adequacy for the bank as a whole at that time.

(4) **Capital raising and shareholder value**

Foreign shareholders currently account for about 10% of the Standard Bank Investment Corporation Limited (“SBIC”) shareholder base by value. The returns which those foreign investors received from investing in SBIC shares declined substantially in 2001 as result of the weaker rand. The SBIC share price fell from 421 US cents per share in January 2001 to 263 US cents per share in December 2001, amounting to a reduction of 38% in US dollar terms.

(5) **Sentiment**

The decline in the rand had a negative impact on staff morale, particularly in the bank’s international operations. The sentiment of foreign investors remain generally negative towards the South African banking sector as a whole, although sentiment has recently improved.

The Banker Survey of July 2001 ranked SBIC as 146 out of the top 1000 commercial banks worldwide. Based on the decline in the rand from July 2001 to December 2001, SBIC’s ranking is estimated to have dropped to 203. This reduces the international
standing of the Standard Bank Group and could impact on the future cost and ability of SBIC to raise foreign loans.\textsuperscript{10}

3 The Deloitte & Touche team\textsuperscript{11} investigated the forex profits of authorised dealers to determine whether the profits were disproportionate either with the industry as a whole or with historic profit performance as this could have indicated speculative activity outside the norm. The weighted average of the material authorised dealers indexed monthly profits was plotted against the monthly average of the daily-bid-offer spread. Spreads were fairly consistent until September 2001. Thereafter volatility increased with the spread peaking in December 2001. Profits were volatile over the year and peaked in December 2001. No individual material authorised dealer made profits that were out of line with either the average or all material authorised dealers or their own historic profit performance.

\textsuperscript{10} Evidence of Mr SP Ridley, Director: Finance and Operations of Standard Corporate and Merchant Bank (“SCMB”), Standard Bank Bundle 58-61

\textsuperscript{11} Evidence of Immelman, Part K, and Report of DT team 31-33
4.1 The authorised dealers were asked in the Questionnaire\textsuperscript{12} to describe the broad impact that the rapid depreciation of the rand in 2001 had on their organisations. The responses of local banks and local branches of foreign banks were divergent. Whereas local banks were primarily concerned with the possible impact on interest rates and other domestic factors, local branches of foreign banks stressed the negative impact on their profitability when measured in the foreign currency in which they report. Local banks that report their earnings in a foreign currency were similarly affected.

4.2 The authorised dealers reported that there were some short-term positive effects, the most material of which were:

- many banks made large profits on their forex desks in the final quarter of 2001, which they attributed to their market making activities through a combination of wide spreads and high volumes;

\textsuperscript{12} The Questionnaire prepared by Deloitte & Touche. See Part K and the evidence of Immelman DT Report 42-45
many banks reported large foreign currency translation
gains over that period that resulted from converting
foreign assets into rand.

4.3 There were short-term negative effects as well. As result of rising
bond yields – falling bond prices – banks with long bond trading
books incurred losses. As the rand weakened, fears of interest rate
increases reinforced the trend to sell bonds.

4.4 The consensus between the authorised dealers was that the overall
effect of the depreciation of the rand was negative:-

- foreign currency denominated liabilities, restated in
  rand at the weaker exchange rate, resulted in the
  authorised dealers being required to hold larger cash
  and liquid asset reserves in terms of exchange control
  rules;

- the rapid depreciation of the rand reduced the net open
  position that authorised dealers are obliged to hold in
  terms of the Banks Act in equivalent foreign currency
  terms;

- the cost of imported infrastructure including IT systems
  increased;

- a depreciating rand resulted in a reduction in the capital
  and balance sheet structures of South African
authorised dealers as expressed in foreign currency terms;

- the cost of employing foreign experts increased;

- there was negative sentiment towards South Africa, which discouraged off-shore interest in investment opportunities;

- the view that the weakening of the rand was likely to prompt interest rate increases resulted in customers preferring to keep their funds in short-term deposits;

- increasing interest rates had an adverse effect on sentiment towards equities of companies in the banking sector;

- the decline in the value of the rand caused an increase in the margin collateral required where banks had entered into ISDA credit support annexures;

- additional risk management and administration costs were incurred;

- there was a negative effect on the morale of staff, who saw their purchasing power eroded in global terms and who might leave South Africa in order to earn valuable foreign currency, thus contributing to the critical skills shortage in the financial sector.