



Chief financial officer's report **2018**

# CFO report

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*Our results are the value we deliver to our clients through personal service.*

We report our results for the financial year below, under our single Global One Solution: Save. Transact. Insure. Credit.

## GlobalOne Money Management



### Save

For our equity shareholders: we remain well capitalised, pursue a desired return on equity of 25%, maintain a dividend cover of approximately 2.6 and aim to generate sustainable earnings growth.

For our retail and wholesale depositors and bondholders: we target a competitive interest return on investment, low liquidity risk and a stable credit rating.

### Transact

An all-inclusive banking solution that provides diverse ways to transact via any of our channels. This simple solution is easy to access from anywhere, at any time and in any way. The focus is on providing essential banking to all clients, regardless of income level.

### Insure

We are improving our clients' financial lives by expanding our product range. This supports the diversification and sustainability of our business.

### Credit

Our personalised credit solution achieves the best possible credit limit, over the optimal repayment term, with the best interest rate. This is offered to clients based on their past banking and credit behaviour, affordability and stability of their source of income, using data from, the credit bureaus, bank statements and payslip information.

## Save

### Equity shareholders

		2018	2017
ROE	%	27	27
HEPS	cents	3 858	3 281
Total dividends per share	cents	1 470	1 250
CAR	%	36	34

### Earnings up 18%

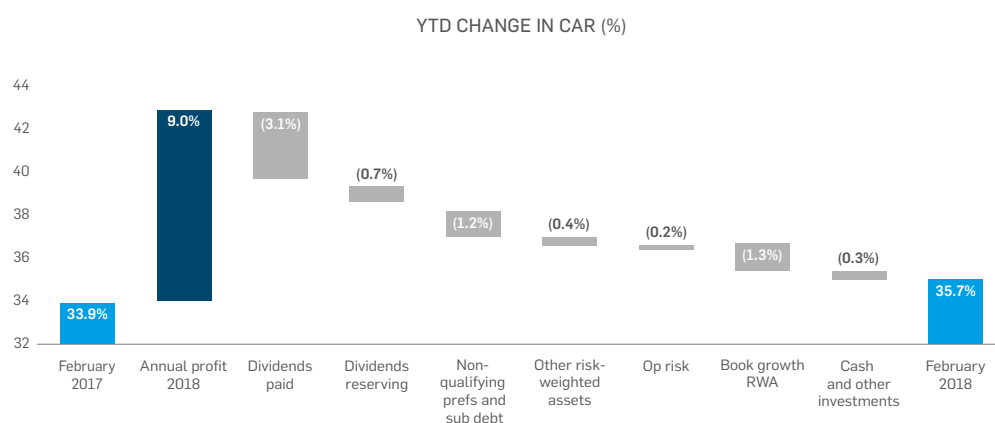
Headline earnings per share (HEPS) increased by 18% from 3 281 cents per share in 2017 to 3 858 cents per share in 2018. We generated a return on ordinary shareholders equity of 27% for the year – consistent with the prior year. The dividend cover remained at 2.6 resulting in a total dividend declared for the year of 1 470 cents compared to 1 250 cents in the prior year, an 18% increase. The compound annual growth rates (CAGRs) are as follows:

	Since listing in 2002 (%)	Last 10 years (%)	Last 5 years (%)	Last 3 years (%)	2018 (%)
Headline earnings	33	39	23	21	18
Headline earnings per share	27	33	20	20	18
Dividend	28	34	21	21	18
Share price	51	37	35	27	15

### Capital

We continue to remain well capitalised, with a capital adequacy ratio (CAR) of 35.7% (2017: 33.9%) and a CET1 ratio of 33.9% (2017: 30.8%). The bank continues to meet all prudential requirements.

A total of R38 million non-qualifying perpetual preference shares and R200 million subordinated debt were redeemed during the financial year. These preference shares and subordinated debt instruments are subject to the applicable phase-out rules in terms of Basel 3.



International Financial Reporting Standards (IFRS) 9 *Financial Instruments*, will become effective for our financial year ending on 28 February 2019.

The group will apply IFRS 9 retrospectively without restating comparative figures. Opening retained earnings as at 1 March 2018 will be adjusted for any differences in the carrying amounts of financial instruments. Our IFRS 9 model has run parallel to our IAS 39 model on a monthly basis for the past 2 years. The current findings indicate that there are no major deviations in the current classification of financial assets as they are largely in line with IFRS 9. We are in the process to align the disclosure and classification of loans and advances in terms of IFRS 9, based on our current write-off policy.

The group has identified that the most significant impact IFRS 9 will have relates to the expected credit loss (ECL) impairment model on the up-to-date book. Currently under IAS 39, we apply an incurred but not reported (IBNR) emergence period of 3 months. Under IFRS 9, we will apply a 12 month ECL view on the up-to-date loan book. Our rescheduled loan book provision that currently considers a 12 month forward looking period will extend to a lifetime ECL under IFRS 9.

The provisioning methodology is aligned to the credit granting strategy by applying the behaviour scores of clients. We identify significant increases in credit risk (SICR) on clients that are up-to-date on their loans, but certain behaviour risk thresholds are reached or specific events have occurred that raise a SICR flag. The 12 month ECL is extended to a lifetime for these clients.

The current IAS 39 provision raised on clients that are in arrears is already on a lifetime ECL and the same is required in terms of IFRS 9.

Based on the IFRS 9 provisioning methodology, we expect our opening retained earnings on 1 March 2018 to be adjusted by an estimated range of between R850 million and R950 million (pre-tax). This is in line with what we disclosed in the prior year after taking the growth in the loans and advances book into consideration.

For capital adequacy purposes, the opening retained earnings and deferred tax adjustment will be phased in as specified per the South African Reserve Bank (SARB) directive 5 of 2017. For CAR purposes, a deferred tax asset balance is risk weighted at 250%. The total CAR impact at a midpoint of this range will be approximately 1.7%. This will result in a CAR decrease of 0.4% for the 2019 financial year.

The new section 11(jA) of the Income Tax Act that relates to the allowance that banks may claim on their provision balance for doubtful debts, becomes effective for tax years of assessment when IFRS 9 is implemented. A further deferred tax asset will arise in our 2019 financial year due to a different percentage allowance which, we will be able to claim when IFRS 9 becomes effective, as opposed to what we currently claim. The increase in the deferred tax asset balance as a result of the new tax law amendments is subject to the same phase-in period. We estimate the total increase in the deferred tax asset due to the change in tax law to decrease the CAR by 0.8%, 0.2% for the 2019 financial year.

## Retail and wholesale deposit and bondholders

		2018	2017
Debt-to-equity		3.5:1	3.6:1
Retail call deposits	R'm	34 909	30 117
Retail fixed savings	R'm	22 915	17 922
Wholesale funding	R'm	6 206	7 543
NSFR*	%	206	187
LCR**	%	1 878	1 152
Credit ratings			
Global:			
– long term		BB	BB+
– short term		B	B
National:			
– long term		zaAA-	zaA
– short term		zaA-1+	zaA-2

\* NSFR – Net stable funding ratio

\*\* LCR – Liquidity coverage ratio

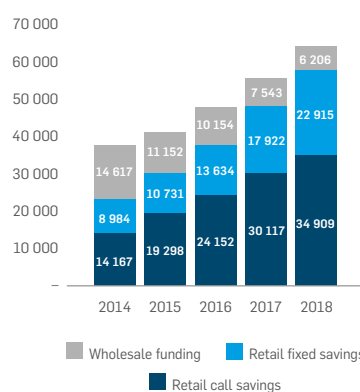
The debt-to-equity ratio decreased to 3.5:1 (2017: 3.6:1). Total deposits increased by 15% to R64 billion in 2018.

Retail deposits increased by 20% to R58 billion of which retail call savings grew 16% to R35 billion due to strong client growth in 15% during 2018. Retail fixed savings grew 28% to R23 billion, reflecting a sustained increase in clients' trust of our brand. The weighted average maturity of retail fixed funding was 18.1 months at February 2018 (February 2017: 18.4 months).

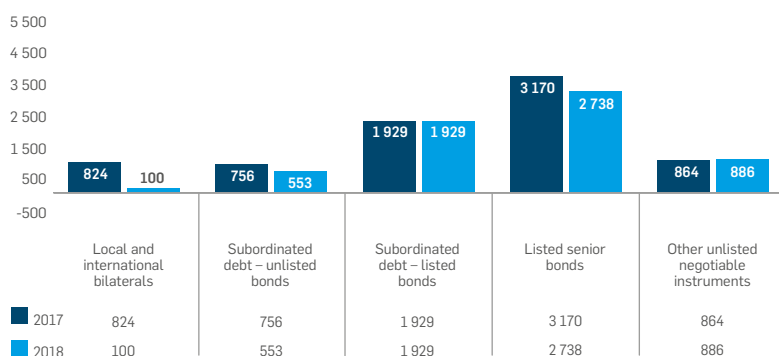
Wholesale funding (institutional bond and other funding) declined by 18% to R6.2 billion in 2018. Wholesale funding was deliberately managed lower due to the loan book growth, compared to strong retail fixed deposits and earnings growth. The weighted

average maturity of wholesale funding was 19.7 months at February 2018 (February 2017: 23.4 months). We auctioned R500 million of bonds in May 2017 that was 4.3 times over-subscribed, indicating continued strong support. We will always retain a presence in the debt capital markets.

COMPOSITION OF DEPOSITS (R'm)



WHOLESALE FUNDING BY NATURE (R'm)



## Liquidity

Our approach to liquidity risk remains conservative. There were no changes to the liquidity policy over the past financial year. The management of liquidity takes preference over the optimisation of profits.

This conservative approach results in inherent compliance with the Basel 3 LCR and the NSFR. LCR compliance was required from 1 January 2015, with a minimum required ratio of 90% for 2018, increasing to 100% by 2019. Our LCR exceeded these minimums with a ratio of 1 878% (2017: 1 152%). NSFR compliance of 100% is required from 2018 onwards. Our NSFR is 206% (2017: 187%).

To reduce liquidity risk, call deposits are only allowed to fund cash flows shorter than 6 months. Funding that is surplus to operational requirements total R34.7 billion (2017: R26.5 billion). These are invested in low-risk, liquid, interest-bearing instruments. These assets provide a positive return.

The weighted average remaining maturity of the investment portfolio at 28 February 2018 was 76 days (28 February 2017: 99 days). None of the longer-term investments has an original contractual maturity of longer than 1 year, which assists in managing interest rate risk.

## Credit rating

Capitec Bank is rated by Standard & Poor's Global Ratings (S&P). S&P affirmed these ratings on 24 November 2017:

Global	– “BB” long-term rating
	– “B” short-term rating
National	– “zaAA-” long-term rating
	– “zaA-1+” short-term rating

The global scale long-term ratings carry a stable outlook. In terms of S&P's outlook on our stand-alone credit profile, we believe that we met all their requirements on capital, risk and funding to ensure the ratings remain unchanged.

## Transact (non-lending)

		2018	2017
Net transaction fee income	R'm	5 127	3 923
Net transaction fee to net income	%	41	37
Net transaction fee income to operating expenses	%	81	72
Active clients	million	9.9	8.6
Branches		826	796
Devices			
– ATMs		1 168	1 128
– Dual note recycler (DNRs)		727	525
– Partnership ATMs		2 750	2 371
– Total		4 645	4 024

The growth in our active client base, the expansion of our device and branch network and the investment in self-service banking has resulted in a 31% year-on-year increase in net transaction fee income (2017: 30%).

A DNR is similar to an ATM but has the enhanced functionality of allowing clients to also deposit cash instead of having to walk into a branch. The fees charged to a client to deposit cash at a DNR is 90c per R100 compared to a branch cost of R1.90 per R100.

Quality banking clients are those who have stable inflows into their account and stable product usage over a consecutive 3-month period. Our quality banking client base grew by 18% to 2.6 million clients (2017: 2.2 million). At 28 February 2018, our quality banking clients comprise 26% of our total active client base.

Primary banking clients are those who make regular deposits, mainly salaries.

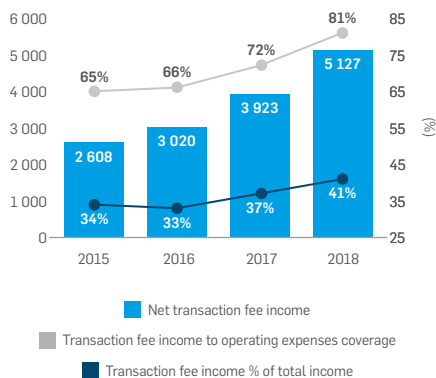
We increased our primary banking accounts on average by 31 000 per month in the 2018 financial year.

Our diversification objectives include covering all operating expenses with net transaction fees by 2022. The net transaction fee income to operating expenses increased from 72% to 81%. The net transaction fee income as a percentage of total net income improved to 41% (2017: 37%).

At 28 February 2018, our device network increased by 4% for ATMs and 38% for DNRs, with our device net transaction fee income increasing by 41%. Our device net transaction fee income comprises 19% of our total net transaction fee income for the year.

Net transaction fee income from debit orders, of which the majority relates to our quality banking clients, increased by 17% year-on-year (2017: 19%). Our branch network increased by 4% and income from branches increased by 27% (2017: 31%) due to improved efficiency and capacity created in-branch. The net transaction fee income from branches is 24% of our total net transaction fee income for the year. Expanding these networks ensures greater accessibility for our growing client base across all channels.

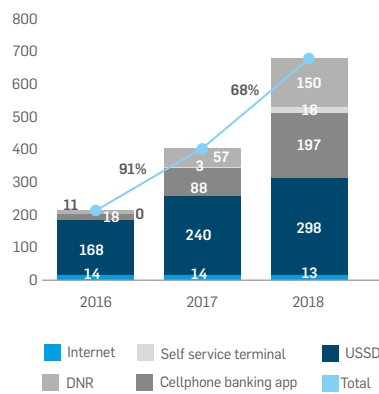
NET TRANSACTION FEE INCOME (R'm)



Our continued focus on and investment in self-service banking innovation is an integral part of our strategy to help clients better manage their financial lives. Self-service banking (banking app, internet banking, self-service terminals, DNR and USSD\*) net transaction fee income increased year on year by 68%. Self-service terminals allow clients to walk into a branch and print bank statements with a touch of a screen and a swipe of a card without needing to speak to a consultant. The fee charged to a client for printing a bank statement at a self-service terminal is R2.50 compared to R5.00 if requested from a consultant. These initiatives directly result in an increase in branch capacity, which enables our consultants to better serve our clients and address their needs, along with achieving savings in bank charges for the client.

The banking app was launched in the 2016 financial year. Its increased popularity is evident from the 2.9 million clients who activated the app. The banking app net transaction fee income growth increased year-on-year by 122% (2017: 401%).

SELF-SERVICE BANKING (R'm)



\* Unstructured supplementary service data (USSD) provides mobile users with menu-driven interactive services – mostly used by clients who do not have smart phones

## Credit

2018

2017

### Credit sales

Value of total loans advanced	R'm	28 292	27 226
Number of total loans advanced <sup>(1)</sup>	'000	3 947	3 508
Average of total loans advanced	R	7 168	7 761
Average loans advanced less than or equal to 6 months <sup>(1)</sup>	R	2 078	1 905
Average loans advanced greater than 6 months	R	32 133	26 605

### Credit book

Gross loans and advances	R'm	47 642	45 135
Average loan size at year end less than or equal to 6 months	R	2 621	2 736
Average loan size at year end greater than 6 months	R	36 302	31 123
Arrears – past due (not up-to-date with contractual obligations)	R'm	2 700	2 855
Arrears to gross loans and advances	%	5.7	6.3
Up-to-date that rescheduled from arrears (not rehabilitated <sup>(2)</sup> )	R'm	1 277	1 583
Arrears and up-to-date that rescheduled from arrears (not rehabilitated <sup>(2)</sup> ) to gross loans and advances	%	8.3	9.8
Up-to-date that rescheduled from up-to-date (not rehabilitated <sup>(2)</sup> )	R'm	1 085	1 088
Arrears and all rescheduled (not rehabilitated <sup>(2)</sup> ) to gross loans and advances	%	10.6	12.2
Provision for doubtful debts	R'm	5 828	5 930
Provision for doubtful debts to gross loans and advances	%	12.2	13.1
Provision for doubtful debts to arrears coverage	%	216	208
Provision for doubtful debts to arrears and rescheduled loans from arrears (not rehabilitated <sup>(2)</sup> ) coverage	%	147	134
Provision for doubtful debts to arrears and all rescheduled loans (not rehabilitated <sup>(2)</sup> ) coverage	%	115	107
Repayments <sup>(3)</sup>	R'm	35 974	33 236
Gross provision for doubtful debts charge	R'm	6 560	6 246
Bad debts recovered	R'm	1 280	1 125
Net provision for doubtful debts charge	R'm	5 280	5 121
Net provision for doubtful debts charge to average gross loans and advances	%	11.4	11.9
Total lending and insurance income (excluding investment income) <sup>(4)</sup>	R'm	15 008	14 362
Total lending and insurance income (excluding investment income) <sup>(4)</sup> to average gross loans and advances	%	32.4	33.4
Net provision for doubtful debts charge to total lending and insurance income (excluding investment income) <sup>(4)</sup>	%	35.2	35.7
Loan revenue <sup>(5)</sup>	R'm	14 596	13 720
Loan revenue <sup>(5)</sup> to average gross loans and advances	%	31.5	31.9

<sup>(1)</sup> Includes credit card. For a number of loans advanced, a month in which the credit card is utilised is counted

<sup>(2)</sup> Not rehabilitated – Clients are deemed to be rehabilitated once they have made contractual payments for 6 consecutive months. Once rehabilitated, the loan is classified as up-to-date

<sup>(3)</sup> Includes bad debts recovered and early settlements where a subsequent loan is taken, the last repayment does not lead to an outflow – prior years are restated to include this

<sup>(4)</sup> Interest received on loans, initiation fees, monthly service fee and net insurance income

<sup>(5)</sup> Interest received on loans, initiation fees, monthly service fee, net insurance income and loan fee expense



### *Loan-granting strategy*

The reason why clients approach credit providers for credit is that they have specific requirements. These requirements include the need for emergency cash, education, second-hand vehicles, and housing.

Unsecured lending plays a beneficial role in South Africa. One example of the role of unsecured lending is that a large section of the South African population live in dwellings on communal land and townships with no title deeds. These people can only build or improve their houses by accessing unsecured finance. Supporting this assertion is the fact that there are only 1.7 million mortgages in South Africa. Furthermore, more than 75% of South Africans do not have access to traditional secured lending to fund assets such as vehicles older than 5 years or appliances.

We encourage clients to match the term of the loan to the requirement for funds. Thus short-term loans and facilities (similar to overdrafts) are used for cash flow reasons, while medium-term loans are matched against appliances and education. The predominate use of long-term loans is for housing. By continuously refining our credit offer, we are able to provide clients unsecured credit solutions that best suit their personal needs and at competitive interest rates compared to the secured credit market.

In order to execute on this solution, we incorporate a comprehensive assessment of the client's behaviour, affordability and source of income. For the assessment, we use information from the credit bureaus, bank statements and payslips. We apply 3 parallel disposable income calculations i.e. the NCA affordability calculation, a Capitec client disposable income calculation that maintains conservative buffers and the client's own calculation. We then apply the most stringent of the 3. Branch staff have no credit granting discretion and all exceptions are managed and monitored by a centralised specialist team.

During the loan application process, we present the maximum loan amount, maximum term and maximum instalment to the client. Within these constraints, the client may select any combination that best suits her or him. We encourage clients to take up credit for shorter periods of time and for smaller amounts. This is done through a pricing model that discounts the interest rate in instances where clients select a term that is shorter than the maximum that they qualify for. This is due to the manner in which the pricing for risk model reacts to the lower default rates for such clients.

The fact that we have 9.9 million active clients allows us to analyse both the financial health of the client and monitor and identify trends. We use this to inform and support our credit granting appetite and to identify risk areas and opportunities.

There are various circumstances where clients may return later to take up additional credit, for example to fund projects such as home improvements or studies, and the funds are required over a period of time as the project or studies progress.

When existing clients apply for further credit, we again conduct a full credit assessment. If a client qualifies for further credit, it can be extended as a further agreement in addition to the current credit; or the client can have the existing credit consolidated into a new credit agreement. This is only available for clients if instalments are up-to-date (not in arrears on any Capitec loans) and clients who have a satisfactory credit risk. Only the amount of the separate new credit will be included in loan sales.

Our scoring models react to instances where a client repeatedly takes up credit, and when their debt to income ratio becomes too high. In such instances we limit the term and amount of credit offered to clients or we decline the application for credit.

We report the net amount of credit issued and we exclude the consolidation loans from loan sales.

The stricter granting strategy that we have applied since 2016 has resulted in lower growth in loan sales and loan revenue, whilst delivering a better performing loan book.

#### *Loan sales*

We achieved loan sales (new credit granted) of R28.3 billion this year (2017: R27.2 billion). The number of loans granted during the year increased to 3.9 million from 3.5 million in 2017.

Loan sales do not include any rescheduled loans. Rescheduling is an amendment to an existing loan contract with no new credit granted. No initiation fees are charged on rescheduled loans.

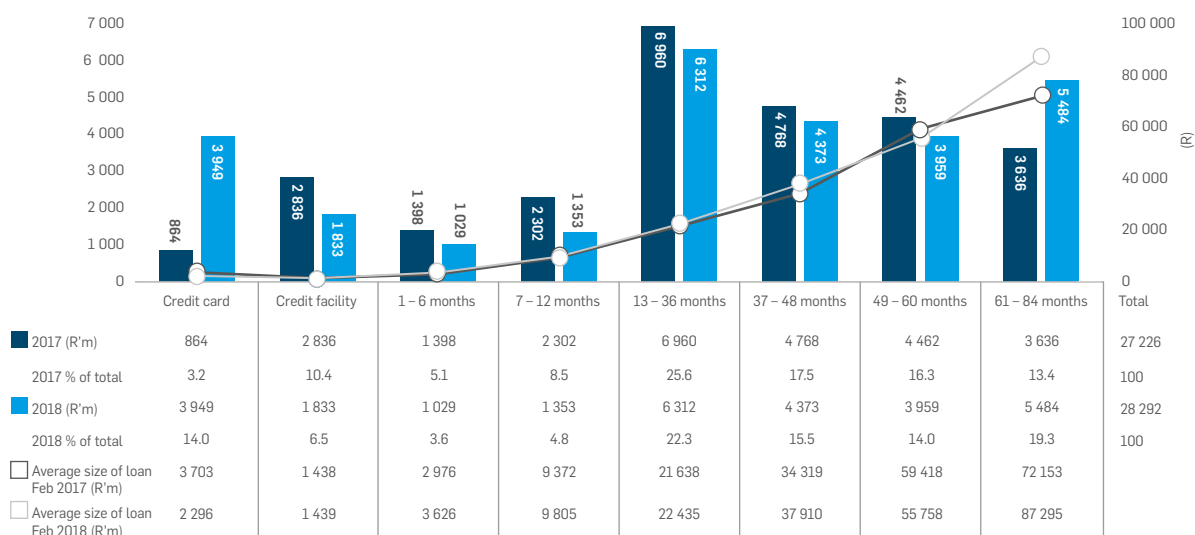
Loan sales in the 61 to 84 month category increased by 51% in 2018. Growth in the 61 to 84 month loans sales is driven by clients earning more than R20 000 (gross monthly income). This was achieved by a more accurate high-income earner risk model, made possible by our growing higher-income client base. These clients that subsequently opt for a shorter-term loan at a more competitive interest rate have driven the loan sales in the 13 to 36 month category.

The 2018 financial year presents the first full year that our credit card has been in operation. By 28 February 2018, 289 000 credit cards were in issue, with gross loans and advances reflecting R2 billion, or 4.2% of the credit book.

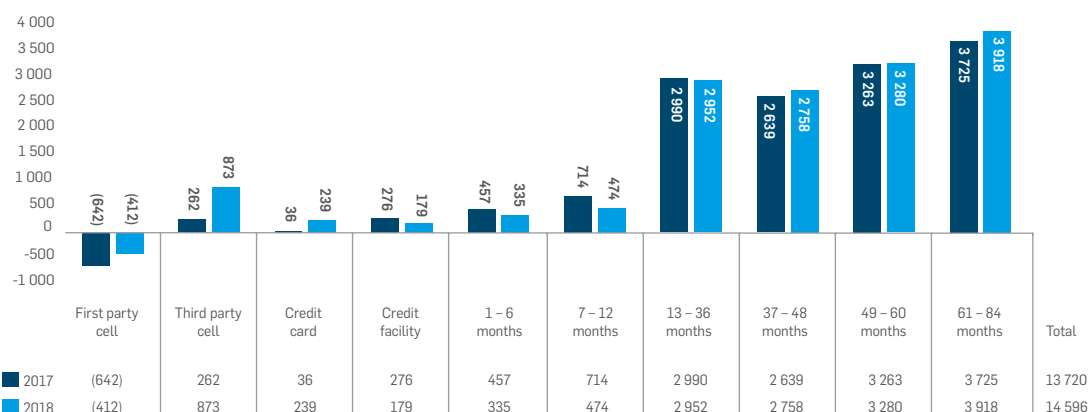
The credit card book is included in loans and advances less than or equal to 6 months. In each month that a credit card is utilised, 1 loan is counted towards the number of loans and advances granted. In terms of loan sales for the year, the average credit amount less than or equal to 6 months increased from R1 905 to R2 078, and the average credit amount greater than 6 months increased from R26 605 to R32 133.

The total average credit amount granted decreased from R7 761 to R7 168 due to the number of credit cards in issue during the year compared to the prior year.

### LOAN SALES BY PRODUCT



### LOAN REVENUE BY PRODUCT (R'm)



#### Loan revenue

Loan revenue is in line with the book growth of 6%, but interest income on loans has remained flat for the year. This is as a result of a lower interest yield on lower-risk loans advanced since 2016 and the fact that a larger portion of the book attracts a separable insurance charge.

From 6 May 2016 onwards, all loans greater than 6 months and certain credit card risk categories, required clients to obtain credit life insurance of their choice. We provide credit life insurance to clients under a third-party cell captive structure, if clients choose to obtain the necessary insurance through us. The credit book pre and post 6 May 2016 remains to be reinsured with top-rated reinsurance providers.

All related lending, investment and insurance income is separately disclosed in note 21 of our annual financial statements (included in this document as Appendix A on page 24). To compare interest income on a like-for-like basis when comparing year-on-year, the table below presents a reconciliation of the related loan revenue that takes the all-in charge into account.

Loan-related revenue reconciliation (R'm)	2018	2017	% change
Interest income on loans and advances to clients	12 440	12 389	0
Loan origination fees	776	836	(7)
Monthly service fee	919	875	5
Net insurance income*	873	262	234
Loan fee expense**	(412)	(642)	(36)
Loan-related revenue	14 596	13 720	6

\* Third-party cell captive net insurance income through Guardrisk from 6 May 2016

\*\* First-party cell captive insurance expense on loans granted before 6 May 2016 that are still on the credit book

The loan-related revenue reconciliation provides the comparative basis to the growth in the loan book.

We welcome the final Credit Life Insurance Regulations that came into effect on 9 August 2017. Our credit agreements concluded on or after this date meet all the necessary requirements and fee limits of insuring our clients in unfortunate cases of death, retrenchment, permanent and temporary disability or unemployment.

As the fees previously charged were below the regulatory limits implemented on 9 August 2017, our clients and profitability were not affected by these regulatory changes. For all credit life cover, we charge according to the client's risk and loan balance that remains outstanding. The fee adjusts downwards over the term of the loan as capital is repaid. This ensures our clients only pay to cover the value of the loan balance that remains outstanding. In terms of retrenchment, the Regulations require minimum cover equal to 12 months of the instalments due, but we continue to give our clients cover for the full loan balance outstanding and reinsure on this basis.

The costs incurred for every loan application are calculated and recovered through an initiation fee charged to a client who is successful in their application and takes up their loan. In terms of common practice, we charge the entire cost related to the loan application upfront when incurred. In terms of our accounting policy, the fee to recover this cost is deferred and amortised over the term of the loan on an effective interest rate basis. The fee is included under interest income and is disclosed separately in note 21 of the annual financial statements. Initiation fees are only charged on new loan sales and all initiation fees comply with the National Credit Act (NCA). No initiation fees are charged on rescheduled loans. When a client receives additional credit on consolidation of a loan, only the additional credit that is advanced is subject to initiation fees. Only this new credit advanced is included in loan sales for the financial year.

Initiation fees comprise 5.2% of total lending and insurance income (excluding investment income) (2017: 5.8%), and 4.4% of income from operations for 2018 (2017: 5.3%). We charge clients a monthly fee for term loans, overdrafts, facilities and credit cards that are well below the NCA price caps. Monthly fees comprise 6.1% of total lending and insurance income (excluding investment income) (2017: 6.1%), and 5.2% of income from operations for 2018 (2017: 5.5%).

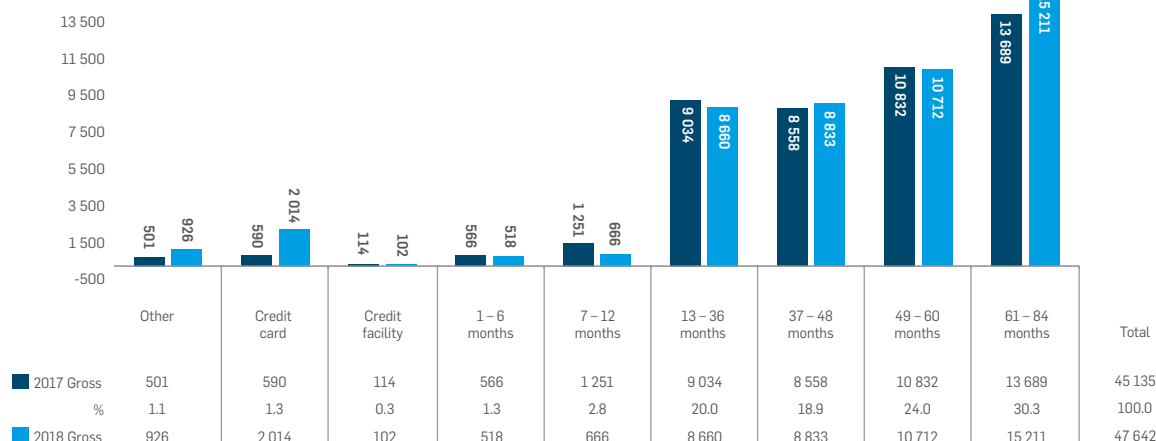
Reconciliation of the credit book (R'm)	2018	2017
Opening gross loan book	45 135	40 891
Credit sales – Value of total loans and advances	28 292	27 226
Total lending and insurance income (excluding investment income)*	15 008	14 362
Repayments**	(35 974)	(33 236)
Third-party cell captive cost***	563	214
Bad debts written off	(6 662)	(5 447)
Bad debts recovered	1 280	1 125
Closing balance	47 642	45 135

\* Interest received on loans, initiation fees, monthly service fee and net insurance income

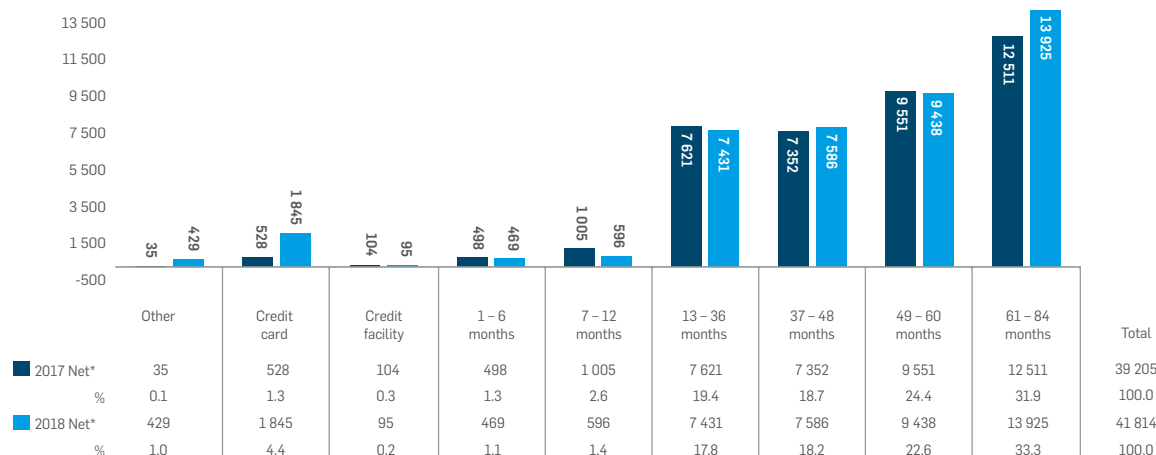
\*\* Includes bad debts recovered and early settlements where a subsequent loan is taken, the last repayment does not lead to an outflow – prior years are restated to include this

\*\*\* Third-party loan insurance through Guardrisk is an option to our clients since 6 May 2016. We reflect the income net of cost. The cost represents third-party reinsurance costs

### GROSS LOAN BOOK BY PRODUCT (R'm)

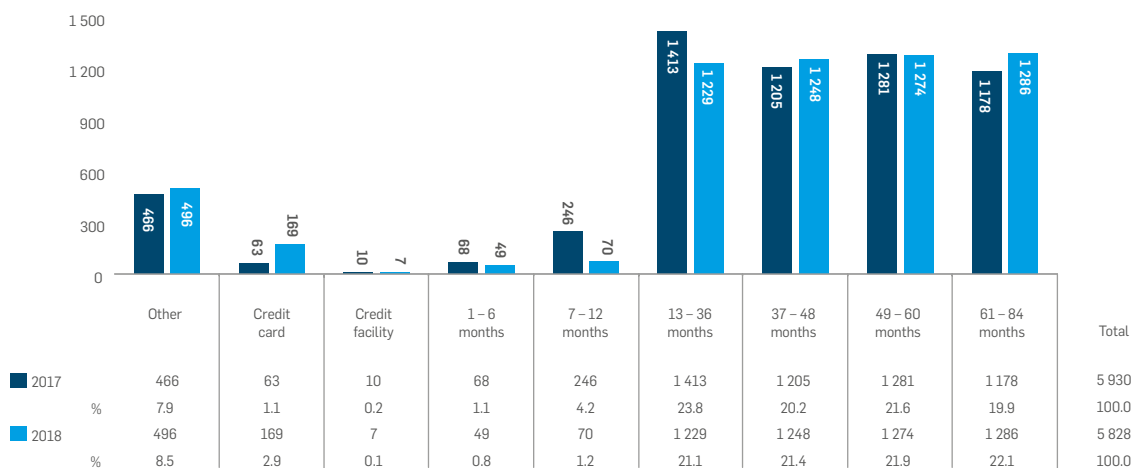


### NET LOAN BOOK BY PRODUCT (R'm)



\* Net loans and advances net of impairment provisions.  
It should be noted that the above chart is not a maturity analysis. Clients repay part of the capital on each of the product types in the following month, the month thereafter and so forth.

### PROVISION FOR DOUBTFUL DEBT BY PRODUCT (R'm)



## *The credit book*

The following terminology is used when referring to the credit quality of loans and advances to clients:

<b>Loan status</b>	<b>Description</b>
Up-to-date	Clients that are fully up to date with their original contractual obligations or amended contractual obligations that are rehabilitated, post rescheduling, are classified as up-to-date.
Arrears	Past due loans and advances reflect the total outstanding balances, where 1 or more instalments (or part of an instalment on any of the client's loans and advances) remain unpaid against the contractual payment date, that is 1 day past the contractual payment date but not more than 3 months in arrears. The arrears balance therefore includes rescheduled loans when the adjusted instalment was not paid.
Rescheduling	Rescheduling refers to an amendment of the original terms of the loan contract, as formally agreed between us and the client. Rescheduling is used as a rehabilitation mechanism for clients in arrears who are contacted successfully by centralised collections. It is also used as a proactive mechanism to assist up-to-date clients who contact us when wanting to reschedule their loans due to changes in their circumstances. No initiation fee is charged on a rescheduled loan as no new credit is granted.
Rehabilitated	Clients are deemed to be rehabilitated once they have made contractual payments for 6 consecutive months post rescheduling. This is supported by statistical analysis.
Rescheduled from up-to-date not rehabilitated	These are loans and advances relating to clients that were fully up to date with their original contractual obligations, however have contacted us to reschedule the original terms of their loan due to a change in their circumstances and have made payment under the rescheduled terms. These loans are up-to-date with their amended contractual obligations post rescheduling but have not yet made consecutive payments for 6 months under the amended contract.
Rescheduled from arrears not rehabilitated	These are loans and advances relating to clients that were in arrears and were subsequently rescheduled and have made payment under the rescheduled terms. These clients are up-to-date with their amended contractual obligations but have not yet made payments for 6 consecutive months under the amended contract.
Expected recoveries receivable	The net present value of expected future recoveries on loans written off.
Write-off	The earlier of loan balances that have a legal status, e.g. debt review or deceased, handed over or are 3 months or more in arrears, are substantially written off.

## Analysis of net loans and advances by status – 2018

GROUP								
R'000	Performing book					Non-performing book	Expected recoveries receivable	Total
	Up-to-date	Rescheduled from up-to-date not rehabilitated	Sub-total	Rescheduled from arrears not rehabilitated	Sub-total	Arrears		
Gross loans and advances	41 673 695	1 085 352	42 759 047	1 277 234	44 036 281	2 699 936	906 273	47 642 490
Cumulated impairment	(3 234 766)	(188 907)	(3 423 673)	(649 648)	(4 073 321)	(1 754 774)	–	(5 828 095)
	38 438 929	896 445	39 335 374	627 586	39 962 960	945 162	906 273	41 814 395
Provision %	7.8	17.4	8.0	50.9	9.2	65.0		12.2

## Analysis of net loans and advances by status – 2017

GROUP								
R'000	Performing book					Non-performing book	Expected recoveries receivable	Total
	Up-to-date	Rescheduled from up-to-date not rehabilitated	Sub-total	Rescheduled from arrears not rehabilitated	Sub-total	Arrears		
Gross loans and advances	39 084 980	1 087 996	40 172 976	1 582 527	41 755 503	2 854 870	524 984	45 135 357
Cumulated impairment	(3 024 728)	(166 384)	(3 191 112)	(820 757)	(4 011 869)	(1 918 508)	–	(5 930 377)
	36 060 252	921 612	36 981 864	761 770	37 743 634	936 362	524 984	39 204 980
Provision %	7.7	15.3	7.9	51.9	9.6	67.2		13.1

## Credit quality of gross loans and advances shown in up-to-date

R'000	GROUP	
	2018	2017
Up-to-date – never rescheduled	39 452 802	36 624 152
Up-to-date – rescheduled from up-to-date and fully rehabilitated	1 228 460	1 529 180
Up-to-date – rescheduled from arrears and fully rehabilitated	992 433	931 648
	41 673 695	39 084 980

The average loan size at year end greater than 6 months was R36 302, whereas the average loan amount sold (new credit granted) greater than 6 months was R32 133 for the current year. The difference is best explained by the way of an example:

Assume 4 loans of R12 500 each and 1 loan of R50 000 were granted during the year. This results in an average loan amount sold of R20 000 per loan for the period. If 1 of the 4 R12 500 loans is fully repaid, the average loan size at year end would be R21 875.

This example explains the possibility of having an average credit book greater than the average credit granted.

Loans and advances in the up-to-date not rescheduled status as a percentage of gross loans and advances increased from 81.1% to 82.8%. Arrears as a percentage of gross loans and advances decreased from 6.3% to 5.7% in the current year. This is a direct result of the implementation of our stricter granting strategy and rescheduling policy since 2016, along with the increase in the number of clients in debt review (discussed under bad debts written off below). Our arrears as a percentage of gross loans and advances are low due to our strict write-off policy.

Arrears and up-to-date loans rescheduled from arrears (not rehabilitated) to gross loans and advances, decreased from 9.8% to 8.3%. Arrears and all rescheduled loans (not rehabilitated) to gross loans and advances decreased from 12.2% to 10.6% in the current year. The rescheduling policy that we applied has prevented lower risk clients from rescheduling that are currently up-to-date with their loan instalments and clients in arrears from rescheduling if their risk is deemed to be too high.

The significant increase in expected recoveries received of R906 million (February 2017: R525 million) is due to a larger proportion of the credit book that related to debt review being written off. Loans that are written off due to debt review have a higher recovery.

If the client is in arrears due to challenges regarding the client's inability to repay the debt, we either negotiate with the client to immediately bring the arrears instalments up to date, or we attempt to help and manage the situation through agreeing a course of action with the client by amending the loan agreement (loan reschedule).

The first solution is preferable, as it:

- reduces arrears if the client pays on the same date;
- improves our cash flow;

- helps restore the client to a creditworthy position; and
- limits the overall cost of credit for clients.
- Practically, there is a risk that placing too much pressure on clients (such as expecting clients in financial distress to repay 2 instalments in a single month when they cannot afford to do so) can be counter-productive. In such a case, clients could refuse to cooperate, stop communicating with us and stop paying instalments.

Unforeseen circumstances may lead to reduced income or increased expenditure for the client. The circumstances may include:

- employers that reduce overtime and bonuses or place staff on short pay due to difficult economic conditions;
- strikes;
- clients may be forced to change employment at reduced salaries due to poor performance or health problems; or
- financial problems faced by employers.

These instances may result in a client missing an instalment on a loan and being in arrears.

We have extensive history that measures the yields we can receive by handing clients over to external debt collectors. We monitor the cash flow yields that we receive from this process against internal collection processes, including rescheduling. We optimise the strategy for different client groups and use handover samples for each strategy to monitor the relative performance and validate the strategy for each client group.

Factors that we consider in delivering the optimal strategy for a client include:

- the risk profile and payment history of the client;
- the arrears status of the client (1 or 89 days in arrears, for example);
- whether the client was rescheduled previously;
- the credit exposure amount;
- free cash flow estimates derived from clients' bank accounts or credit bureau records (salary less debit orders); and
- any information we have about the client's employer.

Depending on a combination of factors, the optimal strategy is to encourage clients with some free cash flow or limited credit exposure to bring arrear instalments up to date; or assist clients in cash flow difficulty but have good behaviour history, to reduce their instalments and extend the term of the credit agreement (i.e. reschedule). When there is a clear temporary interruption of income such as a strike or a client is on maternity leave, we may allow a reduced



instalment for a short period (typically 3 months) with subsequent increased instalments, in order to assist the client through this period (i.e. variable reschedule). We hand over clients and write the loan off, when the problem appears to relate to the clients' unwillingness or inability to pay.

We use system-based rules to limit instances where we allow rescheduling. We do not reschedule all loans that meet our criteria, as this depends on the individual circumstances of each client applying to reschedule. Successfully treating clients that were in arrears decreases the overall quality of the loan book, as clients who would otherwise have been written off remain on balance sheet. We do however, treat, monitor and separately disclose the performance of these clients. (See provisions discussed below.) We monitor the performance and cure rate of reschedules. Based on statistics, we decrease write-offs by approximately 25%.

This process allows us to optimise collections and reduce clients' debt levels. Our aim is always to partner with our clients through both good and tough times and act in their best interest.

### *Provisioning*

Capitec uses a provisioning model based on historic roll rates using the Markov chain method. At every month end, each loan is categorised with a specific status, for example:

- up-to-date with a contract delinquency of zero (CD0);
- clients who have missed an instalment and are 1 day up to 1 month in arrears (CD1);
- greater than 1 month up to 2 months in arrears (CD2);
- greater than 2 months up to 3 months in arrears (CD3); or
- clients that reschedule from either up-to-date or arrears statuses that are now up-to-date or in arrears.

The model calculates the historic rates at which clients change statuses between the categories. We typically use a 12-month rolling average, but also monitor longer-term

(24-month) averages to understand trend changes. We apply the most conservative result, i.e. if there were "bad" trends 13 to 24 months ago, we stretch the statistics to the past 24 months. If the bad trends occurred in 1 to 12 months, we use the 12 months, so the effect is not watered down. When instalments are not fully paid, our model reflects clients in the higher delinquency status (i.e. we treat partial payment similar to no payment).

Furthermore, we raise a provision on client as opposed to product level, i.e. if a client with more than 1 loan (term loan and a credit facility) defaults on any of his/her loans, the total balance of the client (term loan and credit facility) attracts the higher CD provision percentage.

We stratify the Markov roll rate results into similar groups to ensure results are stable and appropriate to predict future cash flows for clients with similar characteristics. We stratify on aspects such as client risk groups, time on book, product term, payment frequency (monthly, fortnightly or weekly), default statuses, employment, industry and rescheduling status. From 1 March 2018, we will also apply the behaviour scores of clients to this list.

One of the fundamental principles that we designed into the model is to distinguish between status changes from arrears to up-to-date due to the repayment of instalments, as opposed to status changes resulting from rescheduling. This is important, as we use the model to estimate cash flows. When the status of a loan changes from CD1 at the end of the first month to CD0 (up-to-date) at the end of the second month, the model interprets this as a repayment. However, a status change from CD1 to CD0 accompanied by a rescheduling indicator reflects no repayment. We record status changes for rescheduled loans separately, which enables us to estimate cash flows accurately for rescheduled loans.

The model combines the roll rate matrices with a loan amortisation model on a loan-by-loan basis. The specific features of each loan such

as balance, interest rate, fees, remaining term, instalments and arrears status, combined with the roll rates applicable to loans with the same characteristics, estimate the expected cash flow and balance amortisation of the loan. The rolled-up results enable us to analyse portfolio and segmented views. The doubtful debt provision calculation amounts to the excess of the balance of a loan over the present value of its expected cash flows, discounted at an effective all-in rate (all fees and interest).

At 28 February 2018, the model estimated average provision rates of 8% for clients in CD0, 42% for clients in CD1, 78% for clients in CD2 and 88% for clients in CD3. The model estimated provision rates of 17% for clients rescheduled out of arrears (not rehabilitated) and since rescheduling remained in CD0. This is more than double the provision rate for clients who have never rescheduled, but less than half the percentage relating to clients in CD1. Although the model predicts a default rate of 17% for rescheduled clients, the provision is maintained at 51%, as we do not release the arrears bucket provision when the client reschedules. Provisioning rates change monthly and are based on statistics.

We continuously validate the results by monitoring the cash flow yields on the rescheduled portfolio relative to similar clients in arrears. The results confirmed that rescheduled clients perform significantly better than clients that remained in arrears, but worse than not-rescheduled up-to-date clients. The analysis also indicated that the risk remained elevated for a period of approximately 6 months (9 months in the case of variable rescheduled loans due to the 3 month period during which we allow reduced instalments) relative to clients who have not rescheduled.

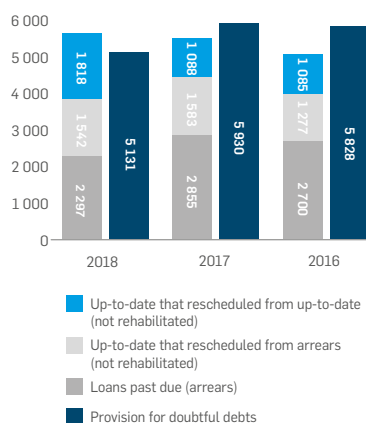
For provisioning purposes, we release the difference between the arrears provision and the rescheduling provision over a period of 12 months. Should the client default on the rescheduled loan, the client is included in CD1, but at an increased provision percentage, that reflects the escalated risk. The provision results confirm the validity of the strategy of rescheduling, where the appropriate client characteristics were identified, as an effective solution to rehabilitate clients in arrears.

The provision for doubtful debts as a percentage of gross loans and advances decreased to 12.2% from 13.1% last year. The movement is a reflection of the performance of the loan book and stricter granting strategy.

The up-to-date portion of the loan book that carries a lower provision balance increased, while the loans in arrears that carry a larger provision balance decreased. This resulted in the total decrease of the provision balance when compared to the growth in the loan book.

We continue to be prudent in our approach to provisioning, with an arrears coverage ratio of 216% (2017: 208%), arrears and rescheduled loans from arrears not rehabilitated coverage ratio of 147% (2017: 134%), and arrears and all rescheduled loans not rehabilitated coverage ratio increasing to 115% (2017: 107%).

PRUDENT PROVISIONING



### Bad debt written off

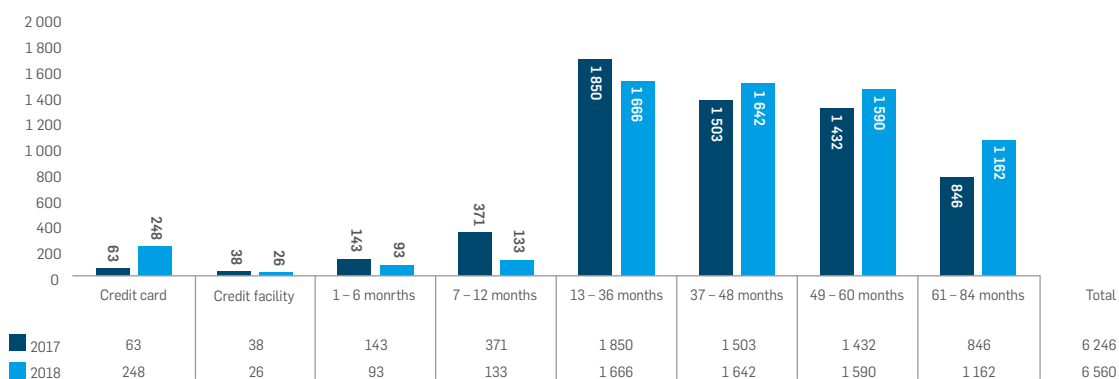
The net provision for doubtful debt charge was R5.3 billion for the year, an increase of 3% (2017: R5.1 billion) and is 11% (2017: 12%) of average gross loans and advances. The net impairment charge comprises bad debts written off, the movement in the provision for doubtful debts and bad debts recovered.

As per our bad and doubtful debt methodology, a client who is in debt review, is substantially written-off, irrespective of the clients' loans status prior to being in debt review. The client could be up-to-date with all instalments but once in debt review, the balance is immediately written-off without rolling into arrears. The major increase in bad debts written-off in the current year is due to the increase of clients in debt review and loans advanced under a different granting and risk strategy of prior periods that was provided for.

The decreased movement in the provision for doubtful debts balance is due to the stricter granting strategy and the overall performance of the loan book.

	2018	2017	2016	2015
Bad debts written off	6 662	5 447	3 981	4 396
Movement in provision for doubtful debt	(102)	799	1 274	220
Gross provision for doubtful debt charge	6 560	6 246	5 255	4 616
Bad debts recovered	(1 280)	(1 125)	(854)	(602)
<b>Net provision for doubtful debt charge</b>	<b>5 280</b>	<b>5 121</b>	<b>4 401</b>	<b>4 014</b>

GROSS PROVISION FOR DOUBTFUL DEBT CHARGE (R'm)



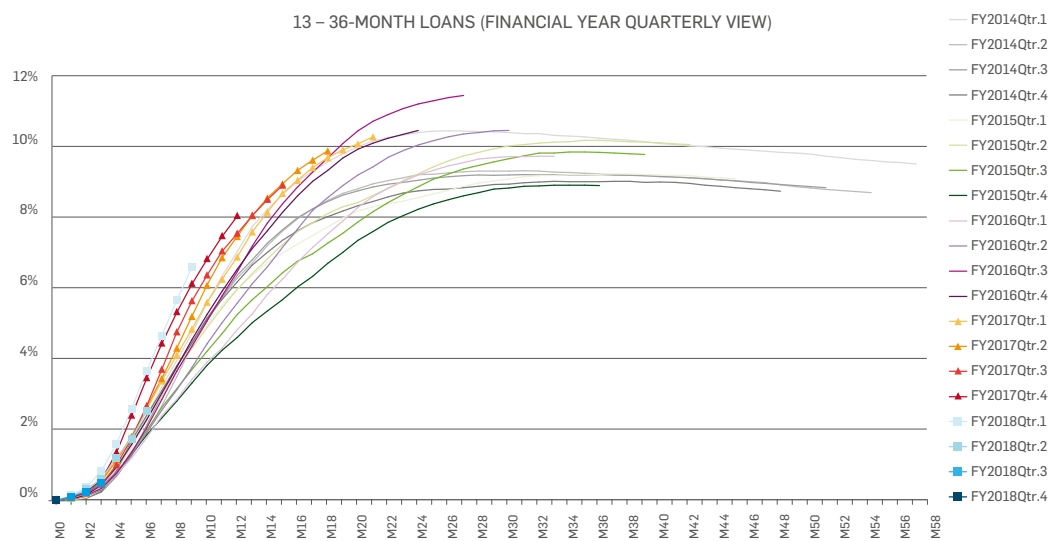
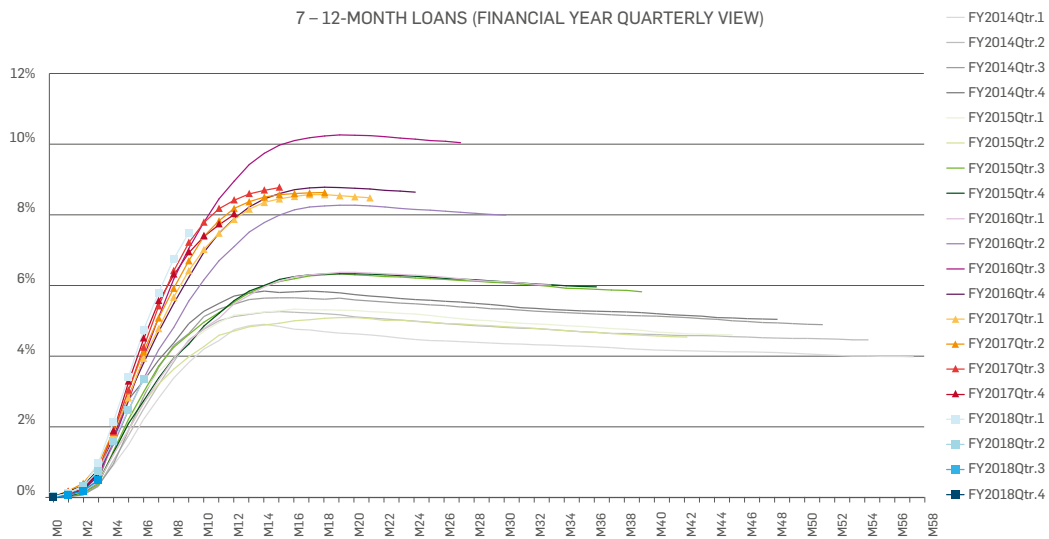
### Recoveries

Bad debts recovered increased by 14% year on year from R1.1 billion to R1.3 billion in 2018. This increase is due to the improved efficiencies in our debt collection environment.

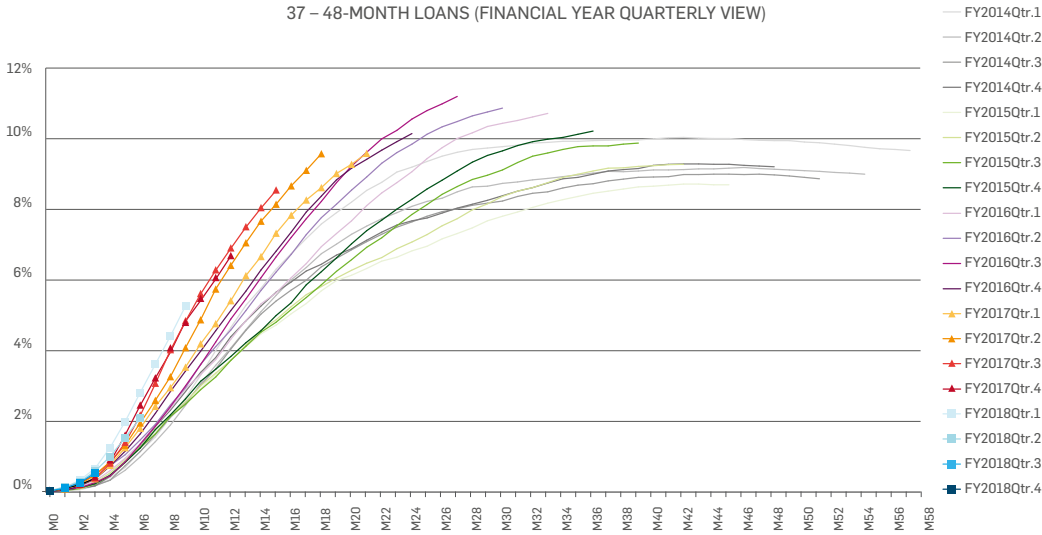
*Vintage graphs*

We grant credit using risk based pricing, and price for the probability that a client will default on payments. This is expressed as a probability that a client would be 3 months or more in arrears, legally handed over to external debt collectors or under debt review (written-off). As part of the continuous evaluation of performance against the priced risk, any deviations identified in specific groups of clients are addressed to ensure we remain within our risk appetite.

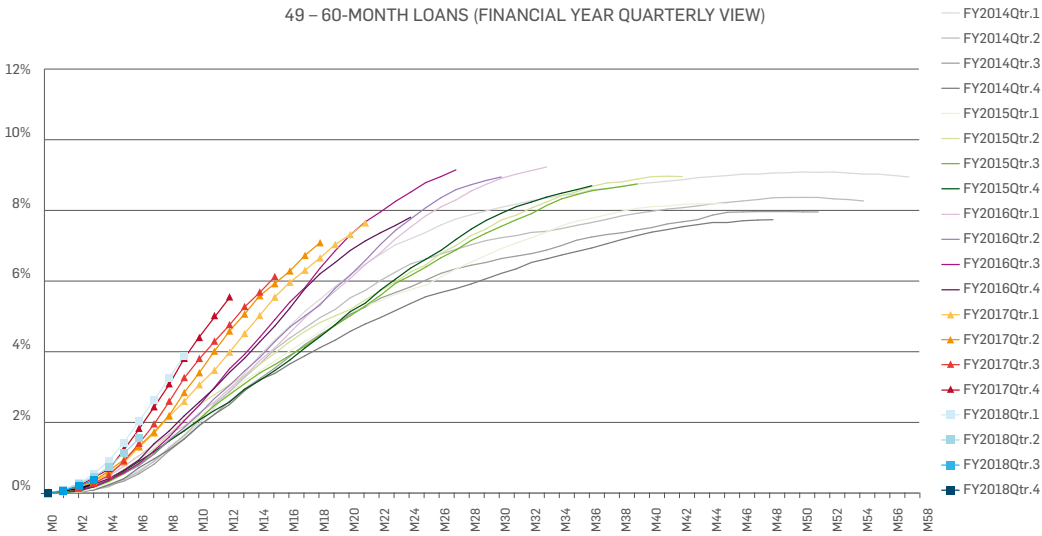
The vintage graphs below express the balance at risk at time of write-off as a percentage of the total original planned instalments for the loans granted in a given quarter. The vintages reflect our experience of write-offs but do not include post write-off recoveries. (Over the past 2 financial years we have found debt review to have been a large contributor to our bad debts written off. Our experience of recoveries on debt review is more than on other written off debt. If this was factored into the below vintages, the curves would trend lower).



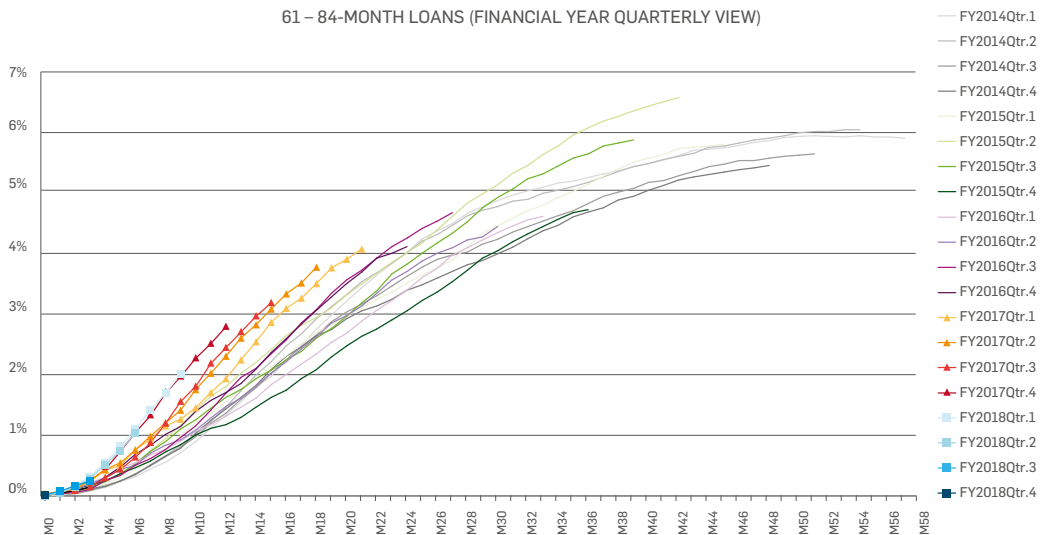
37 – 48-MONTH LOANS (FINANCIAL YEAR QUARTERLY VIEW)



49 – 60-MONTH LOANS (FINANCIAL YEAR QUARTERLY VIEW)



61 – 84-MONTH LOANS (FINANCIAL YEAR QUARTERLY VIEW)



### Operating and capital expenditure

		2018	2017
Cost to income ratio	%	36	34
Number of employees		13 333	13 069
Operating expenditure	R'm	6 364	5 439
Employee costs	R'm	3 294	2 835
Capital expenditure	R'm	829	1 000

Client-centric focus and personal service drives investment in operations. The objective this year was to enhance the client experience by improving efficiency and the diversification of our Global One Solution.

Our cost-to-income ratio increased from 34% for 2017 to 36%. Operating costs increased with 17% for the year in line with earnings growth.

Improving efficiencies and increasing capacity in existing branches resulted in 30 new branches opening in strategic areas during the year compared to 76 new branches in the prior year.

Basic employee salary expenses increased by 18% (2017: 21%) due to the growth of key personnel in digital solutions focused on business development.

Capital expenditure decreased by 17% (February 2017: 42% increase) as a direct result of executing the strategy of improving efficiency and capacity in existing branches.

## Regulation

The regulatory environment constantly changes. We proactively contribute to and manage our regulatory environment by taking care of the interests of our stakeholders and clients.

The table below summarises the status of these developments and their impact:

Regulator	Status
<b>South African Reserve Bank (SARB)</b>	<p>Capitec is closely involved in the development of a more secure debit order collection system called Authenticated Collections/DebiCheck which aims to replace the existing AEDO and NAEDO systems. The banks and selected users are in a pilot phase and the system must be fully implemented by 31 October 2019. The impact of changes will be addressed in our processes.</p> <p>Review of the various methods used for calculating the capital requirements for credit risk, and the introduction of a method for holding capital on interest rate risk positions. Capitec is involved in the working groups that are part of assessing these developments.</p> <p>Introduction of the Deposit Insurance Scheme (DIS), a wholly owned subsidiary of the SARB, which will require banks to contribute to the fund. Contributions are based on the level of covered deposits, which covers up to R100 000 per client deposit.</p> <p>IFRS 9 will implemented from 1 March 2018. Capitec has selected to phase in the CAR impact as specified per SARB Directive 5 of 2017. For CAR purposes, a deferred tax asset balance is risk weighted at 250%. The total CAR impact will be an approximate 1.7% decrease by adjusting the opening retained earnings and the related deferred tax asset.</p>
<b>South African Revenue Service (SARS)</b>	<p>A new section 11(jA) of the Income Tax Act relating to the allowance banks may claim with respect to the balance of doubtful debts provision becomes effective in the first tax year of implementing IFRS 9. A further deferred tax asset will arise due to a different percentage allowance which we will be able to claim, when IFRS 9 is effective, as opposed to what we currently claim. The increase in the deferred tax asset balance as a result of the new tax law amendments is subject to the same phase-in period for CAR purposes. We estimate the total decrease on the CAR to be 0.8%.</p>
<b>Department of Trade and Industry (dti) and National Credit Regulator (NCR)</b>	<p>Draft National Credit Amendment Bill was published in the Government Gazette, No. 41274 of 24 November 2017 and BASA submitted its comments to the Portfolio Committee of Trade and Industry. The Bill introduces a "Debt Intervention" mechanism (similar to debt review) which includes the right of the National Consumer Tribunal (NCT) to extinguish a debt in its entirety. An amount of debt may need to be written off as well as the formation of a debt intervention department within the bank.</p> <p>MFSA (Micro Finance South Africa) is challenging the NCR and DTI regarding the economic feasibility of the Credit Life Insurance Regulations. If the court agrees with MFSA the regulations published in the Government Gazette 40606 on 9 August 2017 may be suspended.</p>

Our 2019 financial year budget has been approved by the board and we look forward to executing on the strategy and objectives that we have set ourselves to achieve.



**André du Plessis**  
Chief financial officer

# APPENDIX A

R'000	GROUP		COMPANY	
	2018	2017	2018	2017
<b>21. Net lending, investment and insurance income</b>				
<b>Interest income</b>				
Loans and advances to clients	12 439 709	12 389 250	-	-
Loan origination fees	775 807	836 080	-	-
Non-bank money market placements	893	178	215	126
Money market funds and term deposit investments	1 522 756	1 288 157	-	-
Treasury bills	21 972	30 986	-	-
Bank balances	6 294	10 095	-	-
Resale agreements	79 658	18 331	-	-
Debentures	1 517	4 116	-	-
Interest-bearing instruments	625 851	357 234	-	-
<b>Total interest income</b>	<b>15 474 457</b>	<b>14 934 427</b>	<b>215</b>	<b>126</b>
<b>Loan fee income</b>				
Monthly service fee	919 328	874 938	-	-
Net insurance income <sup>(1)</sup>	873 524	261 883	-	-
<b>Total loan fee and insurance income</b>	<b>1 792 852</b>	<b>1 136 821</b>	<b>-</b>	<b>-</b>
<b>Total lending, investment and insurance income</b>	<b>17 267 309</b>	<b>16 071 248</b>	<b>-</b>	<b>-</b>
<b>Interest expense</b>				
Retail savings	(1 626 026)	(1 373 051)	-	-
Retail fixed deposits	(1 813 130)	(1 287 741)	-	-
Other unlisted wholesale	(79 824)	(95 045)	-	-
Subordinated debt	(297 452)	(338 860)	-	-
DMTN	(283 035)	(352 218)	-	-
Negotiable deposits	(82 468)	(102 844)	-	-
Other	(2 514)	(2 062)	-	-
<b>Total interest expense</b>	<b>(4 184 449)</b>	<b>(3 551 821)</b>	<b>-</b>	<b>-</b>
<b>Loan fee expense</b>	<b>(412 867)</b>	<b>(642 445)</b>	<b>-</b>	<b>-</b>
<b>Total lending, investment and insurance expense</b>	<b>(4 597 316)</b>	<b>(4 194 266)</b>	<b>-</b>	<b>-</b>
<b>Net lending, investment and insurance income</b>	<b>12 669 993</b>	<b>11 876 982</b>	<b>215</b>	<b>126</b>

<sup>(1)</sup> Refer to note 9 of the annual financial statements.



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