T +27 21 809 5900 F +27 21 880 1130
1 Quantum Street, Techno Park, Stellenbosch 7600 PO Box 12451, Die Boord, Stellenbosch 7613
www.capitecbank.co.za

24 May 2018

Viceroy Research Group
E-mail: viceroyresearch@gmail.com

Dear Sirs

**RE: OPEN LETTER TO THE AUDIT COMMITTEE**

We refer to your open letter to the Audit Committee of Capitec Bank Holdings Limited ("Capitec") dated 16 May 2018.

Before we deal with the substance of the six questions you pose to the audit committee, we would like to make some general comments regarding the broader interaction between yourselves and Capitec to date:

We believe that external parties such as auditors, regulators, analysts etc. are important role players in public equity markets and have a valuable role to play in exposing financial wrongdoing. At the same time, it is expected of all market participants to behave in a responsible manner that will enhance the public's trust in the functioning of public markets. In assessing the way you have chosen to engage with Capitec, we have come to the conclusion that you should have engaged differently, which would have avoided a lot of the misunderstanding which has characterised the whole affair thus far. You chose to start off with launching a public campaign, appealing to regulators with strongly-worded and emotive demands and then only writing a letter to the board at a later stage, followed by the latest letter to the audit committee, all the while refusing to meet face-to-face with Capitec management. In our own experience, you would have gained a lot by first engaging with management, then escalating any unanswered questions to the audit committee, then addressing the whole board and only when you had exhausted all other avenues appealing to regulators in a public campaign.

In every instance of the allegations made by yourselves, Capitec management has professionally responded in detail and have painstakingly pointed out where you misunderstood certain concepts or made certain errors in calculation. The audit committee is satisfied that management has comprehensively refuted all your allegations to date.

Most of the six questions you pose are quite technical in nature, which is to be expected given the complexity of banking and accounting disclosures. What follows are simple answers to your questions, referenced to an appendix with the more technical substantiation of the answers.

1. **Can the audit committee justify management's analysis that Capitec loans are trending towards the long-term?**

Yes, we can. Your analysis in Figure 2 is incorrect due to the effect of the credit card on the shorter end of the loan book. If you repeat the analysis excluding the credit card, which is fundamentally different in nature to a term loan, your answers would correspond with management's analysis that Capitec loans are trending towards the long-term.

Capitec Bank Holdings Limited Reg. No.: 1999/025903/06
Directors: R Stassen (Chairman), GM Fourie* (CEO), LA Dlamini, AP du Plessis* (CFO), MS du P le Roux, K Makwane, NS Mashiya*, JD McKenzie, NS Mjoli-Mncube, PJ Mouton, CA Otto, JP Verster *Executive director. Company Secretary: YM Mouton

We also note that your analysis in Figure 5 does not take into account the reclassification of loans that are subject to consolidation between the <6 months and >6 months term categories. This also applies to the more detailed term categories as disclosed in the Integrated Annual Report. Capitec Management has taken this into account in the data which supports their claim.

**2. Can the audit committee elaborate on the nature of internal consolidations and provide analysis into the net loan sales executed to customers who have consolidated existing loans?**

Internal consolidations occur in some cases where a client with an existing Capitec loan applies for further credit. A consolidation loan would always be a result of a full credit assessment process that all clients (both new and existing) go through when applying for new credit, to check whether the client can afford the additional credit applied for. The outcome of that full credit assessment process is either a consolidation loan, a new separate loan or no new loan granted. Only the incremental portion is counted toward loan sales. As per slide 19 of the 2018 annual financial results presentation, only 3.3% of loan sales for the second half of the financial year were to 'Frequent Maximum Borrowers', i.e. clients who had taken over 80% of the maximum amount of credit that they qualified for during that six-month period, and then took out more credit again later.

**3. What is the rationale in decreasing bad debt provisions while bad debt is increasing exponentially?**

The increase in bad debt you refer to (the write-off component) is backward-looking, while the bad debt provision is forward-looking, based on the more recent performance of the loan book. It is a common occurrence for the one to increase while the other one decreases (or vice versa) at turning points in economic cycles. It would be more useful if you had analysed the bad debts on a six-monthly basis, rather than an annual basis, to see the recent improvement in the loan book performance more clearly. Note that your own analysis in Figures 11 and 12 ignores the significant increase in bad debts recovered. If you do the same analysis with 2015 as a base rather than 2016, and use net bad debts written off (not gross), which is more appropriate, the gross loan book has grown by 31% and net bad debt written off by a not-too-dissimilar 42%.

**4. Why have Capitec changed their provisioning method?**

Capitec has not changed the provisioning methodology whatsoever. The narrative of the provisioning model in the 2017 CFO report was written in relation to a monthly instalment frequency, which represent more than 95% of the loan book. For a client that pays instalments monthly, CD1 would mean one instalment in arrears and CD3 would mean 3 instalments in arrears. For weekly instalments, CD1 would mean any of the instalments of the first month where after the client would go into CD2 in month 2.

**5. Can the audit committee elaborate on management's analysis of loan book quality?**

The audit committee is comfortable with management's analysis of loan book quality and would highlight the following in terms of Viceroy's own analysis as per Figure 18:

Of the R1,215 billion increase in bad debts written off between 2017 and 2018, R639m was due to the increase in debt review balances written off. Given the relative sizes of the total gross loan book to the debt review book (roughly 20x), the significant contribution of the debt review book to the increase in total bad debts written off does indicate causation, as per management's commentary. For your thesis to be true, the relative contributions of the total gross loan book and the debt review book to bad debts written off should be similar to the relative sizes of the two, which it is not.

On bad debt recovery – given the longer-term nature of debt review recoveries, it will take time for the recovery efficiency ratio to increase, but you can already see the increase when

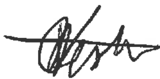
comparing 2018's H2 to H1. The absolute value of bad debts recovered did indeed increase, supporting management's comments.

On curing – Your analysis muddles 'flow' amounts with period-end balances, a fundamental error you have made before. Your analysis in Figure 22 should not divide the total balance falling into arrears by the gross loan book, but rather by the gross loan book *plus* the flow of new loans (as represented by loan sales) and fees, as written off balances includes fees charged to the accounts. Following this procedure will indicate an improvement in balances falling into arrears as a proportion of the total balances that *could* fall into arrears (opening value of the loan book *plus* loan sales).

**6. Can the company elaborate on the effects of IFRS 9 implementation?**

IFRS9 implementation is a comprehensive project that all banks are obliged to implement for financial years commencing from 1 January 2018 onwards, therefore, in the case of Capitec, the 2019 financial year is the year of adoption. In addition to what was already disclosed in the CFO report, more on this will be disclosed at the first-half results to August 2018, The direction of the financial impact is to debit retained earnings and to credit provisions, i.e. it will lead to an increase in provisions, which is to be expected given the lifetime expected credit loss principle applied in the accounting standard.

Yours faithfully



**Jean Pierre Verster**
Audit Committee Chairman
Capitec Bank Holdings Limited

## Appendix

Capitec issued its audited financial results for the year ended 28 February 2018 on 26 March 2018. The financial statements were prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), its interpretations adopted by the IASB, the South African Institute of Chartered Accountants ("SAICA"), Financial Reporting Guides as issued by the Accounting Practices Committee, the Johannesburg Stock Exchange ("JSE") Listing Requirements, and the South African Companies Act. The audit opinion was unqualified.

We, the Audit Committee, reject the assertion that there are misleading accounting practices applied by Capitec.

**1. Can the audit committee justify management's analysis that Capitec loans are trending towards the long-term?**

1.1 Profile of loan sales

Page 57 of the integrated annual report for 2018 ("IAR") indicates that the value of loan sales >= 49 months increased by 16.6%. By dividing the loan sales into the average loan amounts, as disclosed on that page, one can calculate that the number of loans >=49 months increased by 6%. This was a result of focused attention to attract higher income and lower risk clients, as shown on page 23 of our results presentation for 2018.

In contrast, the same page shows that loan sales between 7-48 months decreased by 14% and 1-6 month loans decreased by 26%. This was in reaction to stricter granting criteria, taking into account the tough economic environment experienced during the year ended 28 February 2018. Sales on the Capitec Bank facility decreased by 35%, partly due to stricter granting criteria and partly due to clients migrating to the Bank's credit card.

It was disclosed on page 45 and 56 of the IAR that the 2018 financial year presents the first full 12-month performance of the Bank's credit card. Management provided more detail regarding the performance of the product on slide 28 of the results presentation. Credit card sales increased by 357% year on year, per page 57 of the IAR. Footnote 2, on page 3, footnote 1 on page 54 and page 56 of the IAR explains that:

- Credit card sales are included in sales of less than or equal to six months and
- the number of loans reported for the credit card is the number of months in which a given client utilised the product. As an example, if a client used the credit card twelve times in a given year and on average spent R1 000 per month, that was reported as sales of R12 000, comprising twelve notional loans of R1 000 each.

The growth in the number of loans <6 months was a result of the impact of the credit card, which increased by 657%, compared to a decrease of 40% on the number of 1-6 month loans and a decrease of 35% in the number of Capitec Bank facilities accessed.

The statement that there was no shift towards longer-term loans is therefore false. Most analysts would simply keep the context of the launch of the credit card in consideration.

1.2 Comparison of loan sales amounts against outstanding loan balances

We would like to mention the following aspects in order to understand the comparison between average loan sales and outstanding loan balances:

- One cannot make a meaningful comparison of aggregated average sales amounts against aggregated average loan balances for different product terms. As an example, the 61-84 month loans comprise 19% of the number of loan sold, but 33% of the loans outstanding, because these loans remain on book for seven years. By comparison, 7-12 month loans comprise 4.8% of the number of loans advanced, but only 1.4% of loans on book, as these products run off much more quickly. The result is that the 6-12 month loan

product has a disproportionate impact to reduce the average sales amount. The 61-84 month loan products have a disproportionate impact to increase the average outstanding loan balance. We monitor the relationship between gross sales, net sales and consolidation loans compared with the related average total outstanding balances, as well as separate views for consolidation balances and non-consolidation balances on a granular product level. We are comfortable that these relationships make sense.

- Capitec reports loan sales net of external consolidations, in other words if another credit provider settles a Capitec clients' debt, the Bank subtracts the settlement amount from the value of loan sales, but not the number of loans granted, as the Bank has lost the market share and the revenue stream relating to these sales. This reduces the average loan advanced during the year. External settlement of the clients' loans reduced the average loan amount for loans greater than 6 months by R5 000 for 2018. This is in addition to your noted points, that Capitec reports loan sales net of internal consolidations and exclude rescheduling from loan sales.
- When Capitec reports loan book balances, a credit card account would count as a single account, but when it reports loan sales, it counts every month in which the credit card is utilised. The balance may consequently be much larger than the average amount advanced.
- Capitec reflects the credit card under products < 6 months from a sales perspective, but allocates the balances between <=6 months products and >6 month products, depending on the repayment profile of the clients. Clients that repay the full outstanding balance of their credit card monthly are reflected in <=6 month average balances and clients that repay the minimum amount of their credit card are reflected in >6 month average balances. This affects the comparison between the average sales amount and the average outstanding balance.
- Consolidation loans affect the average loan balances on book, but not the average loan sales, as Capitec report loan sales net of consolidations. The average consolidation component of loans granted is close to the average net loan amounts on a product level, but fluctuations in either number can make comparison of average outstanding balances against average sales amounts meaningless. As noted above, the Bank monitors the relationship between consolidations and consolidation balances on a granular level.

We reviewed the cumulative repayments as a percentage of the original credit granted. On a product level, cumulative repayments against the original credit granted is stable, also between consolidation loans and instances where no consolidations took place. On average, consolidation loans reflected greater aggregate capital repayments against the original capital advanced because these loans have been on book for a longer period.

We also compared the average amount advanced against the average amount consolidated, in order to determine if clients were using consolidations to access small incremental loan amounts. The amounts of additional credit taken were in line with the amounts consolidated. This supports the Bank's view that consolidations occur in instances where clients originally took up significantly less credit than they qualified for, rather than the hypothesis that clients take up small incremental amounts as soon as their credit worthiness allows this.

The Bank's credit- granting model considers the risk assessment of clients that take up credit frequently and reduces the term for which risky clients qualify. This effectively prevents clients with limited debt repayment capacity to take up further credit.
The conclusion of the Audit Committee from the above is that we are comfortable that:

- The loan book as reported is healthy
- the Bank restricts, rather than extend the products offered to clients that take up credit frequently
- the repayment profile for consolidation loans, compared to the original credit granted is healthy and that
- consolidations do not have a significant impact on the overall credit risk profile of the Bank

2. **Can the audit committee elaborate on the nature of internal consolidations and provide analysis into the net loan sales executed to customers who have consolidated existing loans?**

Management explained the reasons for existing clients consolidating credit in detail, with examples, in the SENS released by Capitec on 5 February 2018. It is natural for clients to apply for credit more than once in their life. They may apply to their current credit provider and/or they may apply to other credit providers. They might still have existing credit when they do so. As long as clients who apply for more credit conform to the credit risk appetite of the credit provider at that time, the current credit provider could approve the application.

Your suggestion that "so long a client is current with their loan, they are theoretically able to gain an extension" is false. A consolidated loan would always be a result of full credit assessment process that all new and existing clients go through when applying for new credit. The outcomes of that full credit assessment process are either a consolidated loan, a new separate loan or no new loan granted.

The outright decline rate for applications for new credit, as disclosed in the 2018 annual results presentation (of which consolidations would form part) was 72%. This ratio has increased from 60% in 2017 and 44% in 2016. The increasing outright decline rate is indicative of stricter credit granting criteria. The Bank clearly communicated stricter credit granting criteria over this period to the market on multiple occasions. 2018's decline ratio increased from 72% to 78% if you include clients who pass the comprehensive credit assessment, receive an offer for credit, but do not take up the offer. This is mostly due to the offer being lower than what the client required. The result of this is that in 2018 only 22 out of every 100 clients who apply for credit pass the comprehensive credit assessment and take up credit. Additionally, as shown in the 2018 annual financial results presentation on slide 19, the percentage of loan sales granted to clients who have taken over 80% of the maximum that they have qualified for in the past 6 months and took out more credit again, reduced to 3.3% in the six months to February 2018. The opportunity for clients to qualify for credit across the board, and specifically for frequent borrowers, is significantly stricter in 2018 than in previous years.

The assertion that "As shown through numerous channel checks and evidenced through court documentation, these customers are not always in financial position to repay these loans." is a false statement. The report does not include the "evidence" and we doubt that the "evidence" supplied through these methods will prove this. If this were the case, the performance of the credit book would have deteriorated, which is not the case. In the 2018 annual financial results presentation, Capitec demonstrates:

- its stricter variable income recognition over the past 3 years (slide 17)
- The stricter living expenses calculation introduced (slide 18)

The slides show how the Bank tightened affordability metrics, both from an income and expense point of view. This has contributed to the muted loan book growth over the past 3 years and has resulted in the outright decline ratio increasing as mentioned earlier.

Another false statement that you made concerns the marketing of loans. Capitec does not market loans "as affordable financing for incidental expenses". Clients approach credit providers with a specific credit need in mind.

Capitec offers significantly reduced interest rates for low risk clients that take up credit for shorter periods than the maximum term for which they qualify, to reflect the reduced risk. Clients often take up significantly less credit than they qualify for as a result. When such clients access more credit later on, they may elect to consolidate their existing credit. The related credit risk remains within the Bank's appetite and is similar to clients that take up the maximum amount of credit initially.

The comparison of Capitec's internal consolidations to that of another credit provider is meaningless for the following reasons:

- It compares the credit dynamics in 2018 with that of a period 4 to 6 years ago

- It ignores the effect of the economic environment now versus the economic environment then
- It ignores the fact that the credit granting strategies (including the accept ratios), cost of credit and write-off strategies of the different providers are/were and is completely different and
- It ignores the competitive environment historically and currently. Are credit providers comparatively more aggressive or conservative when granting credit to Capitec's credit clients?

To conclude:
- Repeat business is good for a credit provider, as long as the credit provided falls within that provider's credit risk appetite and in accordance with the relevant laws
- Capitec grants all new credit at Capitec through a full credit assessment process. This process is the same for clients with credit at Capitec or credit elsewhere
- Capitec does not market consolidated loans for "incidental expenses"
- Capitec is comfortable that the credit granting strategies in place for new and existing clients meet the requirements for responsible credit granting

**3. What is the rationale in decreasing bad debt provisions while bad debt is increasing exponentially?**

As per Capitec's accounting policy, loans and advances are stated at amortised cost net of identified impairments and incurred but not yet reported ("IBNR") impairments. Loans and advances are considered impaired if, and only if, there is objective evidence of impairment as a result of events that occurred after initial asset recognition (known as a loss event) and these loss events have an adverse impact on the assets' estimated future cash flows that can be measured reliably.

Objective evidence that loans and advances may be impaired includes the following observable data:
- A breach of contract, such as default or delinquency in interest or principal payments. In this regard, instalments past due date (1 day in Capitec's case) are considered a breach of the contract
- Historical loss experience of groups of financial assets with similar repayment terms
- Data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
  - Adverse changes in the payment status of borrowers in the group
  - National or local economic conditions that correlate with defaults on the assets in the group

Capitec substantially writes off clients (and the related impairment allowance accounts) at the earliest of when they are in arrears for more than 3 months or legal hand-over occurs. The Bank recognises the estimated recoveries on term loans discounted at the contractual rates in gross loans and advances as expected recoveries receivable.

The bad debt provision level raised for the year is a direct result of the performance of the loan book and the strict write-off policy to immediately write-off a client in debt review regardless of its loan status being up-to-date or in arrears.

As disclosed in the CFO report and related note 7 (net loans and advances) of the annual financial statements and the integrated annual report for the year ended 2018, more than 65% of the arrears book is provided for versus 9% of the up-to-date loan book. The arrears loan book is 5.7% of the total gross loans and advances for the period ended 28 February 2018 (28 February 2017: 6.3%). The improvement in the arrears and up-to-date loan book therefore resulted in an increased estimation of future cash flows from loans advanced and a related decrease in impairment (bad debt provision).

Loans in arrears decreased with 5% from R2.9 billion at 28 February 2017 to R2.7 billion at 28 February 2018. Up-to-date loans that are that rescheduled from arrears (not rehabilitated)[1] decreased with 19% from R1.6 billion at 28 February 2017 to R1.3 billion at 28 February 2018. Up-to-date loans that are that rescheduled from up-to-date (not rehabilitated) amounted to R1.1 billion at 28 February 2018 (28 February 2017: R1.1 billion). All the related coverage ratios of the bad debt provision increased during the current period due to a better performing loan book and the prudent provision methodology.

The provision for bad debts to arrears coverage increased to 216% in 2018 (2017: 208%). The provision for bad debts to arrears and rescheduled loans from arrears (not rehabilitated) coverage increased to 147% in 2018 (2017: 134%). The provision for bad debts to arrears and all rescheduled loans (not rehabilitated) coverage increased to 115% in 2018 (2017: 107%). These coverage ratios, especially the provision coverage ratio over the loan balances in arrears and that rescheduled from arrears (not rehabilitated) that is more than a 100% provides Capitec comfort that it recognised the full credit charge of these loans and advances in the income statement regardless of its expected recovery based on statistics.

The crux is that the strict bad debt write-off policy impacts the provision. Capitec immediately writes off clients in debt review, irrespective of loan status, without rolling into arrears. This policy significantly impacts both the loan amount written off and the bad debt provision raised. The significant increase of clients in debt review for the current period resulted in the increase of bad debts written off. Due to these loan balances no longer being part of the loan book, the related bad debt provision on these loans do not exist. Furthermore, the provision model takes into consideration potential future write-offs and clients going into debt review. Thus, the higher incidences of clients going into debt review in the 2018 year, will increase the probability of up to date clients going into debt review in future - this is the reason for the increased arrears coverage ratio.

Further, the bad debts written off increased due to loans previously advanced under a different granting and risk strategy of prior periods and previously provided for, were written off in the current period.

Included in the key performance indicators, Capitec reports the net provision for doubtful debt charge to 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. The net provision for doubtful debt charge provides a collective view of the total credit charge to the income statement. From 2015 to 2018 the net provision for doubtful debt charge as a percentage of gross loans and advances remained between 11.4% and 11.9%. From 2015 to 2018, the net provision for doubtful debt charge increased with 31.54%, which is in line with gross loans and advances that increased 31.10% and a credit charge that is consistently applied.

**4. Why have Capitec changed their provisioning method?**

Capitec has not changed the provisioning methodology whatsoever. The Bank always consistently applied the specific loan status and related provision raised. The extract from the Chairman's report in 2017 relating to one, two and three instalments in arrears was to illustrate the average provision raised per category i.e. CD1, CD2 and CD3. The majority of the loan book has a monthly instalment frequency. 95.2% of the loan book repayments as at 28 February 2017 and 96.1% of the loan book repayments as at 28 February 2018 had a monthly instalment frequency.

An example of a client that repays weekly would reflect in CD1 if instalments in week 1 to week 4 were unpaid, CD2 when instalments in week 5 to 8 were unpaid and CD3, when the client misses

[1] Not rehabilitated – clients are deemed to be rehabilitated once they have made contractual payments for 6 consecutive months.

to repay weekly instalments 9 to 12. A client that repays weekly therefore has 4 weekly repayments for purposes of CD's.

The Bank always applied this consistently, regardless of frequency of payment.

**5. Deterioration in loan book quality**

As disclosed in the integrated annual report and reiterated in 3 above, clients in debt review, irrespective of loan status, are immediately written off without rolling into arrears.

As indicated in Figure 18 of your analysis, the total number of clients under debt review for the 2017 financial year was 95 000. For the 2018 financial year, the number of clients under debt review increased to 112 500, an 18.4% increase.

The loan balance of clients in debt review written off during the 2017 financial year was R1.8 billion. This increased with 35.8% to R2.4 billion in the 2018 financial year.

Thus the increase in the number of clients going into debt review for the current period and the increase in the balances of these clients, are the most significant contributors to the 22% increase in bad debts written off in the year.

During a credit cycle, a client takes out a loan, makes repayments, potentially misses an instalment and rolls into arrears, cures, reschedules if they meet specific criteria or is written off with potential recovery post write-off. At every results publication, interim (August) and year end (February), the Bank discloses the balance of the loans and advances that are in arrears (and rescheduled) at that point in time. At 28 February 2017, the audited arrears loan balance was R2.9 billion (6.3% of gross loans and advances). Despite the loan book increasing from 2017 to 2018, the audited arrears amount at 28 February 2018 decreased to R2.7 billion (5.7% of gross loans and advances). This is also true of both categories of rescheduled loans.

The statement that there is an increase in loans falling into arrears is false.

**6. Can the company elaborate on the effects of IFRS 9 implementation?**

The opening retained earnings adjustment on 1 March 2018 due to IFRS 9 is an increase in provisions and a decrease in capital.

Page 27 of the 2017 Integrated Annual Report (IAR) indicated that the expectation then was an increase to provisions.

Page 50 of the 2018 IAR indicates that the 2018 range is in line with the 2017 estimate, adjusted for growth.

Furthermore, page 50 of the 2018 IAR explains further that the expected result of the implementation of IFRS9 is a decrease in the Capital Adequacy Ratio ("CAR") of 0.4% in the 2019 financial year.

The main reason for the increase in the provision caused by IFRS 9, relates to the expected credit loss (ECL) impairment model on the up-to-date book. Currently under IAS 39, the Bank applies an incurred but not reported (IBNR) emergence period of three months. Under IFRS 9, it will apply a 12-month ECL view on the up-to-date loan book. The Bank's rescheduled loan book provision, that currently considers a 12-month forward-looking period, will extend to a lifetime ECL under IFRS 9.