Research on Competition and Regulation: Competition, barriers to entry and inclusive growth

Retail Banking - Capitec case study

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Abbreviations and acronyms

ACM	Autoriteit Consument & Markt/ The Netherlands Authority for Consumers & Markets
ATM	Automated Teller Machine
FICA	Financial Centre Intelligence Act
FNB	First National Bank
LSM	Living Standard Measure
OFT	Office of Fair Trading
PASA	Payments Association of South Africa
PTA	Personal Transaction Accounts
SARB	South African Reserve Bank

Executive Summary

This case study examines barriers to entry in retail banking informed by Capitec's experiences as an entrant. This study will illuminate how the bank was able to pursue the opportunities available in this concentrated and highly regulated sector. The case study will contrast Capitec's success, especially since 2008, to that of other entrants in the retail banking sector. Finally, it will consider whether there are ways in which the barriers which Capitec faced could be reduced for future entrants.

Capitec's entry and growth in transactional banking sparked a competitive response from incumbents, especially First National Bank and ABSA. These banks now offer products that are positioned to compete with Capitec's simple, technology-driven and low cost offering. Across all four incumbent banks, the fees for low-cost accounts have come down in nominal terms. It is unlikely that these effects would have occurred if the status quo had continued without a disruptive entrant or if Capitec had been acquired by one of the incumbents early on.

The positive effects of Capitec's entry are expressed in three ways: new-to-banking customers that now have access to finance, lower bank charges for customers who switch from the incumbents to Capitec and lower prices for incumbents' clients as their banks react to Capitec.

In some ways, Capitec's experience is exceptional. It has surged ahead early attempts to bank the excluded such as Ubank (former Teba Bank) and the Mzansi initiative. Its early financial backer, PSG, chose to go into banking precisely because of the high barriers to entry in that sector. The entry, a consolidation play of small micro-lending institutions, benefited from this lending cash cow, which ensured profitability from the start. This can be contrasted with the experience of Ubank, which has stagnated due to lack of shareholder backing and poor financial results.

Capitec overcame customer's reluctance to switch, a key barrier to entry in retail banking, by developing a simple product that is easily understood. It also worked deliberately to convert its lending clients into transactional banking clients. Some of the bank's executives, having been former bankers, were familiar with the payments system. However, it is clear that the ability of a small, nimble bank to introduce changes in the South African banking environment is subject to the incumbents' willingness to change and their pace. This is a consequence of inter-operability. However, there is scope to improve the manner in which innovations which require co-ordination are introduced into the payments system.

The question of market power has received attention from the competition authorities, which led to a market enquiry into banking, which issued its reports in 2008. Its recommendations sought to make the playing field more open and level. The Banking Enquiry focused attention on retail banking and heightened awareness about competitive behaviour in the sector. Some of its recommendations include:

- Measures by the banking industry to facilitate customer switching
- Transparent pricing with fee disclosures on bank statements
- Non-discriminatory pricing at Bankserv (removing scale disadvantage for small banks)
- Improvements in governance at the Payments Association of South Africa
- Promotion of cash-back at point of sale as a channel

The partial (and ongoing) implementation of these recommendations improved the competitive environment for Capitec though it is not easy to draw direct causal links. The bank's executives also note that the promulgation of the National Credit Act created certainty in the unsecured

lending segment. Before then, the industry had operated under an exemption from the Usury Act, which could have been withdrawn at any moment.

Going forward, there is still some scope to improve the switching process. This could be done by instituting a regulated switching process with mandatory timelines, as suggested by the Banking Enquiry Panel. The incoming ISO 20022 messaging standard makes provision for automated debit order and incoming (salary) payment switching. The SARB should also consider a process where consumers are not liable for interest, penalty fees and other charges incurred due to delays in switching bank accounts (Hawthorne 2014). The sharing of FICA information, with clear guidelines on where liability lies in the case of contraventions (the original or second bank) would also ease switching.

A stricter process to ensure that participants adopt and facilitate innovation, new instruments and other changes is called for. Though there is reluctance to attribute bad faith to the slow pace of innovation in the industry, most stakeholders acknowledge that the historical record suggests that industry-wide change and innovation takes too long in the banking sector.

Regulators can play an active role in facilitating innovation. For example, in the UK, the Financial Conduct Authority (FCA) has an innovation hub. The support offered to new and established, regulated and unregulated financial businesses includes: help to innovator businesses to understand the regulatory framework and how it applies to them, assistance in preparing and making an application for authorisation, a dedicated support team, and a dedicated contact for a year after an innovator is authorised to conduct business.[1] Potential innovators bring ideas to the regulator, not necessarily complete applications, and also their concerns about how the current regulatory framework limits them.

Capitec had aspirations to become a fully-fledged bank offering products for customers to save, transact and borrow money. Technology and business model innovations have expanded the range of institutions that can offer transactional banking services beyond traditional banks. A tiered banking licensing regime could facilitate other modes of entry in the future. Regulators and policymakers appear supportive of the idea of a tiered banking license regime, with a class of banks facing lower liquidity requirements (for instance) but with the ability to participate as full settlement members in the payments system.

[1] Financial Conduct Authority https://innovate.fca.org.uk/ website Accessed 30 September 2015.

1. Introduction

This case study will examine barriers to entry in retail banking informed by Capitec's experiences as an entrant. This study will illuminate how the bank was able to pursue the opportunities available in this concentrated and highly regulated sector. The case study will contrast Capitec's success, especially since 2008, to that of other entrants in the retail banking sector. Finally, it will consider whether there are ways in which the barriers which Capitec faced could be reduced for future entrants.

1.1 Methodology

The study relied on interviews with retail banks, research and industry bodies:

- Banks: Capitec Bank, Mercantile Bank, Ubank
- Regulators and Policymakers: PASA, South African Reserve Bank National Payment System Department and Banking Supervision Department, National Treasury
- Associations: Banking Association
- Research: Solidarity Research Institute, Finmark Trust, Moody's
- Other: Thutuka (payments processor), PSG

Secondary research included review of banks' annual reports, industry reports and the Banking Enquiry review paper by the Centre for Competition, Regulation and Economic Development.

1.2 International review of barriers to entry in retail banking

It is well recognised in the international literature that the banking industry exhibits high barriers to entry. This section provides a high level summary of the most common barriers to entry highlighted in the literature.

Retail banking is a capital-intensive activity. To be able to offer a basic transaction service that competes with at least the minimum product package offered by incumbents requires IT systems, a branch and ATM network (though this might soon change), and brand-building expenditures. Most of these outlays are sunk investments that cannot be recovered in case of failure. Barriers to exit may discourage firms from entering a market in the first place.

Regulations also impose costs to obtain a banking license and the related authorisations, to meet the basic costs of compliance and to maintain a certain level of regulatory capital, whose type and quality is usually specified in law.

The basic capital required, for operational and regulatory[2] purposes, make access to finance crucial in entering the retail banking sector. This serves as a barrier to entry for new banking institutions. Capital markets are not very supportive of new entrants in many countries. This is exacerbated in retail banking, given that a certain proportion of this capital will have to be kept in low-yielding instruments to meet capital and liquidity requirements, rather than being deployed in growth enhancing activities. The roll-out period to achieve minimum efficient scale and profitability can also take time, thus investor expectations for returns have to be managed accordingly.

Transactional banking rests on the principle of inter-operability. The payment instruments that a new entrant provides for its customers have to meet the established norms of inter-

[2] The minimum regulatory capital required is the greater of R250m or 9.5 percent of risk-weighted assets.

operability in that market. In other words, if the standard bank card can withdraw money at any ATM or be used to make a purchase at any merchant with a point-of-sale device, this is the level of service that is expected of any new bank. This means that the bank has to access the payment system and enter into bilateral and/or multilateral arrangements that are required to make this happen.

The erstwhile Office of Fair Trading in the UK (which was replaced by the Competition and Markets Authority) defines barriers to entry as: "…obstacles that increase the difficulty of a firm entering or expanding in a particular market. They arise when incumbents have an advantage over potential entrants that is not due to superior efficiency. Barriers to entry, expansion and exit can be a natural feature of the market or be created, or exacerbated, by the behaviour of incumbent firms."

In various studies spanning since 2002, the former Office of Fair Trading conducted studies that found the following to be significant barriers of entry into retail banking:

- establishing a branch network
- ease of transferring products and accounts (for customers)
- developing a successful brand
- high sunk costs
- acquiring new customers
- access to information regarding customers' credit risk
- access to payment networks, and
- regulation.

Though regulation is quite extensive in retail banking, some studies have argued that it does not pose a serious barrier to entry. OFT (2010) finds no evidence that the requirements related to gaining authorisation to accept deposits and to offer mortgages and other consumer credit products act as a barrier to entry. The only difficulty found in that study relates to the lack of information that entrants suffer with regard to these authorisations. Whereas in the Netherlands, the ACM found that market participants highlighted three areas of concern when it came to licensing - the length of the licencing process, uncertainty affecting the licence requirements and therefore the outcome of the licencing process, and the unforthcoming attitude of the licensing authority (DNB).[3]

In the UK, money laundering and consumer protection regulations were found to be benign as barriers to entry or expansion.

Most new banks in the UK enter the payments system through agency arrangements with sponsoring banks, and these were found to be satisfactory in terms of cost and quality of access. However, in recent case studies of entry, the Competition and Markets Authority quotes an internal note by Virgin Money which highlights potential concerns with agency arrangements in the payment system:

- Service standards whereby the sponsored bank could find it difficult to offer the same standard of service on payments as its sponsor bank (Metro Bank also raised a similar concern in the same set of studies).
- Potential brand damage which could result if payments were delayed.

[3] Autoriteit Consument & Markt/ The Netherlands Authority for Consumers & Markets (2014), Barriers to entry into the Dutch retail banking sector.

- Delay in hearing about industry-wide issues since sponsored banks relied on their sponsor banks to keep them informed of any such issues.
- Project delays which could result due to reliance of sponsored banks on sponsor banks during a project life cycle.
- Inadequate new initiatives since these tended to be directed by sponsor banks, and therefore solutions could end up fitting the requirements of those banks.

However, when probed further, it appears that the provider was satisfied with the level and cost of service provided under its current payment system relationships.

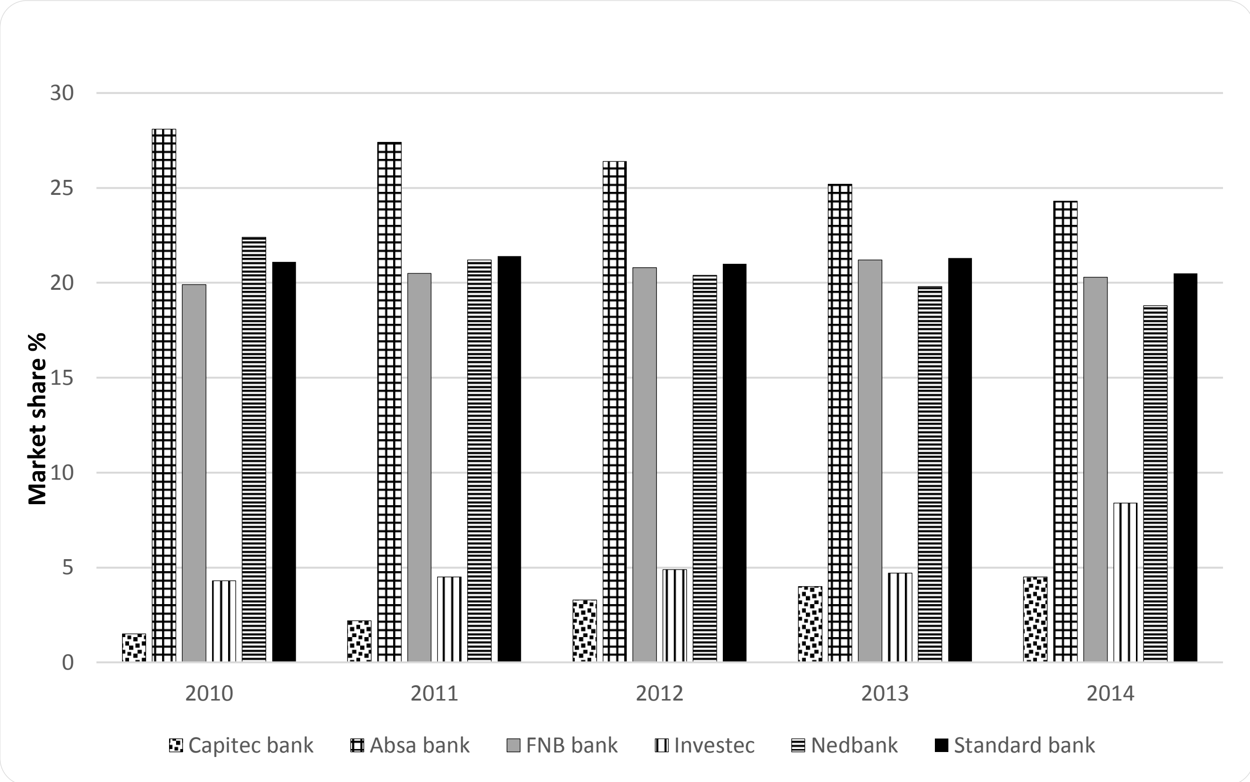
The OFT found switching behaviour, the role of brands and the role of the branch network to be important barriers to entry. The low level of switching by customers made it difficult for banks to attract customers. Customers were also wary to switch to an unknown brand. They also continued to place a high value on a branch network (a finding confirmed by the CMA in later case studies). In the Netherlands, half of all savings accounts consumers have never switched. In the current account market, switching behaviour is even less encouraging; 73 percent of current account holders aged 18 or older has never switched. The ACM puts this down to the 'hassle' factor in changing current accounts. [4]

1.3 Market power and barriers to entry in retail banking in South Africa

The retail banking sector is that part of the financial services industry that is concerned with providing transactional (payments), credit, savings and other financial intermediation and advisory services to individual consumers and small businesses. Over 85 percent of the share of retail deposits is accounted for by the 'big four' banks trading as: Barclays Africa (Absa), Standard Bank, First National Bank and Nedbank (see Figure 1 below).

[4] Autoriteit Consument & Markt/ The Netherlands Authority for Consumers & Markets (2014), Barriers to entry into the Dutch retail banking sector.

Figure 1: Market share of retail household deposits, 2011 - 2013



Source: Capitec Annual report 2014, based on SARB data

The issue of market power in South African retail banking has been traversed in a few studies. Notably, the Competition Commission's Banking Enquiry report engaged with the matter extensively in its final report. The enquiry report defined market power as the ability of a firm to charge prices above those that would prevail under competitive conditions.

The Banking Enquiry panel found that in the market for personal transactional accounts (PTAs), established banks enjoyed market power derived from various factors. Retail banking was characterised by economies of scale which make it difficult for medium-sized businesses to compete in the market. High fixed and common costs underpin market concentration. The banks are characterised in the report as avoiding price competition as far as is possible but competing on other dimensions.

The Panel argued that the banks were taking advantage of various mechanisms to lock customers to a particular banking institution. The panel found that differentiated products and complicated pricing structures allowed banks to remain highly profitable. Banks' power is also aided by the costs of switching customers incur when changing banks.

The recommendations made by the Banking Enquiry panel to improve competition in retail banking have been partly implemented.[5]

Recommendations on customer switching

[5] See Hawthorne, *et al* (2014).

The Banking Enquiry made a set of recommendations with regards to customer switching.

These include a minimum set of standards required for the disclosure of product and price information that would enable comparison of products.

The Panel recommended that the following be included in the Code of Banking Practice:

- standardisation of terminology
- a requirement to communicate in “plain language”
- the provision of minimum information on bank statements and information on charges on every account
- advanced notice of new and altered charges, and
- a regular rights reminder.

In order to allow for comparisons to be made between products and prices, the Panel recommended that the Banking Association publish generic banking profiles for product comparison.

The Panel also called for the establishment of a centralised banking fee calculator, and for comparative advertising restrictions to be lifted.

The Panel recommended that a Code of Switching Practice be created. It would include criteria on the provision of information and documentation, a schedule setting out the terms on which banks were to provide each other with documentation and in terms of which transfers were to take place. It would allow for customers to be exempt from paying fees that are due to failures in the switching process.

The Panel also recommended a central FICA hub to ease switching. This has not been implemented because of lack of clarity on which bank bears responsibility for breaches of the law. If the new bank is liable, it would in any event repeat the FICA process. The sharing of customer contact details across various databases, such as those held by municipalities might ease the FICA burden. At this stage, it is not clear if this would violate consumer information legislation (Protection of Personal Information Act, no. 4 of 2013).

The Panel suggested that the mandate of the Ombudsman for banking services should be expanded to include monitoring and enforcement of compliance with the codes mentioned above (banking practice and switching).

In a press statement issued in 2010 by National Treasury, following engagement with the banking industry, it was announced that the recommendations above would be implemented, but at the discretion of the banks. The Code of Banking Practise was revised in 2012 to effect these changes. Recommendations related to easing the comparability of products were also not taken forward. It was argued that the creation of generic profiles would risk collusion.

Customer profiles and a centralised calculator were not implemented. Though detailed guidelines on switching have been added to the Code of Banking practise, customers are still liable for any charges or penalties that may arise during the process.

Recommendations on the payments system

The structure, functioning and governance of the payments system also presents a barrier to entry in retail banking. Only banks are allowed to participate in the payment system as settlement and clearing agents. By 2013, there were 22 banks registered for settlement and clearing in South Africa. The Banking Enquiry panel made an extensive range of recommendations related to the governance of the payment system and the pricing of inter-bank arrangements.

The Banking Enquiry Panel raised concerns about the level of price competition for ATM services.

It identified two causes of market power in the provision of ATM cash dispensing services. The first was interbank pricing arrangements, which the Panel argued inhibited price competition. The second arose because only registered banks could acquire these services.

The Panel's argued that the pricing arrangements for ATMs could be seen as market allocation. The pricing prevailing at the time meant that banks rarely provided ATM services to rival bank's clients. Non-bank providers could not develop a market for cash dispensing services. Each bank held power over its customers on ATM services, which could result in uncompetitive on-us ATM pricing. The Panel's main recommendation was for a direct charging model for ATMs, where customers would be charged, instead of an interchange setting arrangement between banks. There would be no discrimination between the ATM provider's clients and those from other banks. Subsequent research by the Competition Commission argued that a direct charging model might raise barriers to entry if banks with significant networks found a way to charge high 'off-us' prices. International evidence from the UK and Australia also did not provide clear support for a direct charging model. Customer uncertainty and higher prices were potential risks.

To implement the Panel’s recommendations, banks agreed to:

- provide a detailed breakdown of fees and charges on bank statement;
- display a message on ATM screens where customers are to be charged an additional fee for ATM usage; and
- review the policy of cash back at POS - which is now offered by banks at participating retailers.

The Reserve Bank is implementing a multi-phase interchange determination project, which resulted in new ATM fees being set. However, the process does not allow for public scrutiny of the methodology or input from non-banks (Hawthorne *et al*, 2014).

The Panel raised some concerns about barriers to entry and competition in the payments system:

- Banks were gatekeepers into the payments system. Only banks could become PASA members, giving them power to supervise their non-bank competitors and entrants.
- The path to move from a non-clearing bank to a clearing bank was not set out clearly and that the process was time-consuming.
- Innovation would have conform to the preferences and business imperatives of clearing banks and the payment clearing house, placing potential limits on innovations by non-banks.
- Bankserv Africa's pricing practices could be problematic as it is dominant and owned by the incumbent banks.
- Only clearing banks could issue electronic money.

To remedy this, the Panel recommended that:

- Non-bank providers should be allowed to participate in clearing and settlement activities in low value and retail payment streams.

- The membership and governance of PASA should be revised to include non-bank participants (with objective entry criteria and formal reporting to the NPSD).
- The creation of a Payment System Ombud to ensure fair treatment of all participations in terms of access and pricing.

Hawthorne *et al* find that regulation and policy has focused on developing a growth path for a non-bank to become settling and clearing bank. Though cash-back at point of sale has been implemented, only 4 percent of customers use this instrument, compared to 78 percent for ATMs (Hawthorne *et al* 2014 on 2011 Finscope data).

Some changes have been implemented to improve the governance of the payments system. The chairperson of the council of the Payments Association of South Africa is now an independent member not affiliated to any bank. The representatives of the banks owe a fiduciary duty to PASA and no longer represent a mandate from the banks that employ them. Non-banks can become designated to become members of the payment system's self-regulatory body (Payments Association of South Africa).

The partial (and ongoing) implementation of the Banking Enquiry's recommendations improved the competitive environment for retail banking. Capitec executives also note that the promulgation of the National Credit Act created certainty in the unsecured lending segment.[6] This meant that lenders in the unsecured segment had clear legislation and regulations to comply with, instead of operating under an exemption from the Usury Act that could be withdrawn at any time. The exemption had also restricted lenders to loans up to R10 000 and terms up to 36 months. With the National Credit Act, these restrictions fell away. This allowed for the emergence of a clearly regulated environment where institutions with capabilities in lending on the strength of affordability assessments could develop their businesses. With higher loan amounts and longer terms, unsecured lenders were also able to capture middle class clients.

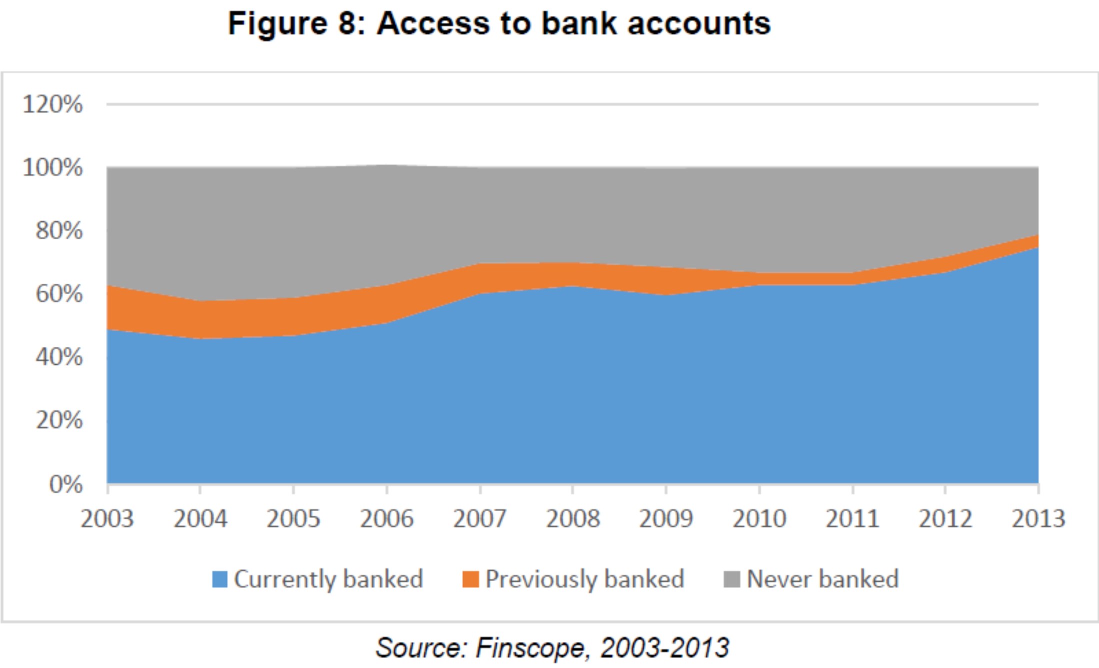
2. South African retail banking industry overview

2.1 Heightened activity in the mass market

Whilst Capitec chose to focus on the neglected mass market segment (particularly the lower end of the Living Standards Measure spectrum), the mainstream banks were also turning to this segment to diversify their earnings, and to fulfil government policy and regulatory requirements. The idea of banking the unbanked came to the fore during the early 2000s, and the population of the unbanked has steadily declined since then.

[6] Interview with Andre Olivier, Capitec, 10 November 2015.

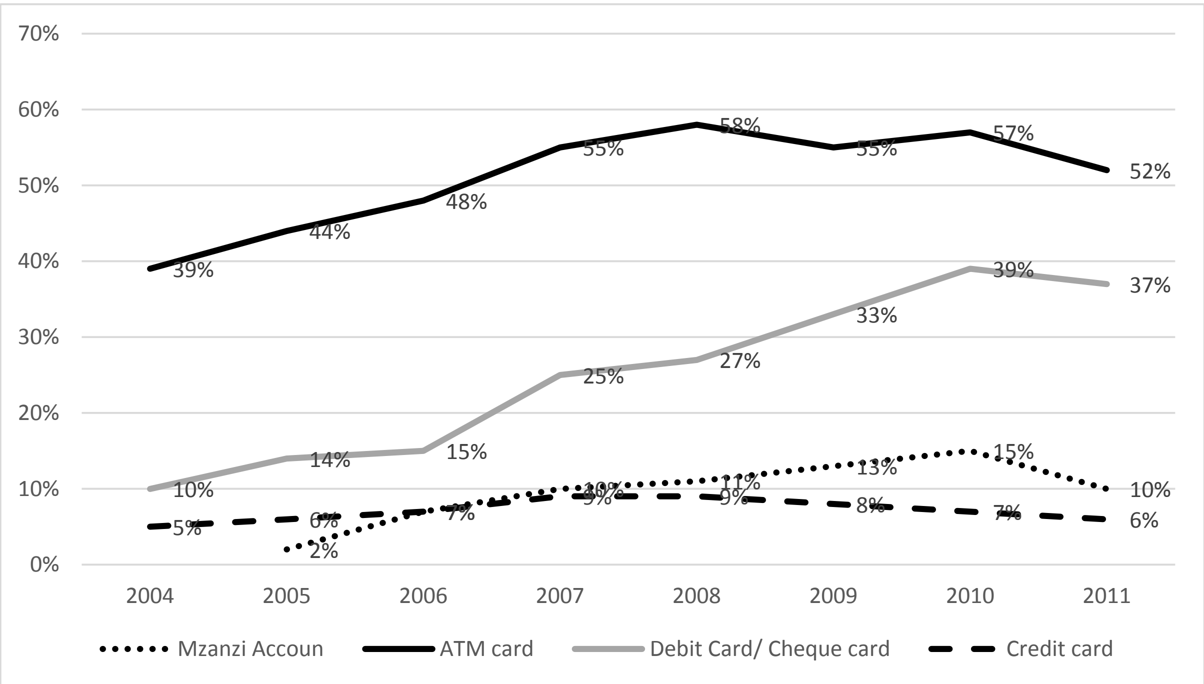
Figure 2: Access to bank accounts



Source: Finscope 2003 - 2013

The Financial Sector Charter, innovations in the market and improving living standards have contributed to this development. In addition, the roll-out of cards to access social security grants has also played an important role in bringing new customers into the formal financial services sector.

Figure 3 Penetration of Payment Instruments



Source: Finscope.

The Mzansi Account was developed by the banking industry to fulfil the financial inclusion commitments made in the Financial Sector Charter.

It was specifically aimed at low income customers. The account had common features though each bank determined its own pricing schedule unilaterally. The account was offered by Absa, FNB, Nedbank, Standard Bank and Postbank. The Mzansi bank account product had mixed outcomes. Each bank committed to create a low-cost bank account branded as Mzansi. The take-up and usage of the account was quite low, possibly due to perceptions that it is a poor quality account for poor people. Restrictions and terms and conditions of its usage may have also hampered take-up. Usage of Mzansi accounts peaked at 15% in 2010 (Hawthorne, 2014). However, it may be argued that it provided the banks with initial exposure to the low-income market. In recent years, FNB and Capitec have offered the cheapest prices for transactional accounts.

2.2 Capitec entered the market during the ‘small banks crisis’

Capitec registered as a bank in 2001, during a very difficult period in the retail banking sector, as the ‘small banks crisis’ was undermining consumer and investor confidence in the sector. The small banks crisis, which unfolded from 1999 to around 2002, saw a number of small banks failing. These bank failures include Regal Treasury Bank,[7] Saambou[8] and BOE[9].

The Banking Supervision Report of 2002 attributes this crisis to a number of factors. The loss of confidence by the public in small banks could be traced to a liquidity crisis in 1999. This, in turn, could be traced to: “the South-East Asian financial crisis of 1997 and the concomitant banking crisis, the Russian financial crisis of 1998 and the related banking gridlock, and the imposition of curatorship over a relatively small bank, FBC Fidelity Bank Limited (FBC), in the last quarter of 1999.” Uncertainty over the impact of the banking system changeover in 2000 (Y2K) and the failure of microfinance business units in banks such as Absa also played a role in driving negative sentiment towards smaller banks.

By 2002, Saambou had gone into curatorship and BOE Bank taken over by Nedbank. The report also details the fate of other small banks. Between 1997 and 2002:

- Ons Eerste Volksbank, The Business Bank Limited, Real Africa Durolink Investment Bank Limited and Unibank Limited were taken over.
- Southern Bank of Africa Limited and TA Bank of South Africa Limited exited the market.
- New Republic Bank Limited and Regal Treasury Private Bank Limited were placed under curatorship.
- Brait Merchant Bank Limited and Corpcapital Bank Limited requested that their registration as banks be withdrawn.

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[7] The run on Regal Bank is said to be the result of external auditors rescinding their approval of the financial statements of the bank’s controlling company in 2001. This led to an outflow of funds creating a liquidity crisis. The bank was placed under curatorship on 26 June 2001 (Bank Supervision Report, South African Reserve Bank (2002).

[8] Saambou’s demise was due to losses in its microfinance activities. It was the seventh largest bank at the time.

[9] BOE faced a run by its wholesale depositors. National Treasury guaranteed that it would fund withdrawals from the bank as a measure to restore confidence. The bank was ultimately acquired by Nedbank.

In a sector that numbered 39 banks in 2001, the crisis saw the exit of 22 banks from the South African banking landscape from the beginning of 2002 to the end of March 2003.[10] This was accompanied by a rise in concentration, with the big four bank's share of total assets rising from 69.5 percent in 2001 to 80 percent in 2002.

PSG, an investment holding company, built Capitec through acquiring micro-lending businesses, which were then integrated to form a unified bank.

Table 1: Capitec timeline [11]

1997 - 1998	• PSG Group acquires micro-lending businesses including FinAid and SmartFin
2000	• Micro-lending businesses become part of PSG Investment Bank, then are 'spun out' into The Business Bank (which had a banking license but had gone bankrupt)
2001	• Capitec becomes a licensed retail bank (name change from The Business Bank registered in 2000) • First ATM installed • Becomes member of Payments Association of South Africa
2002	• Lists on the JSE at R2.75/per share
2003	• Accepts deposits from retail customers • Capitec launches Global One account – loans, savings and transactional banking all in one debit card
2003	• PSG Group unbundles its direct stake in Capitec to its shareholders
2005	• Agreements with Pick n Pay and Shoprite/Checkers for clients to draw cash at tills
2006	• Introduce mobile banking services
2008	• Issues debt securities through a bond programme
2010	• Sunday Times Business Times Top 100 companies survey

Despite the negative market sentiment prevailing during Capitec's early years, it managed to implement an expensive conversion (from micro-lending) and expansion programme without reliance on wholesale funding or retail deposits.

This case study will explore key elements of Capitec entry's strategy, including its financing, capabilities, innovation capacity, access to the payments system and regulatory compliance. The nature of Capitec's entry – as a creation of PSG (an investment holding company) through acquisition of micro-lending businesses – will be examined. This entry mode, against the backdrop of the 'small banks crisis' of the late 1990s and early 2000's, is likely to have appeared risky at the time. However, the ability of PSG to advance capital to the newly formed

[10] Bank Supervision Report, South African Reserve Bank (2002).

[11] Capitec annual reports and website https://www.capitecbank.co.za/downloads/Capitec_at_a_glance.pdf (accessed 30 September 2015).

bank as it integrated its operations and developed into a full service bank would have increased the odds of success.

In terms of capabilities, the case study will consider the skills and experience possessed by the founding team, some of whom were former Boland and BOE bankers. Learning from failure is an important theme in this case study. Executives were not only associated with failed banks, but PSG also bought up struggling institutions like The Business Bank, which were an illustration of how not to run a bank.

The ability to integrate disparate businesses, likely to be embedded in PSG as an acquisitive business, would have played a key role in the early days.

In the popular media and banking literature, innovation is a key theme in explaining Capitec's success. The case study will draw on the literature and case studies with Capitec to trace the evolution of its differentiated business model in terms of pricing, technology and operations. In particular, why was Capitec able to develop this approach to mass banking where some other attempts had failed? These include Virgin Money, a pioneer in the tech-driven approach to banking, and Teba Bank, with its early insights into the low income market gained through banking mineworkers. The case will also consider why incumbents accommodated Capitec's entry.

Capitec's journey through the payments system will be studied. The Banking Enquiry identified access to the payment system, and arrangements within the payment system, as barriers to entry for new banks and also potential non-banking financial services providers. Though Capitec has largely been neutral in its statements about its access to the payment system, its submission to the Banking Enquiry suggests that it faced challenges in introducing new innovations in a forum dominated by incumbent banks.

2.3 Key policies, laws and regulations governing entry and expansion in retail banking

On the basis that retail banking involves taking deposits from the general population and facilitating payments across the economy, this sector is highly regulated across the world. This is to avoid wide-spread financial loss and in the worst cases, deep economic crisis. Entrants into banking have to set aside financial and human resources to comply with an extensive set of laws and regulations. This section highlights some of the primary pieces of legislation governing the sector.

The **Banks Act of 1990 (or the Mutual Banks Act of 1993, or Co-operative Banks Act of 2007[12])** sets out the financial and governance requirements for acquiring and operating a banking license.[13] The Registrar of Banks at the South African Reserve Bank issues banking license.

The capital holdings for banks are governed within the Basel Capital Accord. Tier I capital is common stock and retained earnings and is the basis on which a bank supports its deposit and lending operations. Banks are required to hold a minimum of 7 percent of capital in this

[12] This provides for the creation of co-operative banks owned by members. The rules to implement the act are still in draft form.

[13] Werksmans (2013).

form. Tier II capital includes subordinated debt, convertible securities, and a percentage of loan-loss reserves.

The **National Payment System Act, no. 78 of 1998** regulates the functioning of the payments system. Financial institutions, as intermediaries facilitating payments between payers and beneficiaries, participate in the country's payment system. The national payment system is a set of instruments, procedures and rules that allow market participants to transfer funds from one financial institution to another. Common payment system instruments include credit and debit cards, cheques, debit orders and mechanisms for electronic funds transfer. The payment system falls under the regulatory ambit of the National Payment System Department of the South African Reserve Bank as per the **Reserve Bank Act of 1989.**

The Payment Association of South Africa (PASA) is the only recognised payment system management body in the country. Its role is to organise, manage and regulate the participation of its members in the clearing[14] and settlement[15] system. To be accepted as a member in the clearing and settlement system, an institution must be registered as a bank. It then has to become a member of PASA and to sign various agreements for the payment clearing houses in which it intends to participate.

According to PASA's constitution: 'No person may participate in the Reserve Bank settlement system and/or be allowed to clear unless such a person is a member of the payment system management body recognised by the Reserve Bank, being PASA'.[16] The constitution sets out a range of entry criteria. To become a member of PASA, an institution must be deemed to have the necessary skills and resources to be a member in good standing and to implement systems and any enhancements as may be reasonably required. The institution must also be a participant in a payment clearing house and a Reserve Bank settlement system participant and a signatory to the relevant settlement agreement (save for sponsored members). A member also has to pay the relevant fees, subscriptions, levies or charges as required by PASA.

The body can impose fines for the violation of its rules (such as attempts to frustrate competitors). It may also withdraw a members' status or good standing or terminate its membership. PASA is governed by a council led by a chairperson and deputy chairperson. The chairperson should have 'sufficient skills, knowledge and experience' but may not be employed by a member institution.

The **Financial Intelligence Centre Act** of 2001 aims to combat money laundering and the financing of terrorism and related activities. It does so by establishing a Financial Intelligence Centre and a Money Laundering Advisory Council. It also imposes obligations on financial institutions to verify the identity of their clients and to monitor and report suspicious financial transactions. There are exemptions to the act that have been passed to facilitate banking for

[14] Clearing refers to the exchange of payment instructions between the payer's bank and the payee's bank (Reserve Bank, Starter pack for participation within the national payments system).

[15] Settlement refers to the final and irrevocable discharge of an obligation of one bank in favour of another bank in central bank money ((Reserve Bank, Starter pack for participation within the national payments system)

[16] PASA Constitution Version 1/2013 Effective 28 May 2013

mass market clients whose living circumstances mean that they do not have the records required by the legislation.

The granting of credit to retail customers is governed by the **National Credit Act of 2005**. The act sets limits for interest that can be levied on loans. It also requires credit-granting institutions to conduct affordability tests to promote responsible lending practices. It also provides for debt reorganisation, the collection of credit information and the registration of credit bureaus, debt counselling services and credit providers.

The most recent important change in how the financial services sector is regulated is the evolution towards a 'twin peaks' model. The Financial Services Board will take over 'market conduct' regulation to protect consumers, whereas the Reserve Bank will be responsible for 'prudential' regulation aimed at ensuring the safety, soundness and integrity of the financial system. A voluntary **Code of Banking** practise outlines the minimum standards of service that a bank must extend to its customers. The **Consumer Protection Act of 2008** governs the treatment of consumers in the economy, and where financial services are exempted, the **Financial Advisory and Intermediary Services Act of 2002** applies to banking.

3. The Capitec case study

3.1 The early years

3.1.1 Mode of entry into banking

The business that became Capitec was formed through the acquisition of a number of micro-lending businesses by PSG. At the time, there were many individually-owned micro-lending entities available as targets, many of them run by civil servants who had cashed out their pensions after the democratic transition.[17] The personal loan market was under-developed back then. Lending consisted mainly of secured loans, in addition to loans extended by furniture and other retailers. The PSG move was an attempt to consolidate a few players to create the platform for a retail bank. From the beginning, the aspiration was to be a mass bank covering all individuals with a regular income.

Significant acquisitions by PSG in micro-lending include SmartFin and Finaid,[18] which were bought in 1997. These acquisitions gave PSG a branch network across the country. Fin-aid had 300 branches and only one product: 30 day loans charging 30 percent interest per month (Ashton, 2012). These micro-lending branches were steadily converted into banking branches, at significant cost, to form the basis of what would become Capitec Bank.

The PSG Group had two banking licenses around the time of the formation of Capitec, one from The Business Bank and another for PSG Investment Bank. [19] PSG acquired The Business Bank in apparent good health, but it turned out to be a dud which went bankrupt in 1999. PSG bought out minority shareholders at 5 cents a share (Mittner, 2001). Its license was transferred to Capitec Bank Holdings on March 2001 (Capitec Memorandum, 1998). Capitec listed on the Johannesburg Stock Exchange on 18 February 2002.

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[17] Interview with Mr Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

[18] Finaid offered pay-day loans.

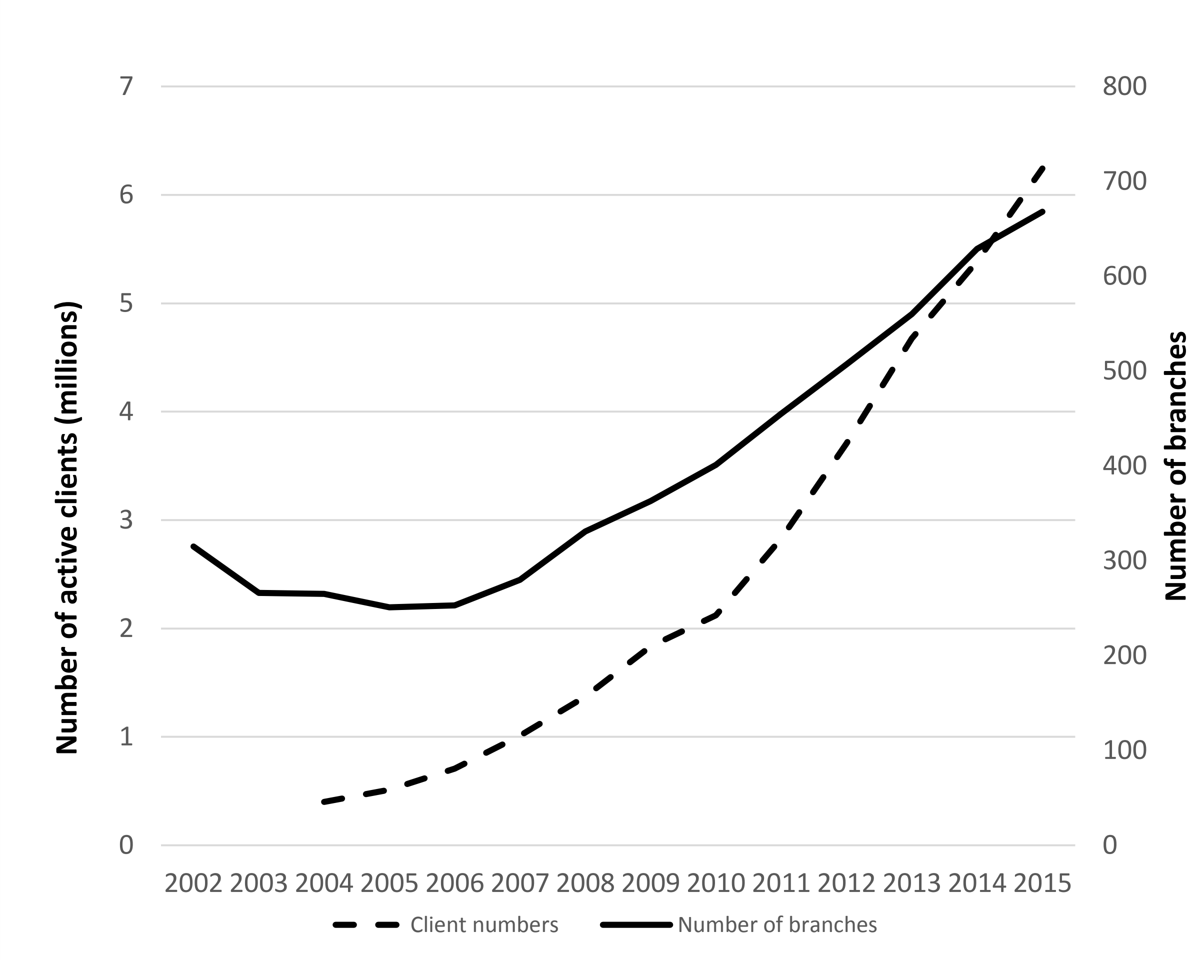
[19] Moody's, January 2006 and interview with Mr Chris Otto of PSG, Stellenbosch.

Though Capitec was built on a set of acquisitions in its early days, it has experienced organic growth since then.

Capitec grew quite slowly initially as illustrated in Figure 1. The number of branches it had actually declined from 2003 to 2005. However, its growth in terms of branches and clients accelerated significantly from about 2008 onwards with the number of branches increasing from 363 in 2008 to 629 in 2014, and the number of clients from 1.1 million to 5.4 million.

By February 2015, Capitec had over 6.2 million active clients. This represents a 16% increase from February 2014. According to Moody's, 2.8 million of these clients deposited salaries and made payments from their Capitec account (using it as primary bank account) (Moody's Credit Opinion, April 2015).

Figure 4: Capitec number of branches and clients, 2003 - 2014

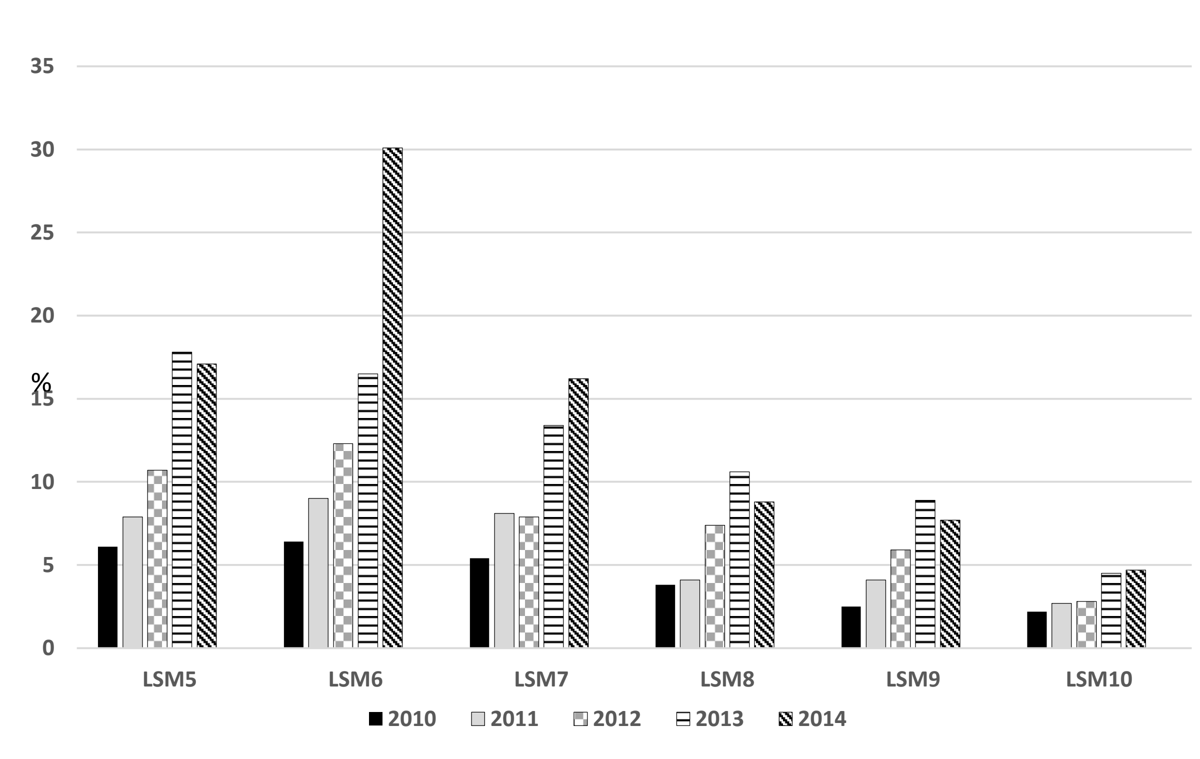


Source: Capitec Annual reports

Capitec's growth has been particularly strong in the low income market. Figure 3 below illustrates Capitec's market share by LSM band for the period 2011 to 2013. It shows that Capitec's market share grew strongly in all of the bands, but particularly in LSMs 5 and 6 where by 2013 it had 17.8% and 16.5% market share respectively.

Capitec executives attribute the bank's apparent growth acceleration from around 2008 to regulatory developments, funding and internal initiatives.[20] The National Credit Act provided the legal and regulatory framework that allowed the bank to extend loan terms. As capital restraints on lending were done away with (only the interest rate limitation was left after the Usury Act), the bank's loan book grew. Regulatory certainty allowed the market to develop. Funding lines also became available and Capitec embarked on its debt-raising note programme. Finally, initiatives to improve branches, system and people came through, which allowed the bank to increase its fee income.

Figure 5 Capitec market share by LSM band

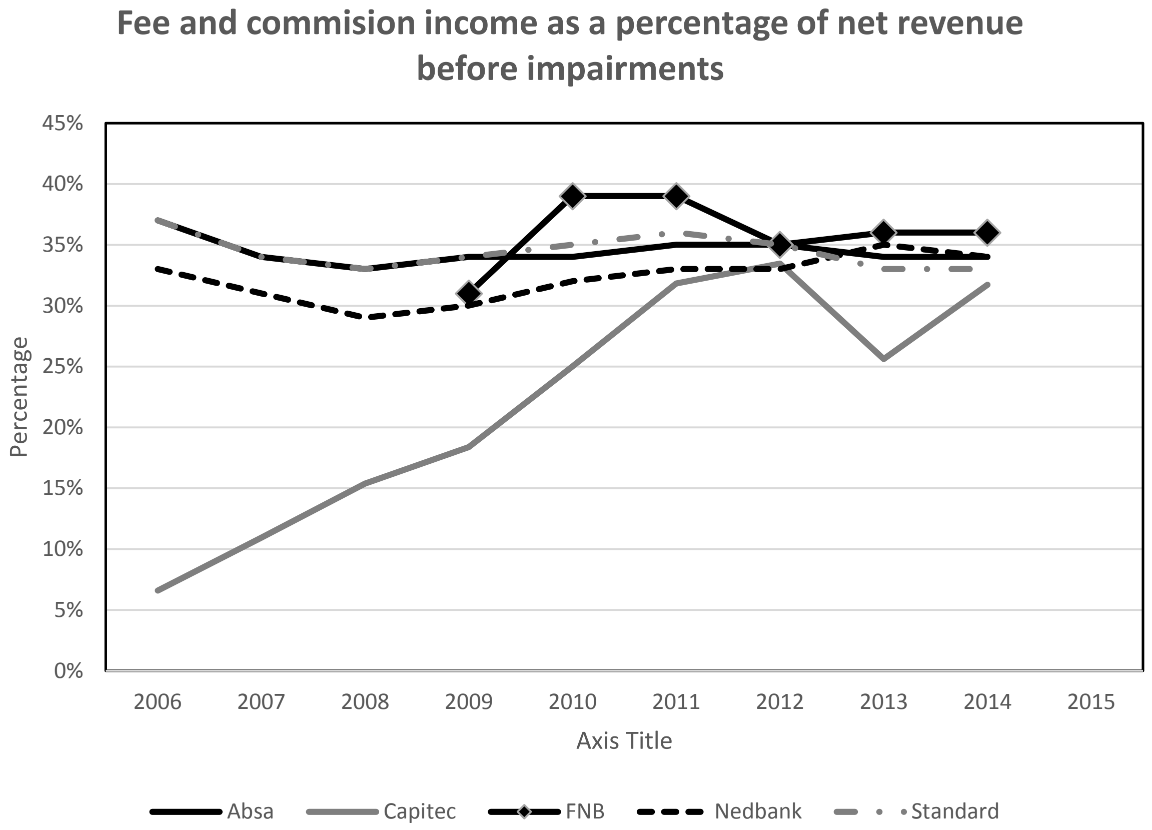


Source: Capitec Annual report 2014, based on AMPS data

Looking at market shares for retail household deposits, however, it is clear that although Capitec's market share has grown strongly, it is still very small compared to the four major banks at less than 5% in 2013 (see Figure 1 above). This performance does not rule out the possibility that there may still be barriers to growth and expansion in the market.

[20] Interview with Mr Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

Figure 6: Net fee and commission income as a percentage of revenue before impairments



Source: Bank annual reports, Hawthorne (2014). Note: Net revenues used for Absa, FNB, Nedbank and Standard Bank, gross revenues used for Capitec based on data availability. Though gross revenues are used for Capitec, its proportion of transaction fees is still lower than that of the other banks.

Source: Absa, Capitec, FNB, Nedbank, Standard bank annual reports

This also ties in with the findings of the banking inquiry review which found that since the banking inquiry newer entrants have increased their share of total deposits, but it remains relatively small (Hawthorne et al, 2014). Capitec's transactional fee income reflects this. As a percentage of operating income before impairments, transactional fee income rose from 13% to 22% in 2015. For the big four banks, the ratio ranged from 29% to 39% over the past nine years.

3.1.2 Sources of finance

At the time of its inception, the funding environment was not favourable for a proposition such as Capitec. However, the founders of the bank saw a gap in the market in the form of the 'badly banked' who needed better retail services. Though not necessarily unbanked, the lower income end of the market was subjected to complex, expensive accounts and poor service. There were various access barriers to obtain and operate accounts such as forms, language and physical barriers. Despite this market gap, the collapse of other lenders such as the Unifer division of Absa and Saambou meant there was no appetite by external funders to put money into Capitec.[21] It relied solely on the resources of PSG. As the managing director at the time, Michiel Le Roux, said in an interview (Bolin, 2003): "We are financing the opening of Capitec branches with our cash flow and operating within strict financial constraints, so we can't be aggressive in our expansion." The bank's 2004 annual report expands further on anticipated expenditure and financing strategy: "Strategically we are supporting the cost of building a bank with our small loans business. The running cost of a bank branch is 34% higher than the cost of running the same branch as a micro-lending branch. In the coming year costs will again rise sharply. Gaining bank customers will require significant expenditure on marketing".

Capitec's one-month loan product meant that it could be self-financing, particularly as this product offering turns capital around quickly. Only in 2007, after the introduction of the National Credit Act did loan terms in the unsecured lending market extend beyond 36 months.

It is highly unlikely that Capitec would have enjoyed success without a shareholder such as PSG. The investment bank provided the capital required for a banking license, which had just been raised from R50m to R250m, and ongoing support. But in line with PSG's philosophy to get companies to list early, Capitec listed on stock exchange in 2002. Its share price went down upon listing. Investors may have found it difficult to assess a business without a clear peer group, given its position as a new and small bank with roots as a micro-lender. According to Capitec executives, investors are generally not supportive of small banks.[22] PSG Group unbundled it stake in Capitec to its shareholders in 2003, only to rebuild it later. This meant, at the time, that Capitec no longer had a controlling shareholder, though directors and management held about 35 percent of the bank's equity.

Main sources of funding

Various sources of finance have been utilised by Capitec since its inception. In the early period between 2001 to 2003, the company was mainly financed by equity which represented more than 80 percent of long term financing at the end of the 2003 financial year. Debt instruments were first utilised in 2004 while deposits became a significant source of finance between 2007 and 2008. The bank raised debt funding from Future growth and European development finance institutions. Discussions to raise debt funding were lengthy and difficult.[23] The rest of the sources of finance utilised over time are depicted in the graph below.[24]

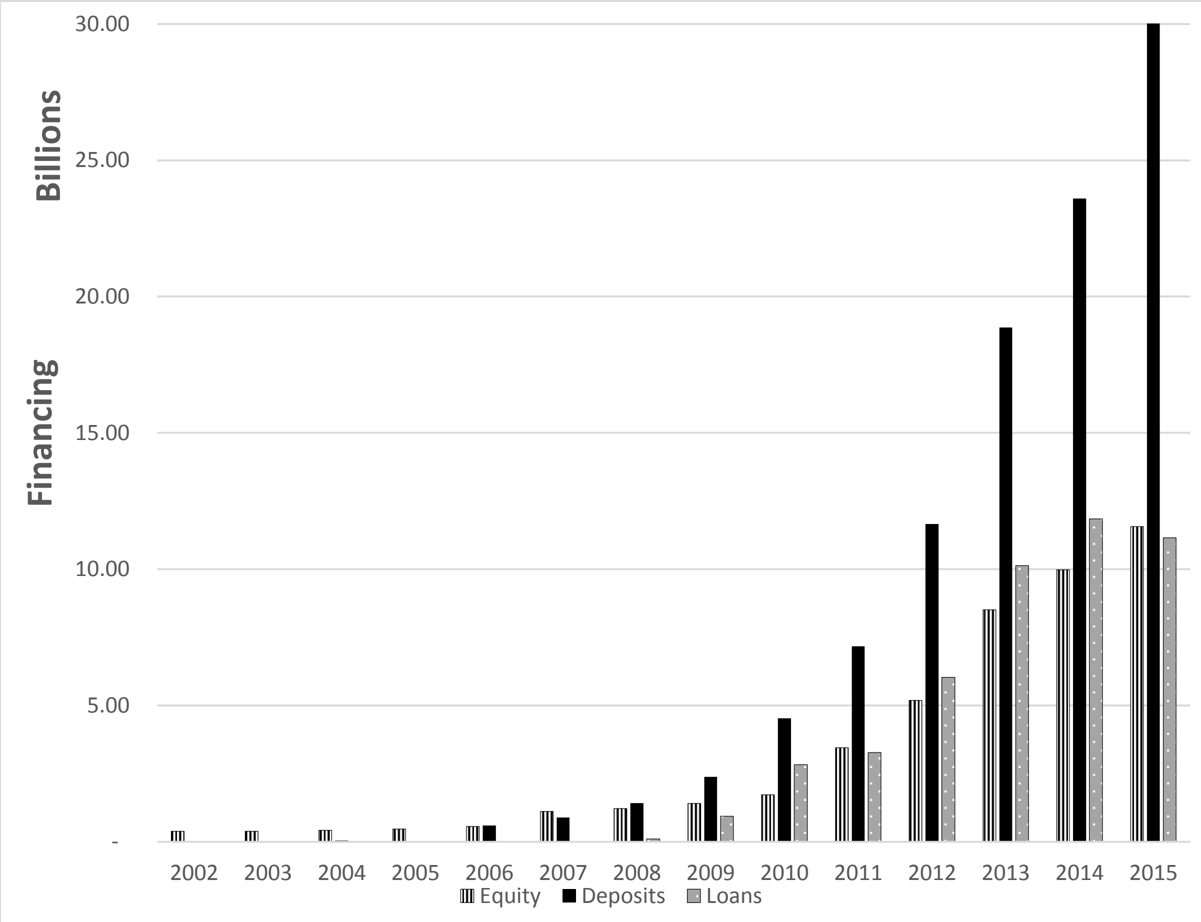
[21] Interview with Mr Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

[22] Interview with Mr Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

[23] Interview with Mr Andre Olivier, Capitec, 10 November 2015.

[24] Capitec annual reports 2003 -2015.

Figure 7 Sources of Finance 2002 – 2015



Source: Capitec annual reports 2003 – 2015.

Share capital and other components of equity

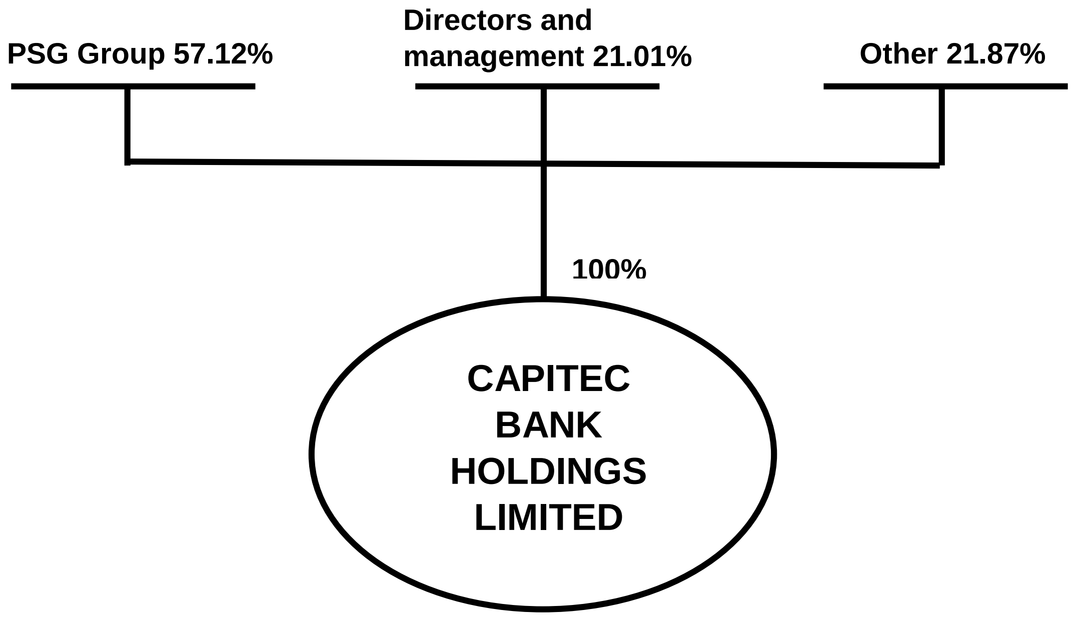
Financing remains one of the biggest challenges for new entrants in the banking sector. This is mainly as a result of the capital intensive nature of banking; it is estimated that one would need between 250 and 500 million[25] in order to meet the license requirements as well as initial operating costs. Moreover funding is very difficult to raise in South Africa especially for new entrants with no track record, investors perceive them as unsafe investments whose returns cannot justify the inherent risk.

Capitec's experience in raising capital echoes the sentiments cited above, the organization struggled to raise financing specifically in the early years. For the greater part of the infant years the company was self-funded and significant portions of profits were retained into the entity. The bank started off with one month loans in order to quickly recoup capital and profits so that it could be reinvested. As a result, on average 71 percent of the profits where reinvested into the entity between 2002 and 2007; highest retention rates of 100 percent and 99.1 percent were recorded in 2002 and 2004 respectively.

[25] The Banks Act, 1990 (2007 amendment) par 70 (2) (a) (i)

The partnership with PSG played a pivotal role in ensuring the survival of the entity specifically in the early days when other investors were sceptical about investing in Capitec. As at 2003 year end PSG held 57 percent shareholding in Capitec while management and other investors held 21 percent and 22 percent respectively.

Figure 8 Capitec's shareholding as at 28 February 2003

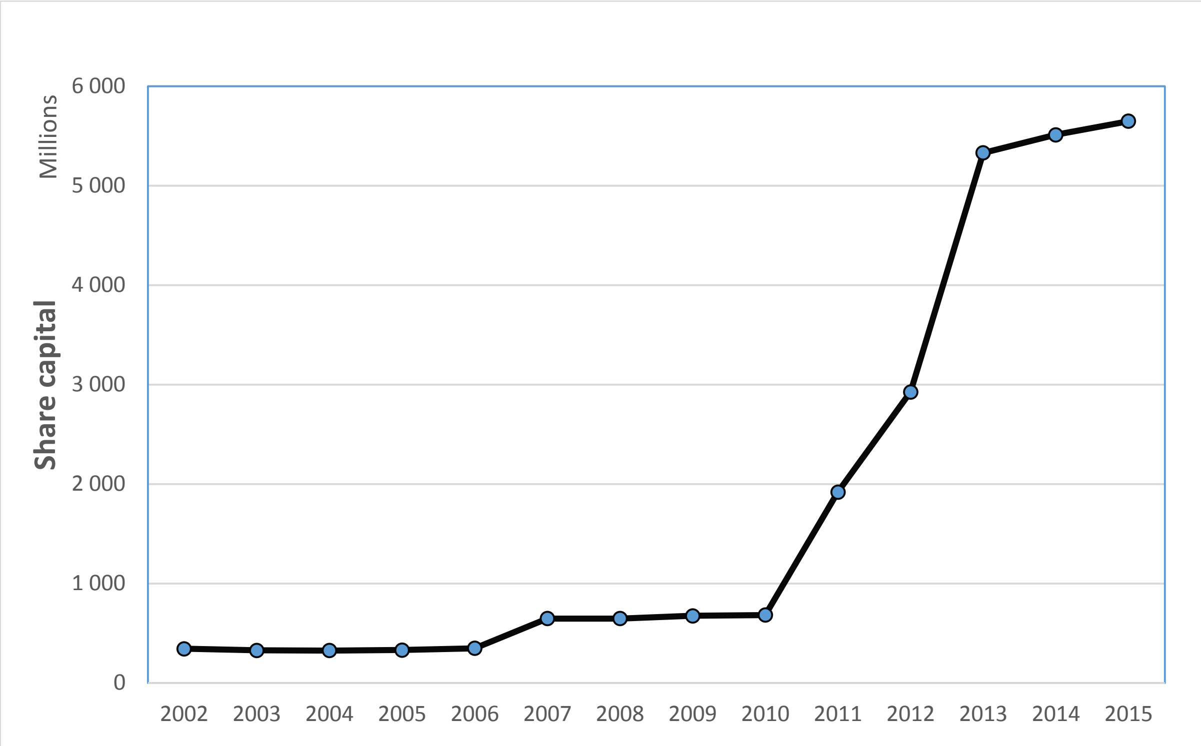


Source: Capitec annual report 2003

PSG acted as a shareholder of reference who provided comfort to the market specifically in the early years when the entity was in its infancy. They also provided Capitec significant amount of equity capital that enabled the bank to advance its operations such as expanding branches across the country.

Capitec's reputation grew as time went by and investors' confidence started to develop which enabled Capitec to raise more capital. During the 2007 financial year, Capitec issued 10 million shares that increased the share capital by 86 percent. There were also share issuances in 2011, 2012, 2013 and 2014 which raised 1.2billion, 1.007billion, 2.4billion, 136million respectively. Figure below shows the movement in Capitec's share capital over the years.

Figure 9 Growth of Capitec's share capital 2002 – 2015



Source: Capitec annual report 2003 - 2015

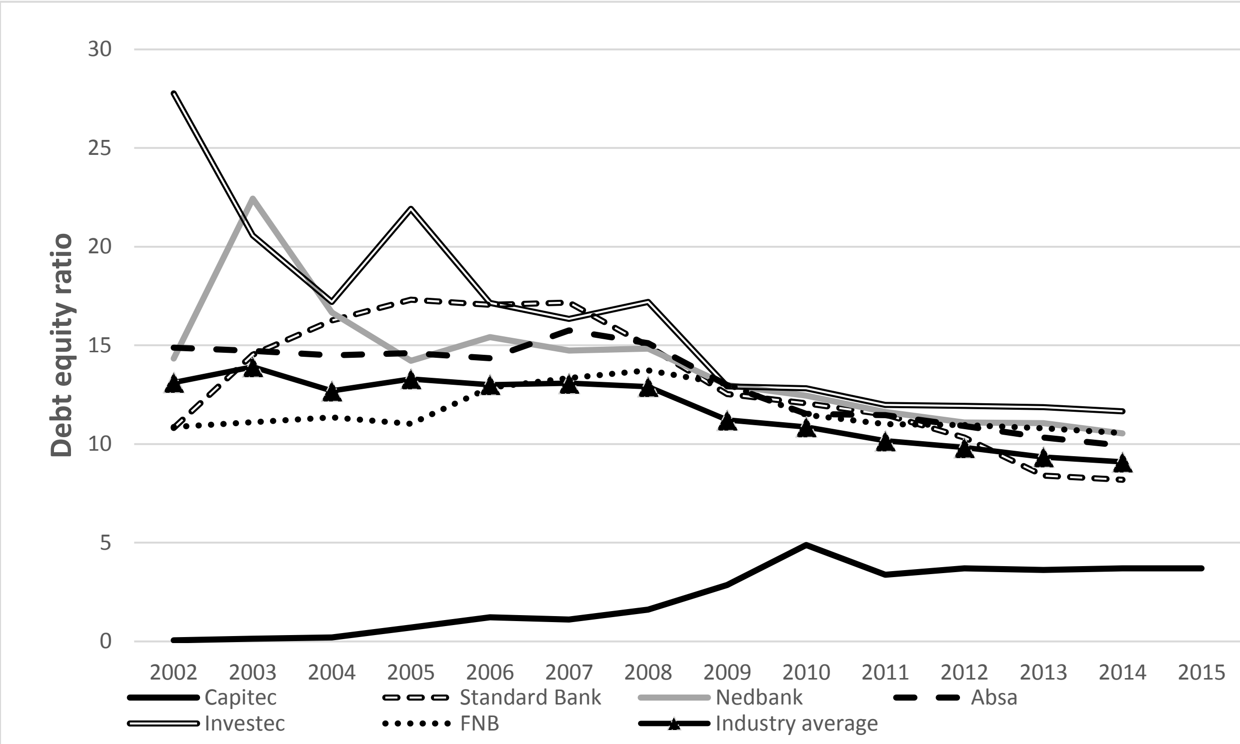
Long term loans and deposits

Capitec Bank adopted a conservative approach towards the utilisation of debt financing. The bank first took on debt instruments in 2004. After 2007 negotiable instrument and the domestic medium term note were the two main source of debt instruments while subordinated and senior bonds were also issued during the 2015 financial year.

Despite emphasis on conservatism, Capitec also attributes part of low levels of debt funding to the inaccessibility of debt markets by small companies. In the early years, Capitec could not issue investment grade debt instruments because they were a small organization with no track record, hence they were limited to specialist financiers such as development finance organisations.

Capitec's level of debt within the capital structure has improved over the years however it is still very low relative to the industry average and the other five banks. Figure below shows the proportion of debt within Capitec's capital structure over the years relative to the other five banks and the industry average.

Figure 10 Capitec's capital structure relative to other banks



Source: Capitec annual reports 2003 – 2015; Investec annual reports 2003 -2015; FirstRand group annual reports 2003 – 2015; Standard bank group annual reports 2003 –2015 & ABSA annual reports 2003 – 2015.

Source: Absa, Capitec, FNB, Nedbank, Standard bank annual reports

Capitec's lack of access to debt financing especially in the early years did not only impact the ability to expand the entity's operations but it also affected the entity's profitability as a result of a low financial leverage. The passage of the National Credit Act brought some relief, as the bank issued bigger loans with a term longer than 36 months, allowing for leverage.

Other than access to markets there is also Basel regulation that affect how a bank is financed, this is discussed in detail in the next section.

Basel III and its impact on financing

Basel rules are a set of reform measures, developed by the Basel Committee on Banking Supervision to strengthen the regulation, supervision and risk management of the banking sector[26]. The latest capital adequacy framework is known as the Basel III and it was developed in the aftermath of the financial crisis of 2008 – 2009.

The new framework has two sets of requirements that are expected to have an effect on how South African retail banks are financed namely, capital adequacy and liquidity requirements. Capital adequacy is the ratio of a bank's capital to its risk, it is set to ensure that a bank can absorb a reasonable amount of loss. Liquidity exposure on the other hand is meant to promote the short-term resilience of the liquidity risk profile of banks by ensuring that they have

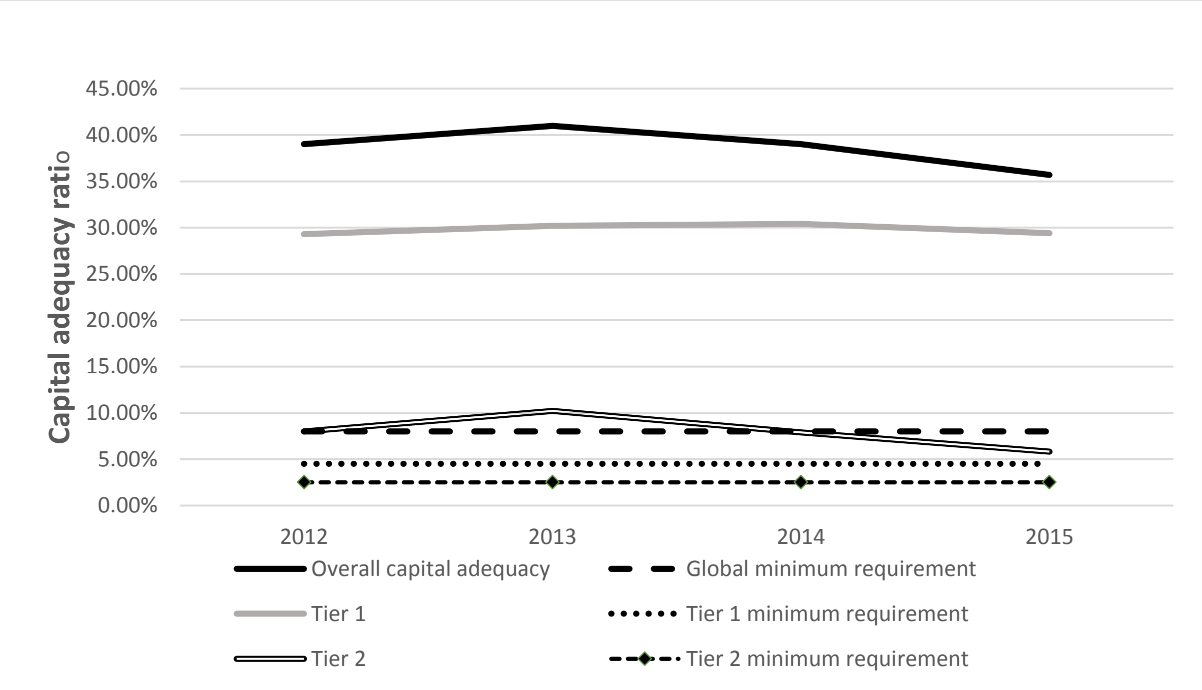
[26] Kvalem, A. T. & Kovanis, M. Basel III: A global regulatory framework for more resilient banks and banking system. (July 2015).

sufficient high quality liquid assets to survive a significant stress scenario lasting 30 calendar days.[27] Liquidity exposure is also expanded through the net stable funding ratio, the proportion of available stable funding relative to the amount of required stable funding. This ratio should be kept at 100 percent on an ongoing basis and it is designed to ensure banks have enough long-term stable funding to protect against a protracted stress period of up to a year.[28]

Under the new framework, a tight definition of what constitutes acceptable regulatory capital has been applied and the capital adequacy common equity tier 1 ratio was increased from 2 percent to 4.5 percent. This entails that banks need to raise more common equity capital financing; a move that is more likely to strain small players in the industry.[29] The introduction of two liquidity ratios is expected to drive firms away from sourcing shorter term funding and move towards longer-term funding arrangements which could have an effect on pricing and profit margins.

Capitec's experience in dealing with Basel 3 guidelines has been encouraging. Although the deadline to comply with these two ratios was set at January 2015, Capitec managed to comply with capital adequacy and liquidity exposure ratios as early as 2012. The graph below illustrates Capitec's capital adequacy ratios over a period that covered 2012 to 2015.

Figure 11 Capitec's capital adequacy ratios relative to minimum global requirements



Source: Capitec annual report 2012 - 2015

There are noticeable costs that came with meeting the capital adequacy ratios; the additional share capital issued to meet the capital adequacy requirements (787 million in 2012; 2.2 billion

[27] Basel committee on banking supervision. Basel III: A global regulatory framework for more resilient banks and banking systems. Bank for international settlements. (December 2010).

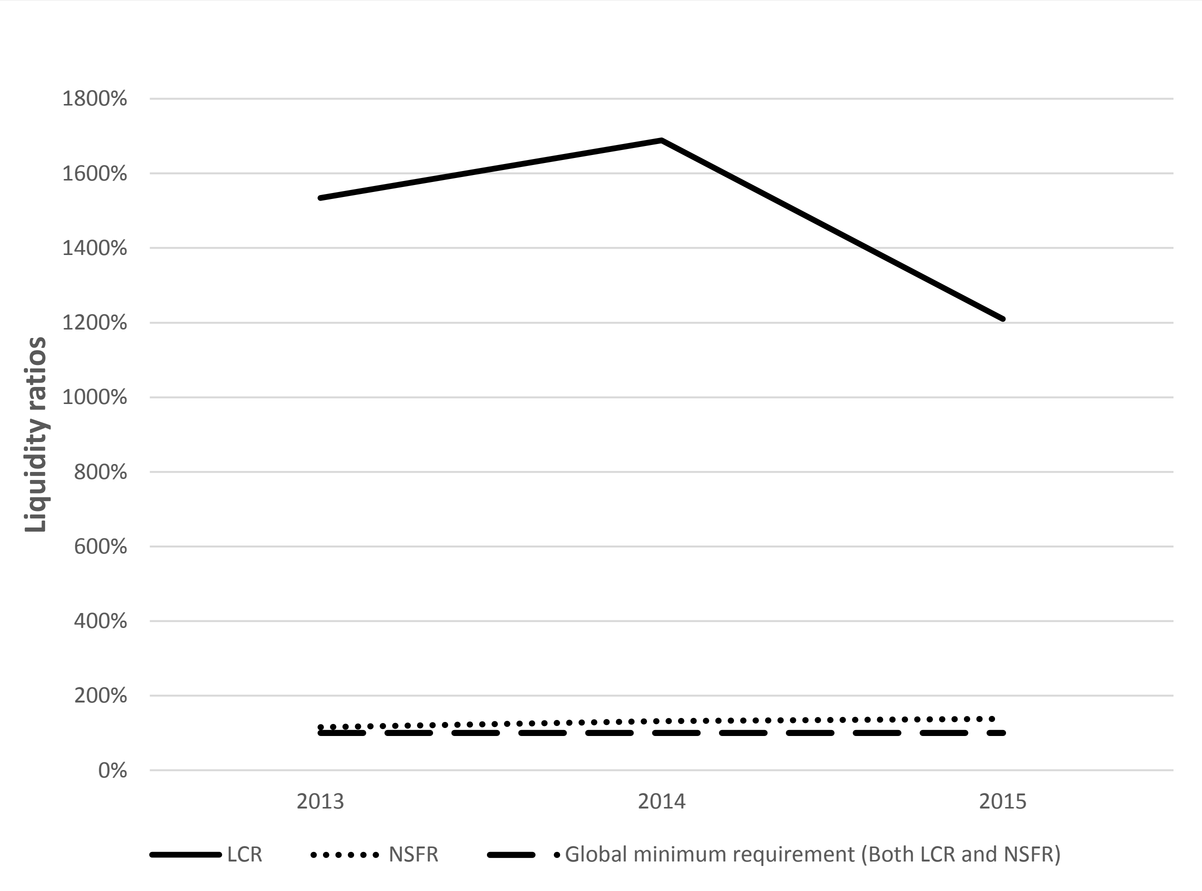
[28] See note 27.

[29] KPMG. 'Basel III: Issues and implications' (July 2015). Kpmg.com.

in 2013) diluted the return on equity. Consequently return on equity decreased as follows; 34%, 29%, 27% and 23% during 2011, 2012, 2013 and 2014 respectively. Furthermore, the cost of funding increased in the short term while the lending activities of the entity were reduced as a more conservative approach to credit provision was adopted.[30]

Liquidity requirements however had a minimal impact on the activities of the organisation. Capitec's preference for longer-term wholesale funding instruments, no reliance on corporate and institutional call funds and healthy retail funding base positioned the bank for compliance with the new liquidity standards (2012). As at 29 February 2012 Capitec complied with both the liquidity coverage ratio and the net stable funding ratio. Figure below shows Capitec's liquidity coverage ratio and the net stable funding ratio in relation to the global minimum requirements.

Figure 12 Capitec's liquidity ratios relative to minimum global requirements



Source: Capitec annual report 2012 – 2015

LCR: liquidity coverage ratio

[30] Capitec annual report 2013

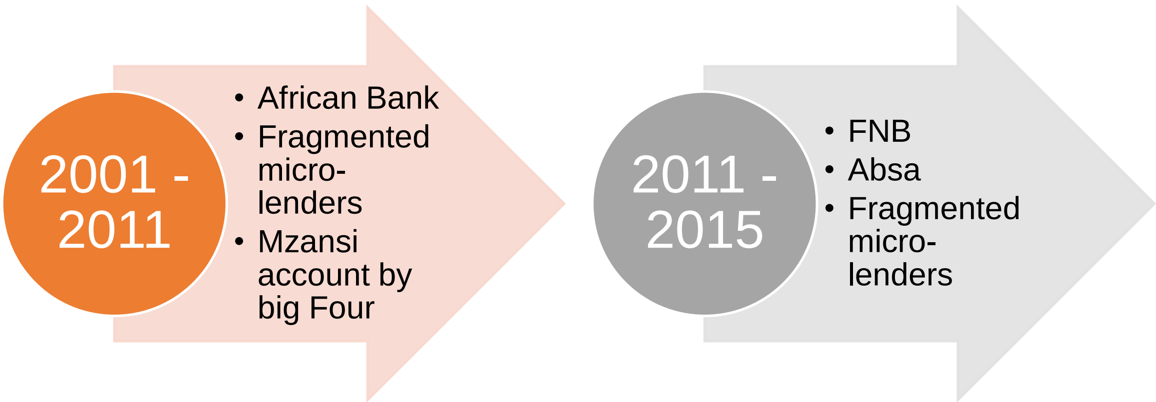
NSFR: net stable funding ratio

Capitec's liquidity coverage has been superior in relation to the other banks. According to BA900 data that banks submit to the reserve bank, as at July 2013 Capitec had the highest increase in long term deposits of 65.4 percent in comparison with Absa, Nedbank, Standard, FNB and Investec that exhibited 23.2 percent, 16 percent, 2.2 percent, 21.6 percent and 21.3 percent respectively[31].

3.1.3 Incumbents' reaction to entry

Other banks may have underestimated or misunderstood Capitec's model and aspiration. However, that has changed.

Thematic shifts in the competitive landscape



The major shift in the competitive landscape was in 2011, when Absa and FNB removed restrictions on low income accounts. According to Solidary Research Institute, FNB's Easy Account and Absa's Transact account are now truly competing with Capitec.

However Capitec still has the advantage of relatively high interest rates on positive balances, which can offset bank charges if the customer maintains a moderately high deposit level.

3.2 Capitec's competitive strategy

3.2.1 Target market and customer acquisition strategy

In line with its ambition to become a retail bank for the masses, Capitec branched into deposit-taking and payments from its origins as a micro-lending institution. Capitec Group describes its focus as providing "retail banking services to all individuals based on the principles of

[31] Maarten M. 'Banks adhere to new capital realities' (July 2015). Financial Mail.

simplicity, affordability, accessibility and personal service" (Capitec Memorandum, 2008). A significant market opportunity was presented by the unbanked and the ‘badly banked’ population. In 2004, only 45 percent of the population was considered to be banked (Finscope).

During Capitec’s early years, the banking industry introduced the Mzansi account for the unbanked. The incumbents also came in with products and services aimed at the low end of the market. These include FNB’s roll-out of mobile branches, Pick n Pay’s Go Banking partnership with Nedbank and Standard Bank’s branchless banking. Capitec did not participate in the Mzansi initiative, but came in with its own attractive offering.[32] According to Capitec executives, the bank did not want to differentiate clients by income. [33] They sought to establish a ‘single status’ culture without the stigma associated with an account for the poor. Incumbents spend a lot of time on market segmentation, and tailoring products to segment. Capitec offers simple product across all segments.

This approach also meant that the bank could benefit from economies of scale reaped by providing standardised products. Specialised products add cost. The standardised approach also means that the bank can use recent graduates and school leavers with just seven weeks of internal training.

Switching is a key barrier to entry for new entrants seeking to lure clients away from incumbents. Historically, South African retail banking customers did not switch banks easily. This was seen as a cumbersome process.

Previously underserved, low income customers might also trust the big four banks more than new entrants as the former have established brands and have built credibility over time.

According to the Finmark Trust, banking customers have been more sophisticated. In the run-up to the 2014 Finscope study, 4 million people switched banks. Banks have also become more transparent about charges, thus facilitating switching.

In evaluating progress on the implementation of recommendations related to consumer switching, Hawthorne *et al* argue that the new market conduct regulator be tasked with creating tools to assist consumers to compare between and choose a banking product. Capitec has overcome some of the challenge to switching by making its own prices and product structures simple and transparent. The bank's executives emphasised that this is key to the Capitec value proposition. This simplicity, in an opaque industry, is regarded as a key competitive advantage for Capitec. In effect, it has turned around barriers to switching into an advantage, because what sets it most apart from other banks, is its transparency. Capitec employed a centralised team to assist prospective customers to switch banks before the practise became widespread. [34] It employed dedicated staff to work on switching clients. Branch personnel were also trained to convert lenders and savers into banking clients.

Advertising costs were not a significant part of expenditure in the early years. The bank relied on basic methods such a flyers. This was partly because the business did not yet have its business model bedded down in terms of differentiating factors or a national distribution

[32] Interview with Mr Jabulani Khumalo, Finmark Trust.

[33] Interview with Mr Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

[34] Interview with Mr Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

network that prospective customers could access.[35] In February 2007, it released its first above-the-line advertising through a television, print and radio campaign.

Capitec steadily turning its unsecured lending clients into banking clients. By 2015, 44 percent of lending clients use Capitec Bank as their primary bank (CNBC interview with CEO Gerrie Fourie (2015)). With depositors, the 'shoe is on the other foot' and the customer is not in a dependent or needy position. This meant that the bank had to invest in changing its internal mind-set to get staff to understand this changed dynamic.

The profile of Capitec's clients has changed over time, with more mid-market customers who would have been previously banked. Its initial customers were 'cash convertors' – they would take out cash soon after the salary is deposited into the account.

3.2.2 Product design (low transaction fees, high rates on daily savings, low interest on loans)

In line with the 'one status' culture mentioned above, the Global One account is available to all income segments. The high interest rates on positive balances are part of the 'affordability' proposition to customers. This has not affected earnings negatively as the bank has a low cost base (very low to cost-to-income ratio by global standards) and has a high margin lending business. The main omissions in the offering are credit cards and overdrafts.

Though three of the four main incumbents did not initially see Capitec as a challenger, they have now responded with similar offerings.[36] These include FNB's Easy Account and Smart Unlimited and Absa's Transact. Capitec offered the cheapest account until around 2012. According to Solidarity Research Institute, Absa's Transact account and FNB's Easy Account now compete strongly with Capitec.

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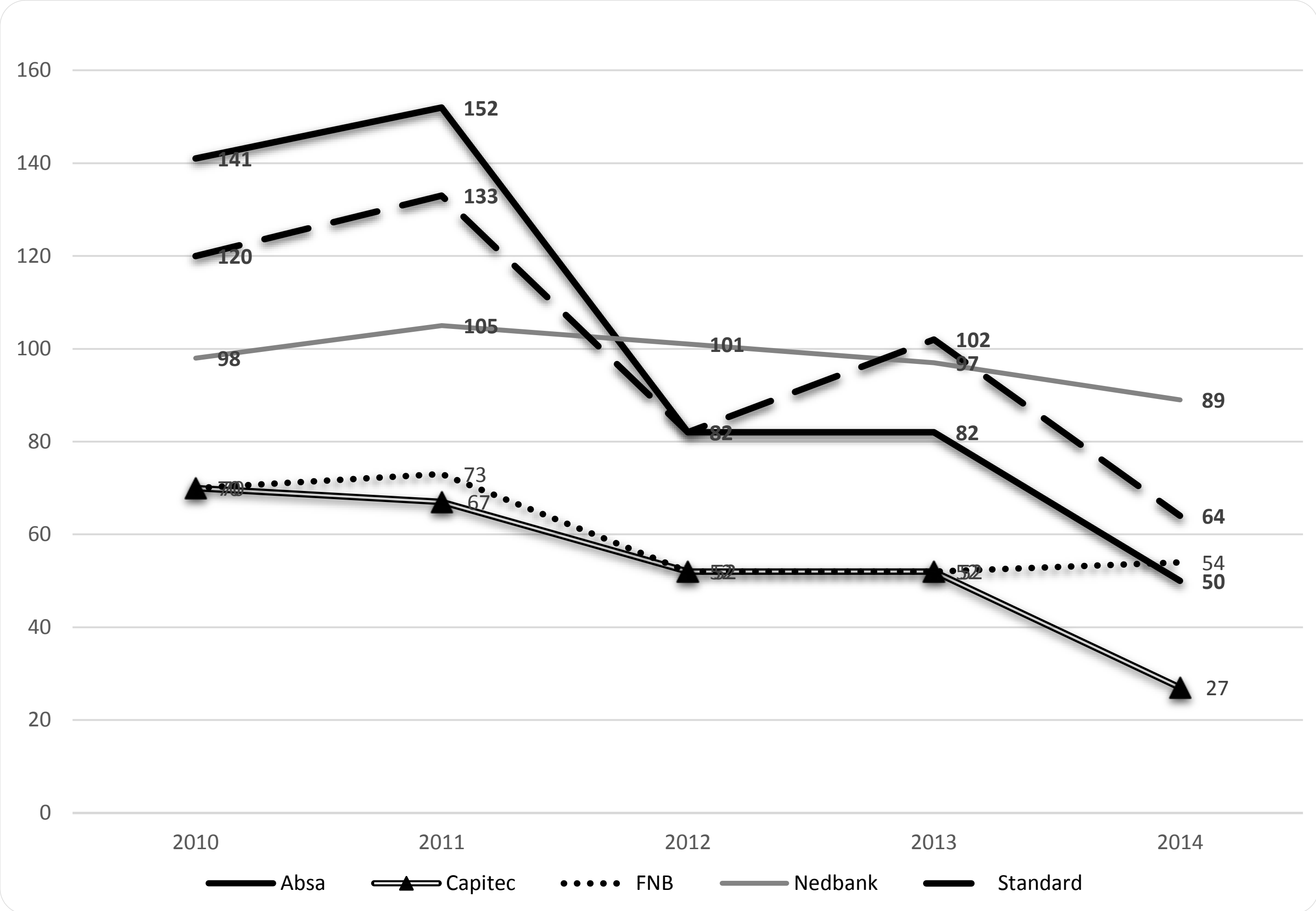
[35] Interview with Mr Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

[36] Interview with Mr Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

Figure 13 Lowest priced bank account (monthly fees)



A key element of the bank's strategy is to locate its branches in places that are convenient to the consumer e.g. commuter nodes such as taxi ranks. From a security perspective, Capitec will locate a branch anywhere as long as it makes business sense. It will deploy the required level of security. Crime is a constant risk, ranging from destruction of ATMs, cash-in-transit heists and threats to staff from card fraud syndicates. However, it is well-known in the market that the bank does not keep cash in the branch.

3.2.3 Infrastructure and technology

Capitec did not have a legacy IT system. Therefore, it could build custom IT infrastructure in line with current market needs, unlike established banks. The bank could also consider new technology as it could not afford a mainframe system. It settled on a core banking system used by banks worldwide, in particular banks in India that dealt with high volumes of transactions. It also relies on the Windows platform, which is a low cost and scalable approach. There was no pressure for the bank to expand into its capacity. Instead, it increased its capacity as needed. The new technology also meant that it could employ new skills coming into the market.

On the negative side, it had to import most of its IT requirements and customising for South African conditions was difficult. [37]

The cost of the building a new IT system was not a significant constraint on cash flow as the bank could start small. The systems were also available at a reasonable time as their providers were also minor players at the time. Now that they have been acquired by larger technology companies, their systems are more expensive now.

The new technology also enabled Capitec to build around the customer. Whereas traditional banks have silos, i.e. a cheque system, a card system etc. Capitec build the various components into one core client-centric system.

Capitec acknowledged in interviews that the IT requirements for starting a new bank are not insignificant. A retail bank needs the system not only to provide services to their own clients, but to connect to other banks. Systems also have to be customised for legislation. For example, early debit orders are only used in South Africa. To link to a system such as Saswitch is also not a global requirement.

3.2.4 Skills and capabilities

Though Capitec was initiated by an investment bank, it soon acquired executives with retail and banking experience, with key personnel having worked at Boland Bank, BOE and Distillers. These executives had experience in banking, but also in operating in low income communities. It is also interesting to note that the banking institutions that the executives were involved with previously, and other banks that had been taken over by PSG such as The Business Bank and Real Africa Durolink, had encountered difficulty if not outright failure. Hence, the executive team came to the Capitec experience with cautionary tales that would have prepared them for building the bank.

Some key IT appointments were also made early on. [38] Luck played a part too, with the shut-down of an IT division in Paarl, making it possible for Capitec to pick the best employees.

The bank was not an employer of choice at the beginning but this has changed. As for the general staff, one of the key challenges was to turn employees with a micro-lending mind-set into service-oriented bankers. There is also a general challenge with numeracy skills, which is particularly acute in areas such as the rural Eastern Cape. The executives gave a rough figure of about 1 out of 50 applicants being appointable for a job in some rural branches. [39]

The staff at Capitec is not unionised. In the matters that have seen it being taken to the CCMA, it has prevailed in around 90 percent of the cases. [40]

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[37] Interview with Mr Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

[38] Interview with Mr Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

[39] Interview with Mr Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

[40] Interview with Mr Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

3.2.5 The take-off in branches and operations

Capitec experienced a pick-up in the number of customers around 2008. Its executives put forward a combination of reasons for this. The National Credit Act formalised the legal and regulatory framework to extend the terms of loans. The capital restraint fell away, with only interest rate limitations remaining. The loan book grew on the back of regulatory certainty.

Funding lines also became more open. The bank embarked on its note programme in 2008. Its internal initiatives on branch expansion, and systems and people development, began to pay off, leading to the growth of fee income.

The bank survived the vulnerable period when it could have been bought. [41] However, the other banks began to imitate its branches' physical layout, advertising messages, switching service and opening hours. As Solidarity reports demonstrate, there was a heightened focus on pricing.

The bank still has a low market share of deposits. The bank had to build trust and reputation with its new banking clients. It offered fixed term deposits from 2008. However, Capitec executives also argue that they are comfortable with the current level of deposits as the bank does not want to attract far more funding than it needs.

4. Payment system regulation and entry in banking

To offer banking products to its clients, banks have to enter into inter-bank arrangements to facilitate payments between customers across the banking sector. Payments instructions are exchanged (cleared) and then settled through Bankserv (daily) and the Reserve Bank's Real Time Gross Settlement system (immediately). The payments system is built on the principles of inter-operability and stability. Banks have to ensure that they can process the instruments provided by other banks and to ensure that their products also meet agreed-upon specifications. The various types of payment instruments (cheque, electronic funds transfer) are organised as payment clearing houses (PCHs). Each PCH is made up of member banks who offer that service.[42] They devise the rules and modalities of the PCH, which are approved by the PASA council. Non-compliance with PASA rules attracts financial penalties.

According to PASA, the main risks within the payment system stem from its interconnectedness, the failure of one institution can lead to the failure of others.[43] The settlement system represents biggest concentration of risk. It is common for this area to be reserved for banks as the bank regulator can enforce collateral requirements against them. Non-bank wanting to play here might as well become a bank, PASA argues, as this would be an easy way to monitor collateral and capital adequacy. Nonbanks could enter as 'designated' member, exempt from banking license. In this way, they can participate in clearing but not settlement.

[41] Interview with Mr Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

[42] The CEO of PASA is not aware of any instance where a bank's application to join a PCH has been rejected.

[43] PASA interview with Walter Volker, CEO of PASA, 22 July 2015.

Despite an advanced payment system, cash is still a significant feature of the South African economy (55 percent of transactions are concluded in cash, by some estimates). The factors driving the usage of cash include perceptions that cash is 'free' (even when customers have paid an ATM fee to access it) and tax evasion. Accessibility remains an issue – the footprint of infrastructure such as point of sale terminals needs expansion. [44] There is also no clear policy to incentivise non-cash payments.

Governance

The council is the supreme decision-making body in PASA. In recent years, there have been various reforms in PASA's governance. The constitution of PASA has been amended to impose on each councillor a fiduciary duty to the payment system, not to the member's bank. The council is led by an independent chairperson. There is no provision for consumer representatives on PASA structures. PASA will soon contract independent compliance officers.

The next step in the reform process is to appoint independent board members. The Reserve Bank is engaged in a review of the payments system. On the table is a proposal to expand membership of PASA to different levels of membership, including non-clearing participants. This would allow PASA to enforce compliance with its rules on these types of institutions. In the current regime, banks have to 'regulate' down the value chain to their non-bank partners, with whom they have a commercial relationship. This introduces risk in an environment where partner could threaten to go to a more lenient bank. [45]

As part of its compliance function, PASA levies penalties on members that contravene its rules. These include penalties for contraventions such as non-compliance with clearance rules, transgression of payment limits, not fulfilling membership requirements, non-compliance with the regulatory framework or with entry and participation rules. The maximum penalty that can be imposed is R10m. In 2014, PASA levied penalties of R1.1m on its members (PASA Annual Report 2015).

4.1 Experience in entering and participating in the payments system

According to Capitec, entry into the payments system was not difficult. In line with PASA's rules, Capitec found a mentor bank to ease it into the various payment clearing house. Absa performed that role. The fees that are charged for these arrangements are likely to be high by international standards.[46] Sponsorship fees are based on values and volumes. There are no guidelines for sponsorship and mentoring arrangements. In PASA's view, entrants can shop around for the best arrangement. The CEO of PASA is not aware of a situation where an entrant has not been able to secure a sponsor. He also knows of no rejections to requests to join the body. However, PASA has no direct influence over negotiations between mentors and mentee banks.

As a new bank unburdened by legacy systems, Capitec was able to introduce new ways of doing things like moving away from fax notification for EFT disputes.

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[44] Interview with Walter Volker, CEO of PASA, 04 September 2015.

[45] Interview with Walter Volker, CEO of PASA, 22 July 2015.

[46] Interview with Walter Volker, CEO of PASA, 04 September 2015.

Capitec was the first to issue a debit MasterCard (as opposed to a Maestro card), which came with a dual messaging system. Initially, some banks did not process the messaging properly. Capitec had to wait for the other banks to be able to acquire the card. To move unilaterally would have meant that customers whose transactions are acquired by those banks would experience poor service. There was a significant delay in roll-out. [47]

To introduce a new instrument depends of the pace of the slowest acquirer. The Banking Enquiry report argued that introducing innovation is beset by two main challenges: gaining permission from the incumbent to introduce the development in a payment clearing house, and negotiating inter-bank fees. The report goes on to argue that innovation might meet resistance from incumbents feeling threatened and also exposes the innovator's intellectual property. Innovations can also be introduced by setting up a new payment clearing house by at least two members. But it is found that this had only happened due to external factors (early debit order payment stream at the behest of the Reserve Bank and Mzansi money transfer in response to the Financial Services charter). The panel was therefore not convinced that this is the best way to bring innovations to the market.

When it was put to PASA that new developments are thwarted in this way, the CEO countered that this is no longer a significant issue. For example, an acquirer has to load the bank identification (BIN) code of a card-issuing bank on its system. Through this process, they could frustrate the bank issuing a new BIN. This is no longer happening. PASA imposes penalties for breaches; such penalties are known to the Reserve Bank and the banking community.

The Reserve Bank acknowledges that industry-wide projects to introduce changes in the payment system are difficult to implement.[48] For example, there is a project in the debit order payment streams to introduce authentication. According to the Reserve Bank, the project is taking a very long time. At the time of the interview, the bank was considering penalties and incentives to encourage timely rollout.

Upcoming changes to the EFT messaging platform might also make innovation easier. The new ISO state will make EFT messages more flexible. With this change, two banks could effect a change on their own without being 'held hostage' by the rest of the sector.

The SASSA card – challenges to innovation in the payment system[49]

Part of the significant increase in financial inclusion and the penetration of payments instruments in South Africa can be attributed to the roll-out of bank accounts by the South Africa Social Security Agency (SASSA). Net 1, though its subsidiary Cash PayMaster and in partnership with Grindrod Bank, set about to move grant payments from cash to electronic means.

Grindrod Bank issues grant recipients with a card through which they can receive a grant and conduct basic transactional banking services. The electronic disbursements of grants reduces the costs of distribution and supports safety. The new card system was rolled out

[47] Interview with Mr Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

[48] Interview with Tim Masela, Divisional Head, National Payment Systems Department, Reserve Bank, 08 October 2015.

[49] This section relies on interviews with Walter Volker, CEO of PASA, 04 September 2015, and the Grindrod website.

from March 2012. Within 17 months, 10 million payments were issued.[50] For MasterCard, the roll-out of SASSA cards was its single biggest enrolment programme worldwide. Grindrod has become a 'significant contributor' to volumes in the national payment system, representing 29 percent of monthly card and ATM transactions through Bankserv. [51]

The card represents an example of innovation that occurred without (or before) integration. The card was designed to use its own biometric standard. The use of finger-point biometrics is reported by Grindrod to have reduced fraudulent grant applications and collections.[52] It could not be used on other banks' point of sale devices. Retailers that accept the card had to deploy specialist POS devices that could read the card, thus operating in parallel to the established payment system.

The cardholder verification method for the card did not fall within PASA rules (which recognise signature, PIN, 3d secure/verified by Visa methods). The biometric standard used was a proprietary system belonging to Net 1. As a result, the retail partners that accepted the card had to buy bespoke terminals. The proprietary electronic purse used was not EMV compliant.

Following intervention by PASA, the card providers had to give users the option to use a PIN. By September 2015, PASA was in the process of finalising a national biometric standard.

Capitec rates itself as an active and effective participant in the structures at PASA. [53] It has also held the chairmanship of the PASA Council.

The charges levied by Bankserv on banks came under discussion at the Banking Enquiry. At that time, a tiered fee structure was in place, with low volume banks paying higher fees per transaction. This changed after the enquiry, with all banks paying the same fee per transaction.

Card schemes

The payment cards issued in South Africa are managed by the two main international associations, Visa and MasterCard. Unlike many other large emerging markets, there aren't any independent card associations to compete with Visa and MasterCard (& Amex, Diners Club to some extent). A domestic scheme would have lower fees and would cater to the vast majority of South Africans who do not require international acceptance of their cards. The industry, through Bankserv, considered creating a domestic card scheme (about five years ago). Banks showed some interest in the initiative, but did not commit to customer volumes. [54] A similar initiative was mooted at SADC level but did not get off the ground.

[50] MasterCard website http://newsroom.mastercard.com/press-releases/ten-million-sassa-mastercard-cards-issued-to-south-african-social-grant/ Accessed 30 September 2015.

[51] Grindrod website http://www.grindrodbank.co.za/Pages/Sassa, accessed 30 September 2015.

[52] Grindrod website http://www.grindrodbank.co.za/Pages/Sassa, accessed 30 September 2015.

[53] Interview with Andre Olivier and Christian van Schalkwyk of Capitec, 29 July 2015, Stellenbosch.

[54] Interview with Walter Volker, CEO of PASA, 04 September 2015.

However, PASA argues that many domestic schemes struggle. In the UK, the scheme closed down. But PASA also pointed out that domestic schemes are in place in Australia, New Zealand and Canada. PASA also argues that schemes have brand equity. International cards are aspirational whereas a domestic scheme may be perceived as second rate. It would also be difficult for a local scheme to compete with the international associations on innovation. [55]

4.2 ATM network and cash-back at point of sale

Access to cash is important to the low and middle income customer base that Capitec competes for. In general, an ATM network is a significant competitive feature in the market for deposit-taking. For small banks with a limited ATM network, the chances are that their customers would withdraw money from other banks' ATMs – off-us transactions – attracting interchange fees from incumbents. The Banking Enquiry found that off-us ATM charges were quite high in South Africa. The mark-up by a customer's own bank was also much higher than the interchange it pays on the transaction.

The Banking Enquiry's main recommendations on ATMs were to move the pricing model from an indirect to a direct charging model and to promote cash back at point of sale. A direct charging model would allow for transparent pricing and stimulates more competition for off-us transactions.

ATM fees should be high enough to encourage third parties to enter this market. Third parties reduce the capital investment required by small banks. There is proposal in the industry to develop 'universal' ATMs for low volume areas. This would reduce the costs of duplicated infrastructure and extend access.

Nonetheless, the prevailing inter-operability of ATMs allows for entrants and small banks to piggy-back on others' networks, meaning that they could still compete for deposits. These banks can choose to subsidise off-us withdrawals to minimise the impact on customers.

For the reasons above, it was important for Capitec to roll out infrastructure for its customers to withdraw cash. Its branches did not handle cash but customers had access to ATM machines co-located at branches. The location of Capitec's ATMs, and customer's transaction behaviour (a few major withdrawals per month) would have alleviated demand for cash at rivals' ATMs.

Another cheap way for consumers to access cash is to withdraw at retail points of sale (cash-back at till). When Capitec enabled customers to receive cash-back at tills in 2005, it was still an under-utilised service in South Africa. This was an attempt by Capitec to save on ATM costs. It was also a secure option for customers. The retailer also benefited as it allowed it to get rid of cash, which is costly to manage. Members of the bank's executive team were able to tap into relationships they had with retailers from their time at Distillers and at Boland Bank.

At the time, most banks could not process cash back transactions. Initially, Capitec had a direct line at Pick n Pay. It got an exemption from PASA to 'sort at source' for cash back at point-of sale.[56] According to the Reserve Bank, this allowed the bank to continue with its

[55] Interview with Walter Volker, CEO of PASA, 04 September 2015.

[56] A customer that wanted cash back at the till would have their transaction processed directly to Capitec Bank, even though Pick and Pay had another bank acquiring transactions at its tills. Sorting at source allows the merchant to choose which bank they will use to complete a transaction. Hence it allows for bilateral transactions that do not have to cleared and settled in the interbank system. If all

business whilst others got their house in order. [57]Other banks appealed this exemption. The appeals process could be used by banks seeking to block an innovation or to buy time.

Cash-back at till transactions have not had mass take-up, with low levels of volumes transacted. Only 4 percent of customers use this instrument, compared to 78 percent for ATMs. Capitec is of the view that fees are not the barrier to greater take-up. Cash-back fees are lower than those for ATM withdrawals. The main challenge is likely to be how customers have been socialised into using ATMs for cash withdrawal. Campaigns to create awareness and encourage behavioural change could increase utilisation of this payment channel.[58]

5. Other regulations affecting Capitec's expansion

FICA

The bank finds FICA compliance difficult to enforce in rural areas. The form of residence envisaged by the law sometimes does not apply in rural or informal areas.

Property

Capitec's strategy is to present itself as a retailer. Over time, it has found ways to secure prime retail locations, away from the typically isolated 'banking section' found in malls. To appease landlords, it sometimes takes long leases.

6. A note on other entry episodes into retail banking

Capitec entered the retail banking market in the early 2000s, and managed to navigate its early years based on internal financing. Since 2008, its growth accelerated and its low cost, high tech model has secured its place as one of the top six banks in the country. However, this is a relatively unique success story in South Africa. In this section, the study reflects on the experiences of other small banks or recent entrants and how they have tackled the considerable barriers to entry into this market.

Ubank (formerly Teba Bank)

The Employment Bureau of Africa (Teba) was created to recruit workers for the mining industry. The agency employed young men from across Southern African to work on the gold and platinum fields for most of the 20th century and continues to play that role, albeit to a limited extent as mines increasingly recruit workers from areas close to mining operations. Teba Bank developed in parallel to Teba and has provided basic financial services to mineworkers from the 1960s. It facilitated the distribution of salaries for the mines. In the 1980s, Teba Bank became a deposit-taking institution. It was granted a banking license in 2000. Teba Bank is owned by the Teba Fund Trust. According to the bank's annual report, The Teba Trust operates as a development trust and distributes its proceeds to beneficiaries, which include mineworkers and their communities.

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merchants were able to sort at source, in the extreme case, there would be little need for the interbank system.

[57] Interview with Tim Masela, National Payments System Department, Reserve Bank, 08 October 2015.

[58] Interview with Andre Olivier, Capitec, 10 November 2015.

In an attempt to develop a customer based outside the mining industry, it rebranded into Ubank. It could be argued that Ubank should have been the front-runner in banking the low-income, unbanked market, given its decades of experience providing basic banking services to mineworkers and running a remittance system between mining and 'labour-sending' areas.

Ubank offers unsecured credit, transactional banking, savings products and term deposits. Its forays into the general population have not been successful to date. An unfortunate financial transaction left a dent of R220m which had to be written off.[59] It is engaged in litigation with regard to this transaction.

Ubank's growth plans are stymied by lack of finance. The bank does not have a 'shareholder of reference' as it is owned by a trust whose beneficiaries are miners represented by the majority trade union and the Chamber of Mines. Profits are used for social projects mainly in education. Its Tier I capital comprises solely of retained earnings. It has no debt on its balance sheet.

Table 2 Key Figures - Ubank, Rm[60]

Primary capital	359
Primary capital adequacy ratio	16.7%
Secondary capital	9 516
Deposits	3 877
Assets - loans advanced to clients	722
Assets – investments	2 800

The bank has engaged a range of investors with limited success. Though Ubank has a 40 year history, potential equity investors will need to see sustainable returns from it. It also faces a challenge in accessing debt as it does not have a credit rating. In recent times, much like when Capitec listed, investors are sceptical about small banks with unsecured lending exposure in light of African Bank's demise. Ubank's struggle with raising Tier 1 capital is not unique with Ithala, Sasfin, the former Abil relied mostly on bonds.

Ubank began its operations with a captive market of mineworkers. The business model is based around their needs. Being heavily cash-dependent, Ubank offers cash transactions for free. It also still offers savings books, as this is what some customers are comfortable with. Its workplace banking model means workers have access to banking on the mines.

The bank has an advantage over other banks when it comes to lending as it understands the compensation associated with shift work. Other banks may miscalculate the affordability threshold if variances in pay due to shifts and bonuses are not well understood. However, mineworkers are also banked at African Bank, and some have moved to Capitec.

[59] Ubank invested in Corporate Money Market, a company which went bust, allegedly due to illegal practices. Absa was Corporate Money Market's trustee and Ubank is taking the bank to court. Interview with Ubank, 05 August 2015.

[60] As at 31 May 2015. http://www.ubank.co.za/wp-content/uploads/2015/09/ubank-quarterly-disclosure-2016-quarter-1.pdf and Interim Financials: http://www.ubank.co.za/wp-content/uploads/2015/02/ubank_interim_financials_2014.pdf and 2014 Annual Report.

In expanding outside the mines, the bank has learned some 'expensive lessons'.[61] Its risk methodologies were based on a close relationship with workers employed in the industry, whereas lending to the general market was not as established. The bank had to tighten its scorecards accordingly.

Participating in the payments system has presented some challenges for Ubank. Joining PASA is easy and there is a clear process to do so. However, to acquire a switch is expensive. Compliance with payment clearing house rules is also difficult as PASA is constantly introducing new ones as it tries to outpace fraudsters. There are only two card schemes in South Africa – Visa and MasterCard. In other countries, small banks have the option to join other card schemes (e.g. in Nigeria e-Transact competes with Visa and MasterCard).

Despite its lead in providing banking services to low-income and working class customers, Ubank operates on the margins of the banking industry. It is still largely serving the mining community and is quite vulnerable to developments there, including the risk of industrial action, which saw the bank making losses in 2014. Without a significant capital injection and a revitalised business strategy (which the bank claims to have but is hampered by lack of capital), it is difficult to see this bank emerging as a competitive force to challenge the big four and Capitec.

Mercantile Bank

Mercantile Bank has been operating in South Africa for 50 years. It started out as the Bank of Lisbon, with its focus on the Portuguese-South African consumer market. It changed its name from Bank of Lisbon in the 1980s after a merger with Mercantile, a non-banking financial institution. The bank was listed on the JSE in the 1990s.

After a period of weak performance, the bank was restructured, with a new core focus on commercial and business banking. It still relied on cheap deposits from retail clients, which were lent out into segments such as commercial property. It is now fully owned by Caixa Geral de Depösitos. In recent years, it has widen its customer acquisition focus beyond the Portuguese-South African community. It is focusing its efforts on attracting entrepreneurs to its bank, a segment it believes is badly served by the banking industry.

Table 3 Key figures - Mercantile Bank (Rm, 2014)

Tier 1 Capital	1 708
Capital adequacy ratio – Tier 1	22%
Tier 2 Capital	11
Capital adequacy ratio – Tier 2	0.2%
Total assets	8 767
Loans and advances	6 223
Deposits	5 792

As a wholly-owned subsidiary, Mercantile's experience with access to finance is largely determined by the standing of its Portuguese parent, which does not enjoy a robust credit

[61] Interview with Ubank, 05 August 2015.

rating. According to the bank's annual report, though Moody's, the credit rating agency, "assessed concerns on contagion risks from CGD, the Bank's parent company, the rating agency has assessed the Bank's financial fundamentals as remaining sound." In the 2014 financial year, Mercantile raised finance (R240m) from the International Finance Corporation through the securitisation of its rental finance book. Mercantile Bank aims to build the number niche bank for business banking in South Africa.

The key area of difficulty identified by Mercantile is the cost of compliance with regulatory changes. Some of these changes are justified but prove to be a disproportionate burden on smaller banks. PASA penalties also hit small banks harder than larger banks as they are imposed as flat rates (not turn-over based). From the bank's comments, it appears that a more rigorous evaluation of the costs versus benefits of new regulation is needed.

7. Policy Implications and Conclusion

The benefits of entry

Capitec's entry and growth in transactional banking sparked a competitive response from incumbents, especially FNB and ABSA. These banks now offer products that are positioned to compete with Capitec's simple, technology-driven and low cost offering. Across all four incumbent banks, the fees for low-cost accounts have come down in nominal terms. It is unlikely that these effects would have occurred if the status quo had continued without a disruptive entrant or if Capitec had been acquired by one of the incumbents early on.

The positive effects of Capitec's entry are expressed in three ways: new-to-banking customers that now have access to finance, lower bank charges for customers who switch from the incumbents to Capitec and lower prices from incumbents' clients as their banks react to Capitec. This can be illustrated by the simple exercise below that shows the 'savings' the latter two effects are likely to have had in the market.

Table 4 Lower prices for clients at incumbent banks

Bank	Clients 2014	Price decrease (2010 - 2014)	Total savings
ABSA	8 600 000,00	R 91,00	R 782 600 000,00
FNB	7 600 000,00	R 16,00	R 121 600 000,00
Nedbank	6 700 000,00	R 9,00	R 60 300 000,00
Standard Bank	10 400 000,00	R 56,00	R 582 400 000,00
			R 1 546 900 000,00

Source: Bloomberg (number of clients), Solidarity Report

If in 2014, customers on the lowest cost accounts at incumbent banks had been charged the same prices as in 2010, they would have paid R1.55 billion more per month.[62]

Table 5 Lower prices for clients who switched from incumbents to Capitec

Bank	**Average price - lowest cost account (2010 -2014)**	**Weighted Market share**	**Weighted average price**
Absa	101,4	29%	R 29,41
Standard bank	100,2	24%	R 24,05
Nedbank	98	22%	R 21,56
FNB	60,2	24%	R 14,45
		Weighted average price - big four banks (2010 - 2014)	**R 89,46**
		Average Capitec price 2010 - 2014	R 53,60
		Difference	R 35,86
		Number of clients who switched (assumed 75 percent of new Capitec clients)[63]	2 449 500,00
		Monthly savings for clients who switched	**R 87 843 969,00**

Customers who switched from big four banks to Capitec between 2010 and 2014 would have paid, on average, R35.86 less per month upon joining Capitec. This gives total savings of R87.8 million per month. This is also not precise as some clients would have switched from a far more expensive account, not necessarily the cheapest. The figures will also be distorted by the presence of multi-banked clients. For the two groups of beneficiaries (switchers to Capitec and those enjoying price decreases at incumbent banks), this brings estimated annual savings in 2014, compared to 2010, to R19.96 billion. This is a rough estimate but indicates the order of magnitude of the benefits accruing to mass market consumers from a more competitive retail banking market. This figure is driven by the fall in bank charges at the big four banks. The presence and behaviour of Capitec does not fully account for why banking charges fell since 2010, but is a significant factor in increasing competitive intensity in the mass market.

The exception that proves the rule?

In some ways, Capitec's experience is exceptional. In an interview with Moody's, the rating agency's analyst could not think of a similar bank anywhere in the world. It has surged ahead early attempts to bank the excluded such as Ubank (former Teba Bank) and the Mzansi initiative. Its early financial backer, chose to go into banking precisely because of the high barriers to entry in that sector. The entry, a consolidation play of small micro-lending institutions, benefited from this lending cash cow, which ensured profitability from the start.

[62] This is not, strictly speaking, the actual savings by customers as the client base in 2014 includes new to banking customers attracted by lower prices.

[63] Though Capitec would not be drawn on a specific figure, it indicated that in recent times, the profile of its clients has changed. With more mid-market customers, it likely that the majority of its new clients were previously banked. However, even if only 50 percent of new clients were previously banked, the overall savings for banking clients would come down to R19.26bn per year.

This can be contrasted with the experience of Ubank, which has stagnated due to lack of shareholder backing and poor financial results.

Capitec overcame customer's reluctance to switch, a key barrier to entry in retail banking, by developing a simple product that is easily understood. It also worked deliberately to convert its lending clients into transactional service clients.

Some of the bank's executives, having banking experience, were familiar with the payments system. However, it is clear that the ability of a small, nimble bank to introduce changes in this environment is subject to the incumbents' willingness to change and their pace. This is a consequence of inter-operability.

Capitec a beneficiary of regulatory changes in the industry

The competitive environment for Capitec was enhanced by regulatory and policy changes that sought to make the playing field more open and level. The Banking Enquiry focused attention on retail banking and heightened awareness about competitive behaviour in the sector. Some of its recommendations include:

- Measures adopted by the banking industry to facilitate customer switching
- Transparent pricing with fee disclosures on bank statements
- Non-discriminatory pricing at Bankserv (removing scale disadvantage for small banks)
- Improvements in governance at the Payments Association of South Africa
- Promotion of cash back at point of sale as channel
- Promulgation of the National Credit Act

The partial, and ongoing, implementation of these recommendations improved the competitive environment for Capitec. The bank's executives emphasised the formalisation of the National Credit Act as a measure that created certainty in the unsecured lending segment, allowing the bank to operate effectively in that space.

Going forward

There is still scope to improve the switching process. This could be done by instituting a regulated process with mandatory timelines, as suggested by the Banking Enquiry Panel. The incoming ISO 20022 messaging standard makes provision for automated debit order and incoming (salary) payment switching. With the system having better information on debit order originators, switching will become easier. The SARB should also consider a process where consumers are not liable for interest, penalty fees and other charges incurred due to delays in switching bank accounts (Hawthorne 2014). The sharing of FICA information, with clear guidelines on where liability lies in the case of contraventions (the original or second bank) would also ease switching.

A stricter process to ensure that participants adopt and facilitate innovation, new instruments and other changes is called for.

Regulators can play an active role in facilitating innovation. In the UK, the Financial Conduct Authority (FCA) has an innovation hub. The support offered to new and established, regulated and unregulated financial business includes: a dedicated support team, help to innovator businesses to understand the regulatory framework and how it applies to them, assistance in preparing and making an application for authorisation, and a dedicated contact for a year after an innovator is authorised to conduct business.[64] Potential innovators bring ideas to the regulator, not necessarily complete applications, and also their concerns about how the current regulatory framework limits them.

Capitec had aspirations to become a fully-fledged bank, but technology and business model innovations have expanded the range of institutions that can offer transactional banking services. A tiered banking licensing regime could facilitate other modes of entry in the future. Both the National Treasury and the Reserve Bank support the development of a tiered banking licensing and regulatory regime.

[64] Financial Conduct Authority https://innovate.fca.org.uk/ website Accessed 30 September 2015.

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Interview List

1. Banking Association – Cas Coovadia, Managing Director, Banking Association, 15 June 2015.
2. Capitec Bank - Andre Olivier, Executive: Card Services and Business Development and Christian van Schalkwyk, Executive: Risk Management and Company Secretary Capitec, 29 June 2015 and 10 November 2015 (with Andre Olivier).
3. Finmark Trust – Jabulani Khumalo, Senior Information and Research Specialist, 19 June 2015.
4. Mercantile Bank – Tom Stilwell and Matthew Coaker, Head of Payment Solutions, 18 September 2015.
5. Moody's – Christos Theofilou, Analyst, 26 June 2015.
6. National Treasury – Workshop on barriers to entry with Micro-economic Policy Team, 28 September 2015.
7. National Treasury – Roy Havemann, Kershia Singh, Nomvuyo Guma, Roelof Goosen, Katherine Gibson, 22 October 2015.
8. PASA – Walter Volker, 22 July and 04 September 2015.
9. PSG – Chris Otto, Non-Executive Director, 30 June 2015.
10. Rand Merchant Insurance Holdings - Dominique Collett, Senior Investment Executive, 15 May 2015.
11. Solidarity Research Institute – Paul Joubert, Senior Economics Researcher, 02 July 2015.
12. South African Reserve Bank National Payments System Department – Tim Masela, Divisional Head, National Payment Systems Department, Reserve Bank, 08 October 2015.
13. South African Reserve Bank Banking Supervision Department – Unathi Kamlana, Chief of Staff and Head of the Executive Management Department, 14 October 2015.
14. Tutuka – Rowan Brewer, Chief Executive Officer, 04 June 2015.

15. Ubank – Harriet Heymans, Chief Financial Officer, 05 August 2015.