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Barriers to entry in banking, lessons from Capitec's experience¹

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It is trite to observe that the retail banking industry exhibits high barriers to entry. It requires substantial amounts of capital, is subject to network effects and scale economies and has regulatory restrictions for prudential reasons. Consumer switching costs mean that it takes a considerable time to build a customer base and earn a return. To compete with incumbents requires IT systems, a branch and ATM network (though this might soon change), and brand-building expenditure to encourage customer switching and to build credibility. Most of these outlays are sunk investments that cannot be recovered in case of failure.

This does not mean that competition in banking is necessarily weak. There are critical decisions which can undermine or encourage more competitive rivalry. Moreover, the Capitec case study demonstrates that rivalry has significantly reduced costs and broadened access to financial services. However, in many ways the Capitec experience points to ongoing issues in banking which need to be addressed to allow new business models

and innovative methods of providing financial services to be developed while not compromising financial stability.

In particular, other country experiences point to the potential for mobile financial services and agency-based or branchless banking to deliver services to lower income segments at much lower costs.² At present, innovation such as introducing a new instrument requires all parties to agree and hence it moves at the pace of the slowest acquirer. The Reserve Bank acknowledges that industry-wide projects to introduce changes in the payment system are difficult to implement.

Regulators can play an active role in facilitating innovation. For example, in the UK, the Financial Conduct Authority has an innovation hub. This provides support to businesses such as assisting them in preparing and making applications for authorisation. The UK is also actively supporting 'challenger' banks.

The regulatory requirements for obtaining a banking license are necessarily substantial,

¹ This brief draws from a case study on the experiences of Capitec funded by National Treasury and reported in CCRED Working Paper 2015/12.

² See Robb and Vilakazi, CCRED working paper 2015/8.

however, the terms for granting a licence do not appear to be transparent. The regulatory orientation in South Africa has been to the incumbents and effectively to privilege them.

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

Taking into account the effect on fees at incumbent banks (for those who kept their accounts with these banks) and those who switched to Capitec, the annual savings to consumers are estimated at around R20bn for 2014. This does not include the benefits of the extension of services with many more South Africans now having bank accounts.

Capitec's growth

Capitec registered as a bank in 2001, during a time when the 'small banks crisis' was undermining consumer and investor confidence in the retail banking sector. PSG, an investment holding company, built Capitec through acquiring micro-lending businesses, which were then integrated to form a unified bank, utilising a banking licence which PSG already held.

As Capitec did not have a legacy IT system, it could also build custom IT infrastructure in line with current market needs, unlike established banks. On the negative side, it had to import most of its IT requirements and customising for South African conditions was difficult.

Even with micro-lending base and a well-known backer (PSG) Capitec could not raise finance and it took a number of years for it to make an impact. The number of

Capitec branches actually declined from 2003 to 2005. Only from around 2008 did Capitec's growth in terms of branches and clients accelerate significantly. By February 2015, Capitec had over 6.2 million active clients. About 2.8 million of these clients deposited salaries and made payments from their Capitec account.

The construction of a branch and ATM network was critical to its success. While changes in regulations meant that cash-back at point of sale (cash-back at till) became possible, the evidence is that customer take-up has been weak. When Capitec enabled customers to receive cash-back at tills in 2005, it was still an under-utilised service in South Africa. However, only 4 percent of customers use this instrument, compared to 78 percent for ATMs, despite 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.

As access to cash is important to the low and middle income customer base which Capitec sought to attract, an ATM network is very important. For the greater part of the infant years, Capitec was self-funded and significant portions of profits were retained in the entity in order to make the investments required in branches and ATMs.

Customer switching inertia is a key barrier to entry for new entrants seeking to attract clients away from incumbents. Capitec was somewhat unusual in this regard in that it started with microfinance clients, some of whom already had accounts with other banks. Capitec then aimed to convert microfinance clients to full banking with deposit accounts. It also sought to overcome some of the challenge to

switching by making its own prices and product structures simple and transparent.

Capitec also sought to move people away from cash, including being 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.

Upcoming changes to the EFT messaging platform might make innovation easier. The new ISO standard 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 Competition Commission market inquiry into competition in retail banking issued its report in 2008 which identified a number of problems and made a list of recommendations. Its recommendations sought to address bank charges in particular, and to make the payment system more conducive to competition. The partial (and ongoing) implementation of these recommendations improved the competitive environment for Capitec though it is not easy to draw direct causal links.

As noted, the impact of Capitec is very substantial. In addition to the lower bank charges, it elicited a competitive response from incumbents in their products and business model, 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.

The Capitec case study also begs the question as to whether another similar rival could have emerged. Capitec demonstrates this is very unlikely as it brought together a unique set of factors including an existing banking licence, a very patient long-term investor willing to take risks in PSG, and the microfinance base enabling these customers to be migrated into bank accounts. Other rivals would have different business models including building mobile financial services, as we discuss below.

Policy measures to improve the competitive environment in retail banking

A range of concrete measures come from the study in banking, including those which go beyond simply the Capitec experience.

- **Switching:** To improve the competitive environment for retail banking, the switching process needs to be enhanced further. 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 consider a process where consumers are not liable for interest, penalty fees and other charges incurred due to delays in switching bank accounts as has been suggested in other studies. 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.

- **Facilitating innovation:** The historical record suggests that industry-wide change and innovation takes too long in the payments system. This suggests the need for a stricter process to ensure that participants adopt and facilitate new instruments. Regulators can play an active role in facilitating innovation.
- **Differentiated licenses:** 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. However, this mooted legislation has not progressed over the past few years.
- **Mobile money:** The regulatory barriers on mobile money transfer should be removed. Transfers do not involve intermediation and are not banking, properly understood. A banking licence should not be required. The mobile network operators have a huge customer database and can do KYC (know your client) much more efficiently now including in conjunction with retail networks which allow for cash-in and cash-out. In the absence of mobile money Shoprite has such a system but lack of rivalry means it effectively reinforces its own position as it is effectively a closed

system with no inter-operability (making a transfer to another network) and relatively high charges.

The adoption of mobile money means a reduction in reliance on cash, lower investments required in physical ATM infrastructure and is a stepping stone for those developing innovative banking products. Of course, it does undermine the position of banks which derive an advantage from their existing network of branches and ATMs as long as this continues to be critical to banking.

- **Branchless/agency banking:** The employment of ICT opens up possibilities for branchless banking. This is essentially available to those doing internet banking already, but those on lower incomes who would benefit most are the least likely to utilise internet banking and instead rely on cash and pay the charges and incur the inconvenience of doing so. The alternative models enable banks to use networks of agents to provide services.

The banks will typically point to the risks in terms of the difficulties in tracing financial flows and monitoring the stability of the financial system. The point, however, is to address how better bank supervision can address these challenges rather than simply to block any changes.