PRUDENTIAL
INVESTMENT MANAGERS

Stefan Swanepoel
Equity Analyst

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Banking on change

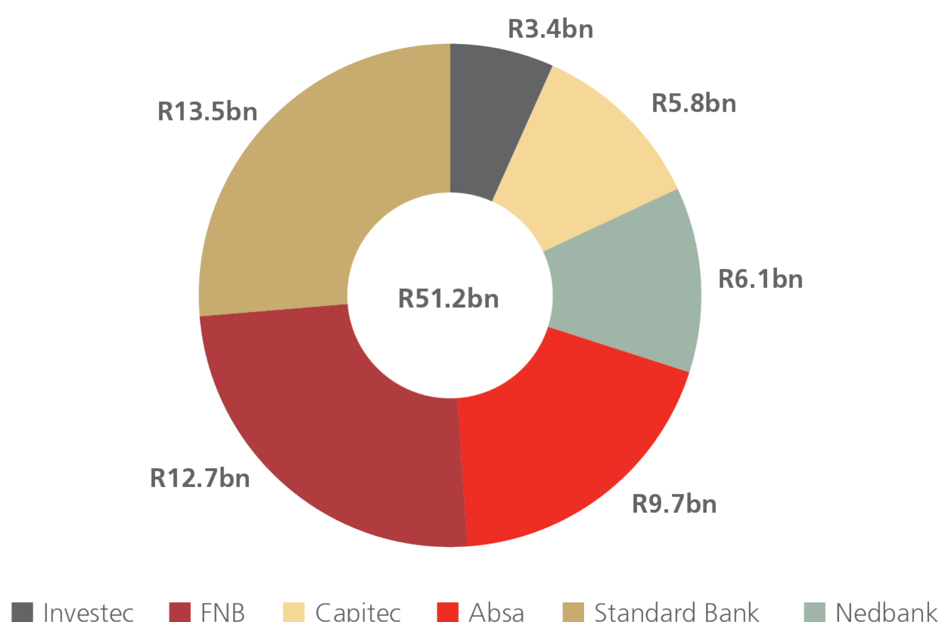
The only certainty there is in life, is change. Whether or not you are prepared for that change will determine your ability to profit thereon. More change is coming to South Africa's banking industry as a handful of new players are entering the market and the South African Reserve Bank (SARB) is examining new models for creating more competition.

A concentrated industry

The local banking industry has been resistant to change historically. It is heavily regulated, and barriers to new entrants have been high, as the South African Reserve Bank (SARB) maintains extensive oversight. All new banking entrants must first apply for a license with the regulator before starting operations. The application process is cumbersome and could easily run over a multi-year period as the SARB puts prospective candidates through their paces. In so doing, it grants all the incumbents sufficient forewarning

of whomever is daring to enter the fray. According to the SARB there are presently 34 banks operating in South Africa (15 of which are branches of foreign banks), in addition to which there are four registered mutual banks and four co-operative banks. The competitive dynamics are highlighted in the concentration among the top six banks, as these collectively hold over 90% of total bank assets and account for over R50bn in profits, as depicted in Graph 1.

Graph 1: SA Retail banking profit pool (R bn)



Source: Company data, Prudential estimates as at June 2019

Banking success is difficult

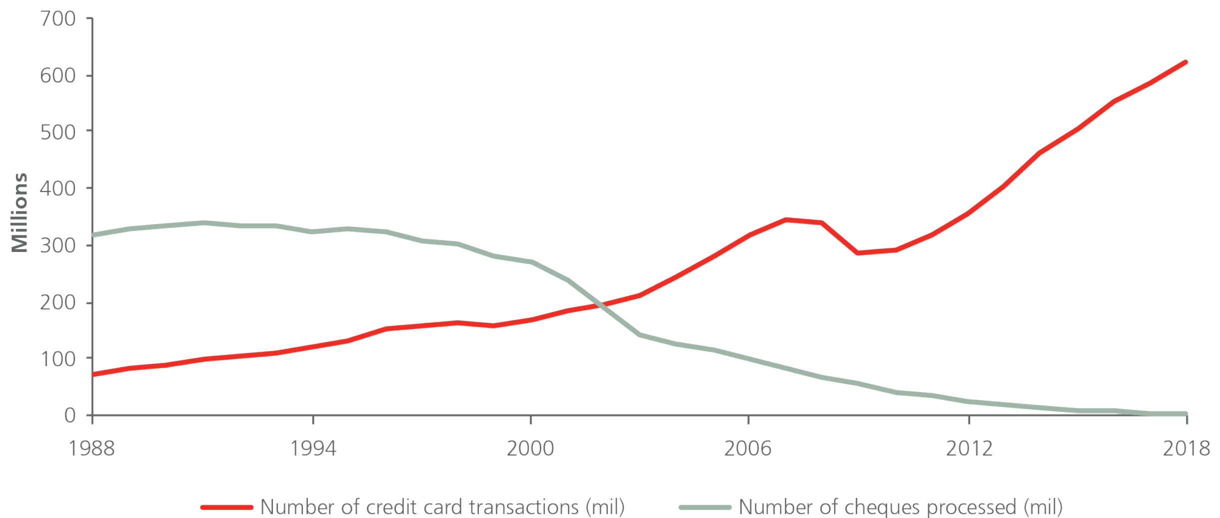
Despite the fact that the banking environment might feel quite stale, with the same old product suppliers all competing for your wallet, the industry has been remarkably fluid over the past few years. While there have been a number of new players in the industry, not all have been successful. Capitec is the most recent example of what a new entrant can do, but it will pay you to remember that many of the founding members were previously involved in the not-so-successful Boland Bank. Similarly, African Bank is trying to be a new kid on the block, but its failure in 2014 is recent enough for most of us to still shudder at the thought. If we

go back in time, we see many others that tried but were not able to succeed: BoE, MTN Mobile Money, Regal Bank, Bank Twenty-Twenty (initially in partnership with Saambou and later owned by Standard Chartered), Saambou, and not to forget the most recent, VBS Mutual Bank. The list goes on… The bottom line is: banking is not easy.

The larger incumbent banks are hamstrung by their old IT systems and bricks and mortar infrastructure. The problem is exacerbated by the fact that many customers have not yet fully migrated onto digital platforms and still have a need to go into branches or use ATMs. Consumers are also complex and the needs of one will be different to the next. While a niche player will always be welcome, it will only be able to be a one-trick pony for so long before it will run out of growth. The biggest issue with new entrants is that few will have the capital and the patience to actually make sufficient inroads into the market. Those that want to succeed will also have to contend with bigger banks that are sitting on substantial cash piles and not hesitating to spend on IT projects.

We criticise the big four banks (Standard, Absa, Nedbank and FNB) as being slow to react to the digital onslaught. Yet we miss the fact that many not only have an active digital presence already, but their digital branches are by far the largest point of new business generation. We forget that the banks are experienced in dealing with change - cheques were the de-facto method of payment not too long ago, as shown in Graph 2.

Graph 2: Cheque vs card usage over time



Source: SARB data

The new bank entrants

If we look at the sector's most recent new entrants, many are fighting for lower LSM consumers. African Bank, PostBank, Tyme Bank and Bank Zero are all largely targeting the entry level consumer. Historically, this has not been the most profitable part of the market, unless you are able to charge exorbitant levels of interest rates on unsecured lending products. The new institutions are nuanced in their various approaches: African Bank and PostBank will rely on their existing branch networks, while Tyme Bank has had to be more creative, tying up with Pick 'n Pay's extensive presence. Bank Zero, similar to Discovery, is making a go at operating without branches. This is not a new phenomenon, however, as Investec has been running this model for years. In fairness, most high-net-worth platforms within the big four banks also offer ancillary services that seldom require you to go into a branch. The trick is rolling this out to a mass customer segment.

Discovery will be a slightly different beast, as it is targeting more mid- to upper-LSM consumers. The problem is that Discovery is not flush with excess capital – something you need if you were to offer complex banking products such as vehicle asset finance or home loans. In the absence of

capital, it will likely offer very limited unsecured products such as overdrafts, credit card loans or personal loans. The concern we have is that if you are a mid-market consumer, you would likely want a car or a home loan. It is inevitable that you will find Vitality members who will flock to the new behavioural bank in an effort to gain more freebies on offer, but these individuals will be hard-pressed to close their other bank accounts as Discovery will not cater to all of their needs. The model focusing on incentivising consumer behaviour is also quite established by the bigger banks, as one finds with programmes like eBucks.

Opening up the banking landscape
While we are not overly concerned about the changes to the banking landscape, we are very focused on what is happening to the country's secure payment system. The SARB, while steadfast in protecting financial stability, does not exist to protect banking profits. It is actively looking at improving the competitive environment, in the hope that this brings down the cost for the consumer. This would open up the door, over time, for international players such as Apple, Samsung or Google pay. With balance sheets at several multiples of those of the SA banks, and businesses designed to focus on innovation, these players could be a much bigger threat than the existing few start-ups. Luckily for the sector – but not consumers – their arrival is not imminent as the SARB is first looking to open up the system on a "regulatory-light" basis.

Looking at success stories in the payment space elsewhere, Kenya's MPESA stands out, but only because it was allowed direct access to the Kenyan payment system without full regulatory supervision. It was a game-changer because it was no longer necessary to partner with a bank. The problem is that, without very careful management and regulation, the operations of so-called "non-banks" like MPESA can open up the economy to new risks. The banks will argue that their cost of doing business is impacted by the cost of regulation, and allowing non-banks to participate in the payment system is placing them at a disadvantage.

In an effort to address the standoff, the SARB is looking at a test case in Nigeria that will operate under a regulatory-light approach. This will be an ideal opportunity for telecommunication companies like MTN or Vodacom to access the national payment system directly and not via a bank. Historically the relationship between telecoms providers and banks has been quite fraught. Because the telecoms companies were not allowed direct access to the payment systems and the banks were not allowed access to the telecoms customers, the model was doomed to fail from the start.

The newer model would require the telecoms companies to hold some capital and the transactional ability of the accounts they offer would be limited. In theory, it will allow cell phone users limited functionality and small account balances with transfers of up to an amount of, say, R 20,000. This would therefore not introduce too much risk, but at the same time allow the newer entrants to settle transactions directly into the national payment system and hopefully avoid an additional layer of costs. The problem is that one or two entrants into this market will not make a difference. Even in the successful case of MPESA – it is still being criticised for its high cost of transactions, largely due to the near-monopolistic nature of its services.

The fight ahead

At the end of it, change is inevitable. Some of the newer entrants will succeed, but many will fail. The one thing that is certain, is that existing banks will have to contend with an ever-increasing competitive landscape. Thankfully, the banking sector has been conservative in growing its assets at a much slower pace than previous cycles. It is well capitalised and provisioned. In our view, it is also without the risk of a dramatic impairment cycle even as the economy turns. The incumbent banks' strong balance sheets and their ability to spend on innovation will mean that they will remain formidable opponents in the fight for a greater share of the consumer's wallet.

For more information, speak to your financial adviser or call our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.