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To:

Hon. Tito Mboweni, Dondo Mogajane, Duncan Pieterse and Nomvuyo Guma

Submission on National Treasury Economic Policy Paper

Focusing on a range of issues, in particular banking and financial services

15 September 2019

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Submission purpose

National Treasury and the Ministry of Finance have requested comments on its paper "*Economic transformation, inclusive growth, and competitiveness: Towards an Economic Strategy for South Africa*" published on 27th August 2019.

Intellidex has been tracking the formation of this paper for some time, the colloquia held by the Minister of Finance and the broader arc of macro and macroeconomic policy development within government. Intellidex advises a range of portfolio and corporate investors on these matters and garners their feedback on an ongoing basis. This work forms the basis for our views expressed here.

Intellidex makes select responses on parts of the paper. We are available for further discussions and interaction on these or other parts of the policy paper.

Intellidex is a leading research and consulting firm founded in 2008 that specialises in capital markets and financial services. Its analysis is used by investors, stockbrokers, regulators, lawyers and companies globally looking to understand capital markets and financial services in Africa. Its strategy research is used by banks, fund managers, stock brokers, wealth managers and other financial service providers to better understand their market places and adapt their businesses. It has a team of analysts in Johannesburg and offices in London and Boston.

Intellidex is completely independent and not affiliated with any financial services company or media house. It prides itself on the integrity and independence of its research.

Recommendations - summary

- Intellidex welcomes the publication of detailed, fact and evidence based rational economic policy into the public debate. Investors are excited by a potential path forwards and a change of mindset that the paper imbues to the state being a facilitator.
- ***Modelling*** – Detailed modelling on sectoral impacts is an important addition to the debate but needs to be carried forwards more explicitly to manage fallout risk. We are sceptical on if reforms upside into growth as additive or if it is more interlinked between reforms acting as limiting factors on each other.
- ***Systems of government and Social Compacting*** – The paper should provide more explicit roadmaps to implementation and lay out clearly how new compacts can be formed with partners in win-win situations. A delivery unit and systems of political capital deployment and accountability are crucial.
- ***The future of banking and financial services*** –
    - Improving competitiveness in consumer banking services is welcome but only marginal in terms of growth impact. We suggest investigating bank account number portability and interoperability of payment systems as further ways to increase competition. But we recommend that bank deposit insurance be implemented as a more effective way to improve the position of new entrants.
    - We recommend that the Mutual Banks Act be used as a basis for creating a second tier of banks with lower capital requirements and low risk business models. The act should be revised and modernised for this purpose.
    - We recommend that SA’s financial industry be allowed to develop as a hub to manage global financial assets and liabilities as low hanging fruit to directly stimulate economic growth and the tax take.
- ***Informal Sector*** – There are welcome references to the informal sector but this could be tied together into one whole with more emphasis on this as the key frontier for higher potential growth and expanded tax base overall. A wealth of academic research in this area could more explicitly be used.
- ***Eskom*** – Welcome interventions in the paper on Eskom and energy need to have institutional structure carefully thought through – for instance the frequency of IRP updates, the way true independence and least cost can be baked into an ISMO and how the relationship between NERSA and ISMO is codified that prevents blockages. Whilst we see coal asset sales in package PPA deals as elegant we are deeply sceptical that there would be buyers at any reasonable price given carbon and stranded asset risk.
- ***IPAP and PPGI*** – There are welcome mindset changes offered on IPAP but more specificity of what these means would be welcome. Similarly, what to do with PPGI after an initial ‘kickstart’ phase for the economy needs to be institutionalised.

Overarching view on the paper

Intellidex welcomes the publication of "*Economic transformation, inclusive growth, and competitiveness: Towards an Economic Strategy for South Africa*" is a much-needed loadstone for the economic policy debate within South Africa.

The paper can be read as either a work of political strategy or a policy document and on both counts serves key purposes.

On the strategic front, as a strategy to reinvigorate business confidence and push the political narrative forward, our experience within the South African advisory and consulting landscape has led us to believe there is a connection to the same debates over economic policy. This paper helps cut through public confusion over policy with evidence-based recommendations, and well referenced and explained policies that are specific and uncompromising. Indeed, while it is true that parts of the paper are not new – and represent either existing policy aims that have languished unimplemented (such as to address market structure issues and competition in banking), or are policies that are supposedly being implemented but moving off on a tangent (such as spectrum) – the value is in bringing everything together as a whole.

The paper has caused quite some excitement among foreign and local corporate and portfolio investors and in doing so shows how clarity of policy thought can support business and investment sentiment within the country. Investors understand the role and shortcomings of an exercise like this but equally welcome the wide nature of the paper in looking for low hanging fruit for the economy.

Policy uncertainty is still a key drag on the economy but equally so is bad policy. The mixture of good growth boosting policy plus policy clarity are the bedrock strengths of the paper.

What is SA selling?

A key problem for investors through the Investment Summit last year and the envoy process has been the question – "what is SA selling?"

The investment summit failed to elucidate a clear answer to this question (famously, the line that South Africa had "trainable labour", was not a great selling point for SA's competitiveness).

This paper now certainly gets at what SA cannot be – it cannot be unsustainable, and the simple recognition of this fact at the very start of the paper allows it to stand out and adds urgency.

The paper then cites the need for competitiveness and labour-intensive growth. However, it never quite gets to a fully mapped out idea of a sales pitch of what a future economy would look like. In this respect we need a vision that sets out how the economy will become a resilient services and manufacturing hub that is resilient in the face of global technological change.

Maybe this is missing the point. Reading the paper, the stark contrast to the mass of budget vote speeches in parliament in June is very much around tone and mindset. The paper does communicate a strong view of state as facilitator, agnostic on state size if it delivers in a fiscally appropriate way. This contrasts with the status quo view of the state needing to be large and leading the private sector which has come out strongly in many pieces of government rhetoric so far since the elections. "Selling" this vision of the state as facilitator is such a change from the status quo that it is refreshing and we note that a large number of investors have picked up on this fact after reading the paper.

Still, future iterations of the paper would benefit from a strong sense of sales pitch in the form of what an end state economy would be like.

Modelling efforts

The modelling efforts in the paper are excellent and set out clearly some important trends that are only half digested through the paper.

For instance (Figure 1) on the shift in composition of the economy, carried through (Table 2) on the sector impact – has profound social and political implications that must be handled through compacts and leadership. The ways these fallouts are treated needs to be addressed as the paper moves forwards into future iterations for it to win over social partners and be cohesive. A section on reskilling and training could be useful in this regard.

Speaking to the eponymous Figure 2 and the numbers elsewhere in the impact study – we are deeply sceptical of if reforms are additive like this or if they are in fact nested and interdependent – i.e. limiting each other.

For instance, removing domestic operating red tape can only be fully felt at some point with the lowering of barriers and cost to trade both of which in turn rest in large part on skills and therefore the availability of visas for skilled immigrants.

Systems of government and social compacting

The paper is designed to highlight the lack of implementation and picking of low hanging fruit, but has little to say about systems of government within this context. The paper should lay out more how government is meant to implement these measures.

The paper does highlight the need for stronger monitoring and evaluation of interventions and policies on an ongoing basis to make policy responsive. NT should highlight the need for open sourcing of all such information.

However, NT should also consider the political economy of such policy issues and the need to rethinking the Presidency function and DPME to streamline the deployment of political capital. It needs plans for downward implementation and accountability back upwards – through, for instance, a Presidential delivery unit overseen by an independent board.

The appointment of independent DGs signed off by parliament could also be another interesting policy to spur implementation.

There is similarly an unanswered question of what exactly improved service delivery really is, and what a more capable state is. These questions need fleshing out – if the private sector is invoked so often as a substitute to state delivery that is more effective then this should be made plain.

Feeding on from this, social compacts are mentioned some six times in the paper. This does feel somewhat like a hangover from the status quo but on a close reading something very different is being advocated – a more streamlined enabling state rather than a state that is dragging everything else along.

In these terms maybe the notion of a compact needs to be explained in its own right as a set of responsibilities to provide for other partners in certain ways – and NT should not be afraid in detailing here more what business and labour also have to come to the table with.

The future of Banking and financial services

Efforts to improve the competitiveness of the banking industry outlined in the proposals are welcome. The industry is one of the most productive in the economy, steadily increasing employment levels and its contribution to economic activity. Our banks, insurers, asset managers, capital markets and associated businesses are a source of national strength.

Nevertheless the banking industry is currently at a high level of concentration. The big four banks control 83% of the industry's assets, compared to 69% of assets in 1999. This inevitably affects the competitiveness of the industry, particularly from a pricing point of view.

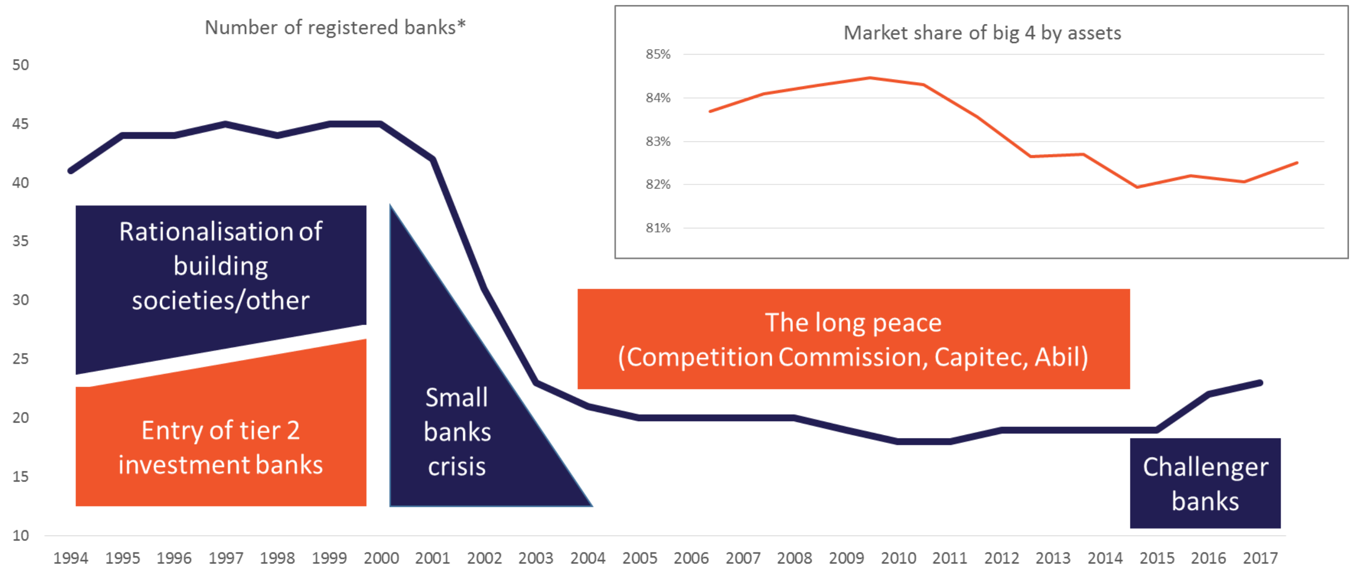
Given this background fact, we welcome the entry of new banks into the market place we have seen in the last two years, including Tyme, Bank Zero, Discovery Bank and a renewed African Bank, a group that we call the challenger banks. In time we also expect the Post Bank and uBank to offer renewed propositions for the consumer market.

While the absolute number of banks can be a good indicator of competitiveness, it depends on their sustainability. The last major phase of bank entry occurred post 1994. It is reasonable to argue that this was not sustainable – by 2002 almost all of those banks, as well as larger ones like Saambou and BoE, had exited the market. That exit process was chaotic, with Saambou and BoE, as well as the smaller banks, facing runs and regulators being forced into resolution processes for several. As an example of an attempt to promote competitiveness, it was clearly at the expense of systemic stability, and therefore unsustainable.

Things do change. It is instructive that the one success story since then, Capitec, has been able to break into the market through innovations in lending. Capitec took the space opened up from a regulatory perspective to build loan books particularly at the smaller end of the market. While Capitec has faced travails along the way, it has withstood significant headwinds and continues to grow, delivering profitability that is far ahead of the rest of the market.

Any move to improve competitiveness now has to consider how we may grow a market of more Capitecs and fewer of those which failed in the era up to 2002 era.

Bank concentration – registered banks over the last two decades



Bank business models depend on a few fundamental factors:

- The cost of funding. Whether this is raised from depositors, lenders through the capital markets, shareholders, or wholesale funders such as development finance institutions, the lower its cost, the better for the bank. Unfortunately, new entrants often face far higher costs than established competitors in raising funding because they do not have the track record or brand to assure funders that they are an appropriate risk.
- The interest earned on assets. Banks deploy funding into loans and other assets that generate a return. The higher this is, all else being equal, the better for the bank. Normal competitive factors mean that returns earned on assets are higher when assets are risky, which refers to the chance they will default and the bank will lose some part of the asset.
- Bad debts. Banks incur a cost for projected defaults when they write loans. This cost expenses future defaults upfront. Various factors affect likely defaults including the state of the economy, but an important driver is a bank's ability to screen clients upfront, which depends on having large amounts of information about the market place. New entrants are often prejudiced in this respect too because they do not have years of data on past client behaviour. Some new entrants are overcoming this obstacle by accessing other data such as consumer behaviour.
- Non-interest revenue sources. Banks earn fees for facilitating transactions, selling insurance and other services and products. These can be quite diverse, with some banks even entering cellphone network provision.
- Operating costs. A bank that is able to build a large book of assets and liabilities and earn revenue off a low cost base is efficient and more profitable.

These general comments about bank business models have several implications for the level of competitiveness in the market. Incumbents tend to have the following advantages:

- Their brands are long standing and well-recognised in the market. Therefore they benefit from client trust and as a result incur lower costs in attracting retail deposits as a form of funding.
- Large banks have larger balance sheets which usually makes them lower risk (able to absorb economic shocks more easily), therefore able to raise funding from wholesale sources at lower cost.
- Large banks benefit from economies of scale in that fixed costs including compliance and back-end systems can be averaged out over a large client pool.
- Large banks are able to deploy capital in excess of the minimum levels required to obtain a banking license (R250m) and therefore do not suffer unnecessary capital expenses.

In examining the proposals in the paper that are intended to increase the competitiveness of banks, we consider them through the prism of these points about business models.

Switching costs regulations

We agree that lowering switching costs will have a positive impact on competitiveness in the market, but it will be marginal. Lower switching costs do overcome one but not all of the issues that face consumers in deciding to move their banking business elsewhere. As discussed above, a bigger factor is the brand loyalty that consumers show toward banks that they believe will be a safe custodian for their money.

For this reason, we believe that the proposed deposit insurance scheme, which was due to be introduced via the Financial Sector Laws Amendment Bill in 2019, will have a greater competitive impact. Insuring the first R100,000 of retail deposits removes the reluctance consumers will have in depositing money in a new bank they may not be familiar with. This is particularly the case for banks that operate outside the typical branch banking model, for example by using fintech. Consumer trust in banking is also affected by whether a bank has physical infrastructure and direct one-on-one engagements with bank employees. A deposit insurance scheme helps to reduce the incumbents'' advantages in this respect too. We therefore encourage National Treasury to implement the deposit insurance scheme as soon as possible in order to give new entrants to the banking sector an important level of trust with consumers.

Switching will help too, although we note the emphasis in discussing switching is on the costs charged by banks in the process of switching. The real costs, however, lie outside of banks, in the hands of the consumer who has to move debit orders and change account instructions with employers and other correspondents. Efforts by banks to make this costless by offering a debit order portability service have only limited effect because the debit order counterparty has to cooperate in the process.

The obvious solution is bank account number portability. Under such a system a consumer has one bank account number that they can move from bank to bank. In the same way that cellphone number portability was important in opening the cellphone industry to competition, so can account number portability. Portability allows consumers to change banks without having to incur the significant cost of giving new bank details to all of their sources of income and expenses.

Bank account number portability is currently being investigated for the European Union and for India. We recommend that South Africa undertake an investigation too. Portability is very positive for new entrants that lead with efficient technology to enable customers to open banks accounts simply. The largest barrier remains the switching costs.

Enabling new banks to attract consumers is only a small part of the solution, however. Consumers are a source of funding and also of transaction fees. In our view, however, the immediate impact of the raft of new entrants has been to reduce transaction fees. We do not believe that basic transaction fees will be a sustainable source of revenue in consumer banking. Account number portability will make this even more the case.

In addition to lowering switching costs, we would also like to propose that NT pursue interoperability as a strategic driver for the financial services industry. We already have interoperability between banks' accounts in that consumers can send money to each other from bank to bank. This is a very limited view on interoperability that needs to be challenged. There are two additional ways to consider interoperability.

First is enabling greater financial inclusion by linking bank accounts to the different savings pockets, e-wallets and other forms of neo-accounts that are prevalent in money-transfers. Money transfers tend to be originated by banked, employed individuals who send money to unbanked relatives or friends. By enabling interoperability, any originating bank account should then be able to send money to any recipient money transfer service to complete the payment. That is only the first step. Next, the recipient of a money transfer should be able to activate that neo-account where their money is held into a fully-fledged bank account, once all KYC and AML requirements are met. Such an intervention will enable greater competition between services, enable greater reach of services for consumers and give startups the ability to leverage vast existing networks of money transfers as the foundation for their innovations.

The second aspect to interoperability is the ability to send money from any bank account to any cellphone number in the country. Banks already offer this service in-house, between their own customers to each other. The next step would be to enable this level of interoperability between banks, and then, in line with the first strategy, between banks and other money transfer providers.

The paper also calls for an investigation of alternative bank license types that would allow banks in specific areas of the market to have a lower capital requirement. This would lower one major hurdle faced by new entrants. We note, however, that a two tier market does already exist in theory – apart from standard bank licenses, mutual banks and cooperative banks are alternatives. It is instructive that Bank Zero is using the mutual bank license, which requires only R10m in capital compared to R250m for fully licensed banks. Finbond Bank also used the mutual license when it registered in . However, the mutual license is not purpose built and really exists as a way to accommodate building societies of two decades ago (the act was promulgated in 1993). The legislation is dated and the mutual bank structure is awkward in several respects. We therefore recommend that this second tier be created by amending the Mutual Banks Act to cater for a modern second tier banking sector that can operate in certain low-risk areas of the market, particularly in facing consumers. The cooperative banks legislation allows for a narrow additional type that is viable in limited circumstances at community level and we don't believe is capable of offering real competition to the existing market.

Another option we believe should be more strongly pursued is enabling the financial sector to become a more active regional player. This is not directly about competition, but can substantially increase the economic activity and tax generation from the financial sector. We believe it can be achieved by creating certain carve-outs from exchange control and some taxes for financial services businesses that manage assets and liabilities in the rest of the world from South Africa. We believe this is a policy strategy that offers low hanging fruit, requiring only the creation of the regulatory space and minimum actual financial investment.

Informal sector

The informal sector only got five scattered mentions within the paper.

The boundary between the informal and formal sector is ultimately where development and positive macro GDP per capita growth is sustainably coming to come from – as informal SMMEs formalise, expand the tax base and employment.

The mentions on reducing regulatory burden and improving land tenure are welcome, however the whole informal sector issue felt like it could be drawn together more solidly into its own section.

Additional recommendations could include formalising SMME opt-outs on a range of regulatory and bureaucratic requirements – including a wider and simpler optout from minimum wage regulations. Or, a requirement for informal sector impact assessments to be incorporated into existing government impact assessments more strongly. The role of economic hubs and supply chains is also important.

NT should look to the work of Andrew Charman and Leif Petersen at the Sustainable Livelihoods Foundation for a more specific toolkit of options.

Eskom and related matters

NT should consider more the need for the ideas contained in the paper to become institutionalised.

For instance, there should be a call for IRP to run every 24 months by a panel of three consultants. In this regard the paper seems to overestimate, we believe, the complexity of the process of updating IRP.

Similarly, much more attention is needed to be given on the ISMO and its legal framework – embedding least cost, the modalities of it signing PPAs with Eskom (say on an individual generation asset rather than company basis) but also how the independence from Eskom and from political interference can be safeguarded. In some ways this is more important and more impactful than IRP. The power contained within an ISMO should be safeguarded in the same way a Chapter 9 institution is, with some line direct to parliament.

The paper does reference the Eskom demand tipping point issue though this is we think more dramatic on the current price path and so the implications of a tipping point occurring should be more clearly laid out.

Reform of NERSA should be more prominent – in particular its role in blocking SSEG. Similarly, a view on how tariffs work vs a ISMO will be very different in the future and this has not entered the public debate enough. The ISMO and NERSA will have to become more symbiotic.

We disagree with the notion in the paper that Eskom coal generation assets can be sold with life-time PPAs. Ignoring the issues with labour and ideology, we think that the proposal simply wouldn't find any buyers at any reasonable price. The key risk is environmental liabilities which are currently unaccounted for by Eskom but would have to be accounted for (and dealt with) by private companies buying Eskom coal generation assets. Similarly, decommissioning costs are currently unaccounted for but would have to be crystallised into a PPA. We do not believe that a private company would accept the legal risk of orphaning environmental liabilities still with the state, and not including decommissioning costs would be legally challenging and unacceptable to the fiscus. Put simply we believe the work that BCG did last year for Eskom still stands – that the price that would be demanded to hold these assets (including likely BEE requirements), factoring in all proper costs, insurance and risk as well as a profit margin would simply be totally uneconomically for an ISMO. Finally, there would be severe stranded asset risk for anyone that bought these coal assets.

Accelerated decommissioning of these assets (the 'Green funding plan') is a far more useful angle on these assets than attempted sale.

IPAP and PPGI

The paper mentions IPAP only seven times and generally in the sense of rethinking it, yet beyond requesting a smaller number of better targeted interventions it doesn't really lay out a fully-fledged view of what a future IPAP should look like. It is true this is another department's domain, yet DTI is currently rethinking the DTI process and NT's public intervention on the subject would be welcome.

The paper doesn't mention the PPGI process at all. Whilst this is in some sense a short run process to kickstart the economy it does have political favour and does have the ear of senior political leadership. A future iteration of this paper should comment on and show how the PPGI process can be aligned to NT's aims. In addition, some thinking is needed on how PPGI and its sectoral working groups can be formalised (without repeating the errors of NEDLAC) into governance processes – once the economy has been kickstarted.