

## **CHAPTER 3**

### **The retail banking environment in a South African context**

#### **3.1 Introduction**

This chapter provides a description of the retail banking environment in South Africa. The aim is to focus on aspects relevant to the research and not to provide an exhaustive description of retail banking in South Africa. The chapter discusses the legal position of retail banks in South Africa, the current environment in which retail banks have to operate, as well as the role of the South African Reserve Bank. It further provides an overview of the regulatory structure of the financial services industry and discusses the various role players in the industry relevant to the research. Finally, some exogenous factors impacting on retail banking services are discussed. Figure 3.1 shows the relevance of Chapter 3 with regard to the other chapters in this report.

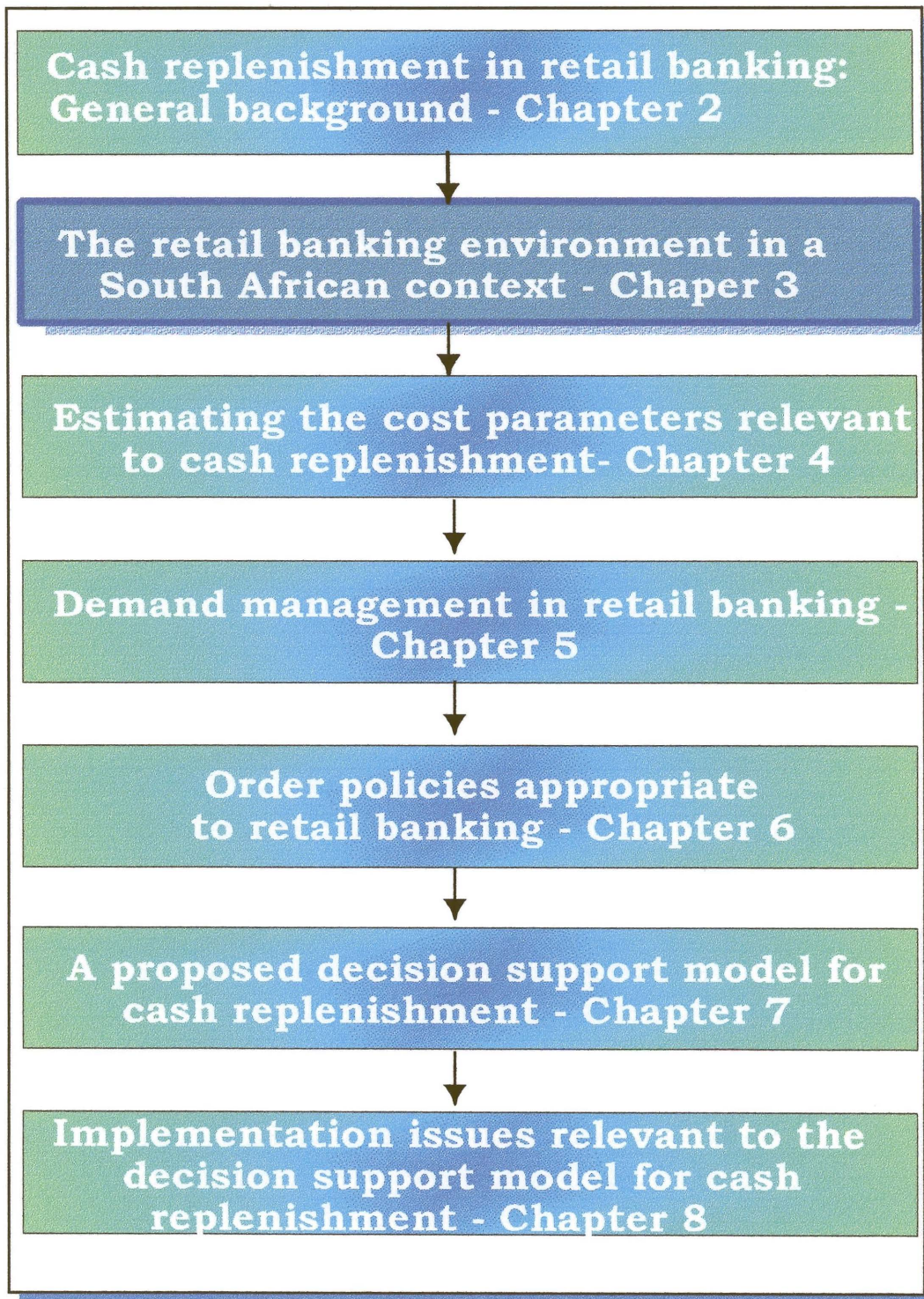
#### **3.2 Retail banking**

Retail or commercial banking is defined in Chapter 1. As pointed out earlier, commercial or retail banks are profit-seeking institutions, deriving profit from two major sources. In the process of realising profit, retail banks perform the following major functions (Falkena *et al.* 1995:69-70):

- Accept deposits, notably cheque deposits;
- provide credit, mainly in the form of overdrawn accounts;
- make payments and perform collections by means of a clearing system;
- render financial services;
- act as authorised currency dealers; and
- assist in the execution of monetary policy.

**Figure 3.1**

**The structure of the report indicating the relevance of Chapter 3**



With reference to the specific problem under review, the first main function mentioned above, i.e. accepting deposits, is of the greatest significance. As Falkena *et al.* (1995:69) state:

*Commercial banks accept from the public (persons, business concerns, and other institutions) demand repayable deposits on current account that can be drawn by way of cheques or other electronic funds transfer means.*

The Banking Council – South Africa (1997:5-6) prefers the following description:

*The commercial banks, now more commonly referred to as clearing banks, are involved in one way or another in almost every monetary transaction that takes place in the country, from cheque-processing and the provision of cash to electronic transmission of funds and the handling of credit and debit card transactions. A substantial distribution network of branches, agencies and ATM's handle these transactions.*

These banks therefore provide retail banking services.

### **3.2.1 Legal position of banks in South Africa**

Falkena *et al.* (1995:75-76) state that all deposit-taking businesses are regulated by the Banks Act (Act 94 of 1990). This Act stipulates certain prudential requirements in respect of capital, cash reserves, liquid assets and large exposures. The cash reserve requirements may be used as an instrument of monetary policy (an increase in reserves would naturally be restrictive), while other requirements may be structural in nature. According to the Banks Amendment Act of 1994, capital requirements are the higher of R50 million or a specified percentage of the bank's risk-weighted assets and off-balance sheet activities.

Relevant at this point is to note that similar requirements which were in force in Canada have been lifted. Prior to this, Canadian banks had absolutely no incentive to reduce their cash holdings, but as a result of the lifting of the requirement, cash has become an important issue. Gammage of Toronto Dominion Bank is quoted as saying: "*All of a sudden, our inventory of cash becomes a non-earning asset*". (Johnson 1994:31-33).

In addition to the capital requirements enforced upon South African banks, certain requirements pertaining to liquid assets and cash reserves (a subset of liquid assets) have to be adhered to. A bank must hold an average daily amount of liquid assets of not less than 5% of the average daily amount of its total liabilities to the public. Liquid assets would *inter alia* include any credit balance in a clearing account with the South African Reserve Bank and bank notes and coins in a bank's vaults and automated teller machines. (Falkena *et al.* 1995: 79).

It is interesting to note that methods have been developed to maintain a zero surplus on capital requirements in a federal reserve account. The application of a time series forecasting model to this situation is described by Balzano (1978: 99-105). A South African banking official, in an interview, remarked that South African retail banks do not pay much attention to this aspect and as a rule carry a huge surplus on the capital requirements as determined by the South African Reserve Bank. This is confirmed by Johnson (1994:31-33) as the attitude found in Canadian banks prior to the lifting of the capital reserve requirements regulation.

A further four acts have a bearing on banking institutions. These include the Companies Act, No. 61 of 1973, the Currency and Exchanges Act, 1933, the Usury Act, 1968 and the Credit Agreements Act, 1980 (Falkena *et al.* 1995:79-80).

### **3.2.2 Current environment of retail banking**

At the end of 1996, more than 50 banks were operating in South Africa, providing banking services in more or less the same financial market. On May, 13, 1997, according to a list supplied by the South African Reserve Bank, 53 banks were finally and provisionally registered in South Africa (KPMG 1997:50-51).

Banking in South Africa is conducted by (Banking Council 1997:5):

- Four “major” banking groups with national distribution networks, each with assets in excess of R90 billion;
- five “medium-sized” banks with distribution networks, and/or assets in excess of R5 billion;
- twenty-four “small” South African banks with assets of less than R3 billion;
- ten subsidiaries of foreign banks;
- nine branches of foreign banks;
- four mutual banks; and
- fifty-nine registered representative offices of foreign banks.

According to the annual report of the Banking Council dated 31 December 1997, a total of 3 446 branches and agencies and 7 200 ATM’s serve the South African retail banking industry. These far-flung distribution networks and large staff complements, especially of the country’s major banking groups are expensive to maintain. Together with the fact that banks are not recovering the real cost of handling and moving cash, has resulted in high cost ratios. (Banking Council 1997:5)

Not only is the competition among banks extremely keen, but also between banks and other financial institutions. For example, some competition arises between banks’ deposits and life assurers’ saving schemes. It is frequently alleged that the South African financial sector is over banked (Fourie *et al.*

1999:75-76). The comment is often made that the market is unlikely to continue to support this number of banks and some consolidation in the financial services sector has recently occurred with retail banks merging with life insurers in an attempt to gain full advantage of utilising a common customer base. The consolidation in the financial services sector is far from over – refer to articles such as “*Southern en Momentum se belange smelt saam*” and “*Liberty oorweeg opsies met Standard-belang*” (Sake-Beeld 1998a:16).

It was recently stated that the increasingly competitive and complex nature of the retail financial services industry has compounded the focus on key profit drivers such as return on capital, gaining market share, maintaining/increasing margins and so forth. In this list, reducing the cost base is quoted as the fourth most important issue and one of the most critical due to the current pressure on margins (KPMG 1997:24).

A challenge facing banking institutions in South Africa is to expand their services to the third world component of the South African population. It is claimed that 60% of all South Africans do not make use of any banking services (Anonymous 1996a:1). With the growth in the informal sector of the economy in South Africa, the number of prospective customers in this segment is therefore significant, but numerous obstacles have to be overcome in the attempt to reach this market. These problems include the following (Falkena *et al.* 1995:83):

- Potential customers are not sufficiently interested in the services provided;
- typical deposits made and loans required are smaller than those of the existing customer base; and
- technologies which have proven successful in other environments may not be particularly suitable to this market segment.

Bankers in fact differ on the nature of the specific needs of low-income consumers of banking services. Basic banking, which is assumed to be what low-income consumers require, is defined as addressing three needs, *i.e.* a way

to obtain cash, a way to make payments to third parties and a safe and accessible place to keep money (Scott 1988:32). Traditionally bankers have seen consumers in this category as high risk customers and have charged accordingly for services rendered. In addition to inaccessibility, the high cost of financial services rendered by banking institutions has deterred consumers from making use of these services.

Despite the problems in servicing this market segment, the major South African banks have made massive investments in technological infrastructure to extend banking services to low-income earners nation-wide. The international banking community indeed regards South African banks as world leaders in providing appropriate banking services for low-income communities (Banking Council 1997:6).

It is however the presence of this component of the market in South Africa which leads to an on-going need for cash handling in banks, rather than a move toward a cashless society.

### **3.3 The role of the South African Reserve Bank**

The South African Reserve Bank in its role as the central bank of the Republic of South Africa has the following main functions (Falkena *et al.* 1995:55):

- The issuing of bank notes and coin;
- acting as banker to the government;
- acting as banker to other banks;
- providing facilities for the clearing and settlement of claims between banks;
- acting as custodian of the country's gold and foreign reserves;
- acting as "bank of rediscount" and "lender in the last resort";
- engaging in public debt management and open-market operations;

- supervising banks;
- collecting, processing and interpreting economic statistics and other information; and
- formulating and implementing monetary and exchange rate policies in co-operation with the Ministry of Finance.

Only some of these functions have particular reference to the research in question. These functions are discussed briefly in the following paragraphs.

### **3.3.1 Issuing of bank notes and coin**

The Reserve Bank has the sole right to issue bank notes and coin in South Africa as stipulated by the Reserve Bank Act of 1944. All bank notes issued by the Bank are printed by the South African Bank Note Company (Pty) Ltd, a wholly owned subsidiary of the Bank. At present notes are issued in denominations of R10, R20, R50, R100 and R200. In 1989 the sole right to make, issue and destroy coins was transferred to the Bank by Act No. 49 of 1989. Another wholly owned subsidiary, the South African Mint Company (Pty) Ltd was established to manage these functions. The denominations, masses of the coins and the standard fineness of the relevant metals are set out in the Secondary Schedule to the South African Reserve Bank Act, 1989. It allows for the production of ordinary circulation coins in denominations of 1c, 2c, 5c, 10c, 20c, 50c, R1, R2 and R5. (Falkena *et al.* 1995:55-56). At the end of March 1997, the notes in circulation amounted to R19 249 million and the total amount of coins in circulation outside the banking sector amounted to R1 508 million. (Fourie *et al.* 1999:54)





### **3.3.2 Custodian of banks' cash reserves**

The South African Reserve Bank acts as custodian of the cash balances of other banking institutions by virtue of the legal cash reserve requirements that have been in force at different times and in different forms, as determined by the South African Reserve Bank Act. Under normal circumstances, the banking institutions will endeavour not to hold reserve balances in excess of the minimum requirements with the Reserve Bank, although this is possible. The Reserve Bank is allowed to pay interest on deposit liabilities, but does not necessarily do so (Falkena *et al.* 1995:57). The existence of required reserves on which no interest return is received by the financial firm, reduces revenue (Hancock 1991:21).

Nearly all depository institutions must keep some minimum portion of assets in cash or otherwise liquid form. These reserve requirements affect the marginal prices of various financial services. (Hancock 1991:20-21).

### **3.3.3 Supervision of banks' activities**

The main aim of bank supervision by the Reserve Bank is to create a legal and regulatory environment that will optimise the quality and effectiveness of risk management in banking institutions. The actions of the supervisory authorities are thus aimed at enhancing the proper management of risks, *i.e.* credit risk, liquidity risk, interest rate risk, market risk and currency risk, thereby ensuring a safer environment for depositors. The extent of supervision entails *inter alia* the establishment of certain capital and liquidity requirements and the continuous monitoring of the institutions' adherence to these legal requirements and other guidelines. In addition, the performance of an individual bank is measured on a continuous basis against developments in the relevant sector as a whole. (Falkena *et al.* 1995:61).

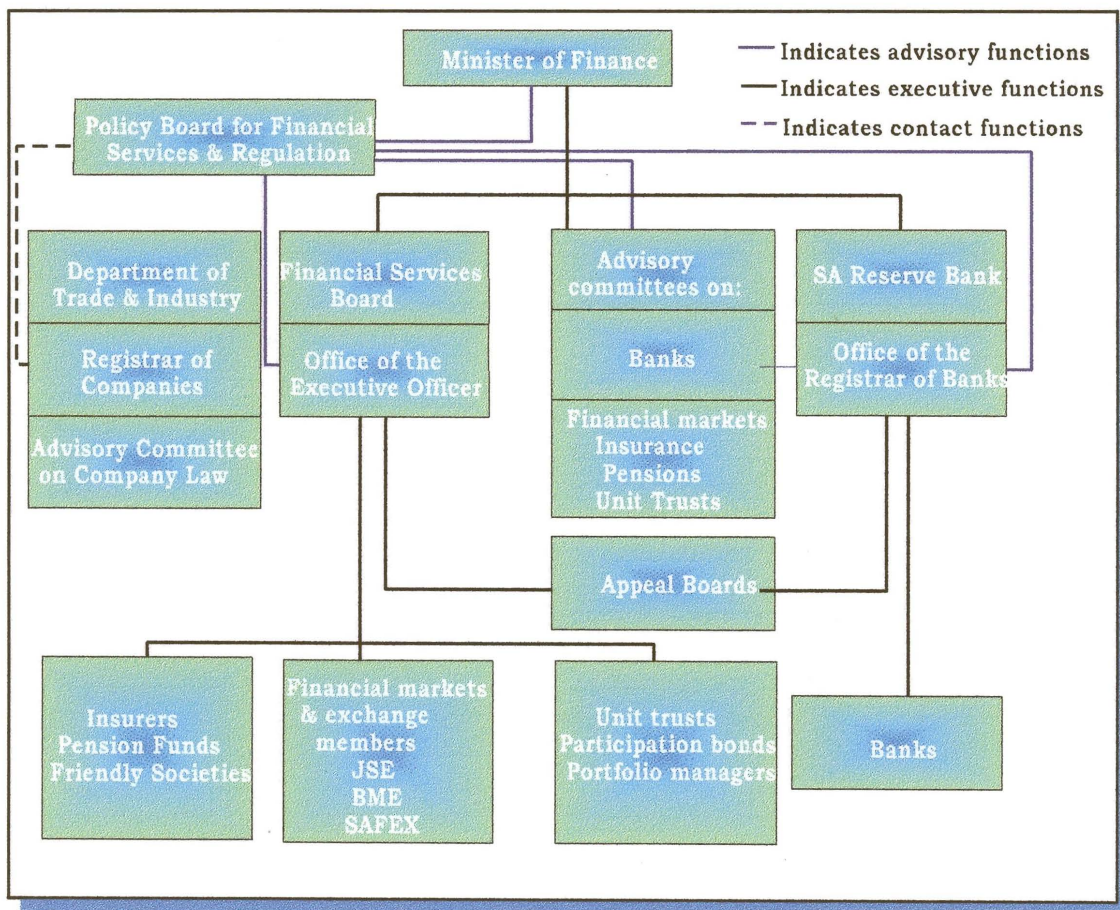


Wiese (as quoted in KPMG 1997:3) states that the Office of the Registrar of Banks, as part of the South African Reserve Bank, under the provisions of the Banks Act, 1990 and the Mutual Banks Act, 1993, is responsible not only for supervising the business of banks and mutual banks, but for the prevention of activities whereby deposits are solicited or accepted from the general public in contravention of these acts.

Figure 3.2 indicates the regulatory structure pertaining to the financial services industry (KPMG 1997:7).

Figure 3.2

Financial services regulatory structure



Source: KPMG. 1997. *Banking Survey Africa 1997*. South Africa: Financial Services Group of KPMG South Africa.

### 3.4 The South African cash cycle

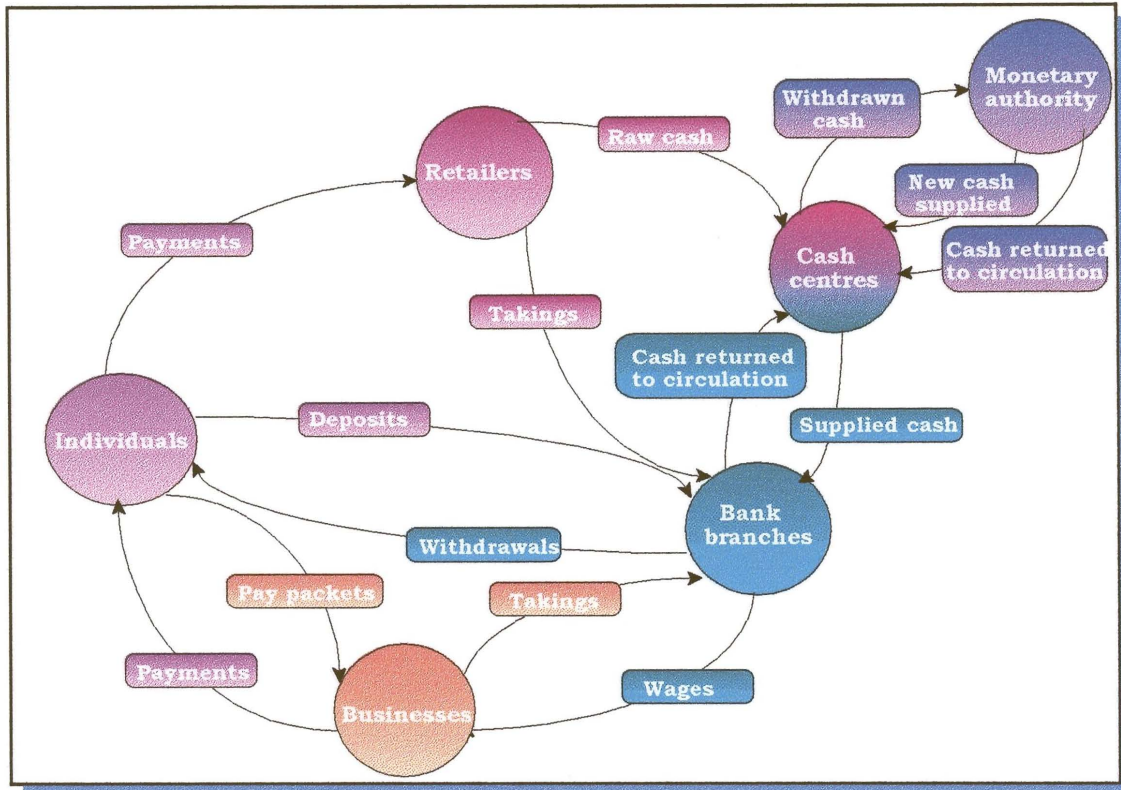
Figure 3.3 shows a typical currency cash cycle prevalent in every national economy (De La Rue s.a.:3). For purposes of this research, emphasis will be placed on the flows between the cash centres and bank branches (embodied by branches, agencies and ATM's) as well as certain factors influencing the flows downstream from the bank branches, *i.e.* deposits, withdrawals, takings and wages, which determine the cash demand patterns at a particular branch.

An interesting statistic provides insight into the scope of the South African cash cycle. According to the Banking Council there were 300 million cheque transactions to the value of R5 000 billion and 160 million ATM transactions to the value of R24 billion in South Africa during 1997 (Banking Council 1997:5).

In South Africa the function of providing cash to bank branches has been outsourced to SBV. This company was established in 1986 by three retail banks, Standard Bank of South Africa, Barclays (now First National Bank) and Volkskas (now part of ABSA), hence the name SBV. The company is owned by the banks and at present moves 95% of the bulk money in circulation in South Africa. It operates country-wide, performing three functions, *i.e.* transport, security and treasury. In addition to moving cash, it is also responsible for transporting gold coins, travellers cheques and foreign currency. It does not serve individuals customers, only banks. The value of notes handled on a daily basis by SBV is in excess of R1,5 billion. About 60 tons of coin are moved daily. This is achieved by daily having on average 300 vehicles transporting cash, travelling approximately 70 000 kilometres per day. Functions performed by SBV include sorting notes into three categories, *i.e.* ATM quality notes, fit notes and unfit or soiled notes. The latter are returned to the SARB to be destroyed. During the sorting procedure counterfeit notes are identified (approximately 30 notes per day) as well as notes that have been sorted incorrectly for example a R20 note amongst R200 notes. Of these sorting errors, 90% represent fraudulent transactions (Gregor 1998). It has been rumoured that a management buy-out is in the offing in the near future or that the SARB may take-over SBV.

**Figure 3.3**

**The currency cash cycle**



Source: De La Rue. s.a. *Cash handling strategy*. United Kingdom: De La Rue Systems.

### 3.5 Exogenous factors influencing the environment

It is of equal importance to take note of various exogenous factors that are at present influencing the retail banking environment in South Africa.

#### 3.5.1 The crime situation

The most important exogenous factor impacting on the retail banking environment is the occurrence of bank related crime. According to the Crime Information Management Centre (CIMC) of the South African Police Service, 497

bank robberies were reported during 1997, while 230 robberies of cash in transit (not only bank related) occurred during the same period. The figures represent a decrease of 31% when compared to the 1996 figures (22,6% fewer bank robberies and 43,9% fewer robberies of cash in transit). If compared to the figures quoted by the Banking Council – South Africa (formerly known as the Council of South African Banks or COSAB), there is a discrepancy. According to the Banking Council 465 bank robberies occurred during 1997 against 408 in 1996 – an increase of 12,3% (Banking Council 1997:20). Of the 465 robberies reported in 1997, 103 were bank related robberies of cash in transit (SAPS 1998:10-12). According to the Banking Council figures, the bank-related robberies which occurred during 1997 involved R140 million, attacks on ATM's cost R2 million and burglaries cost R2 million (Banking Council 1997:20).

Various explanations are put forward for the discrepancy in the figures quoted by the CIMC and the Banking Council. These explanations are indeed irrelevant to the present study. However, the conclusion reached in the CIMC report is very relevant:

*It logically follows from the latter facts that the conventional banks suffered an increase in the frequency of bank robberies, while robberies at other financial institutions decreased. At the same time, the amounts stolen from conventional banks and the degree of violence employed by the criminals involved also increased.*

This has also lead to the intense media interest in crimes targeting financial institutions. (SAPS 1998:10-12).

The banking sector has made on-going efforts in 1997 to counteract the increase in bank and cash-in-transit robberies at great cost. Extensive capital expenditure was undertaken on items such as video cameras, metal detectors, double doors and so forth (estimated at R100 million), guard services employed (estimated at R80 million) and protection of cash-in-transit (estimated at R200 million). (Banking Council 1997:20)

From the above, it is obvious that optimisation of the amount of cash to be held at any branch, agency or ATM, as well as the optimisation of deliveries (especially minimisation of interim deliveries), will be to the advantage of any retail bank. Not only will this reduce the amount of cash held unnecessarily at a cash point, it will also reduce the risk of cash in transit robberies – not only of occurring, but also minimising the loss should they take place.

### **3.5.2 The emergence of the cashless society**

It is often claimed that in the not too distant future the need for cash to facilitate monetary transactions will disappear altogether. From the point of view of central banking, the impact of so-called e-cash will for example, be significant on monetary policy, whereas the impact on retail banking will be a marked effect on cash handling operations (Birch 1998a:1-2). In anticipation of this phenomenon conferences, such as *Preparing for a cashless society in the 21st century: Strategies for implementing an electronic payment system*, were arranged in 1996 by ICM Conferences, Inc. of Chicago.

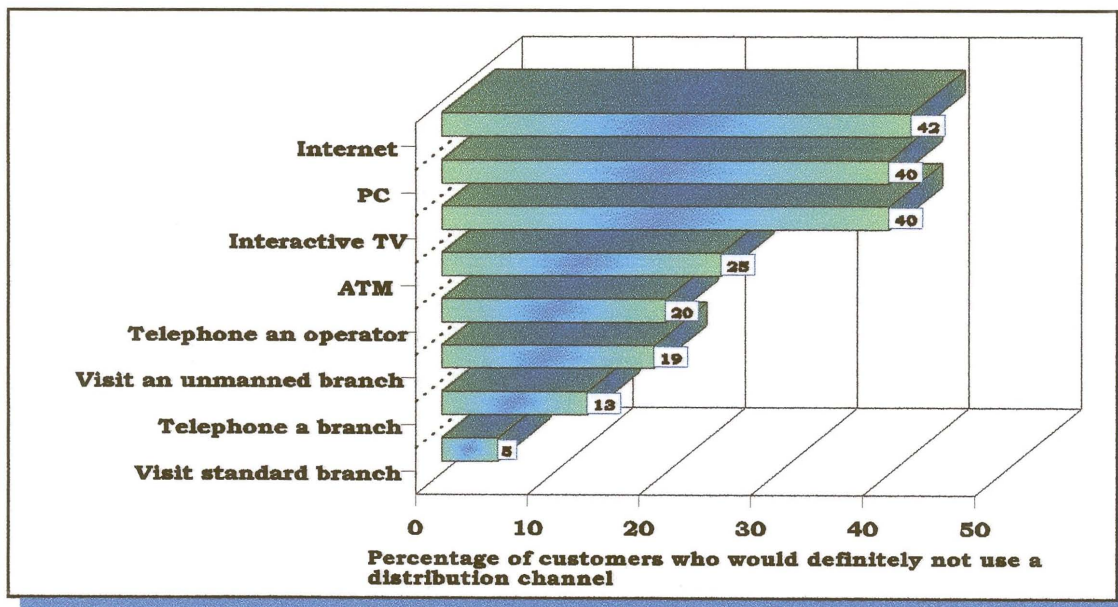
However, despite the expectations with regard to e-cash and the preparations being made to facilitate the use of e-cash (for example development of appropriate technology to prevent fraud), a claim made by senior members of the banking world at the conference on *Cash handling into the 21st century* held in Singapore during September 1997 was the following: *Cash is here to stay – the cashless society will not happen*. This claim was based on new industry studies which show that electronic forms of payment were substitutions for cheque rather than cash transactions. Recent research in the UK has shown that cash still accounts for 85% of all personal payments and 66% of all payments over £1 stressing the central position of cash even in a first-world economy (De La Rue s.a.:7).

It is claimed that the developing countries (for example in Eastern Europe) are just moving out of totally cash-based societies (De La Rue s.a.:7). Despite the

debate on a developing economy such as that of South Africa will ever become a cashless society – refer to articles such as “Cashless world a long way off” which appeared in the Financial Mail of 5 December 1997 (Bidoli 1997) – it is a known fact that the South African retail banking industry, specifically the so-called big four South African banks (ABSA, Standard, First National and Nedcor), is investing huge amounts in pioneering new methods of electronic banking (Anonymous 1998:72).

In a study quoted by KPMG(1998:26) customers were asked to indicate which channels they would definitely not use for obtaining various banking products. The results of this study seem to support the claim that the cashless society will not happen. The results of the study are shown in Figure 3.4. It is further claimed that customers maintain a strong preference for personal service, particularly for cash and that cash is either fully or partly responsible for about 75% of branch visits (De La Rue s.a.:9).

**Figure 3.4**  
**Percentage of customers who would definitely not use**  
**a distribution channel**



Source: KPMG. 1997. *Banking Survey Africa 1997*. South Africa: Financial Services Group of KPMG South Africa.



### **3.5.3 Unconventional competitors in retail banking**

The retail financial services industry is fiercely competitive. However, competition in this industry does not only emanate from traditional rivals, but recently other sources of competition have come to the fore. In the United States of America, NCR and 7-Eleven stores are the leaders in new era retail banking with the installation of full-service automated financial service centres in 7-Eleven stores in Austin, Texas. These centres provide cheque cashing, bill payment, money transfers, money orders and so forth (NCR 1998:1-2).

In South Africa, a national retailer has recently begun providing deposit-taking services *“in partnership”* with one of the local banks, and is in fact presenting itself to the public as a bank. Informal lenders and deposit-takers are also playing an increasingly important role in the provision of banking type services in South Africa, particularly at the lower end of the market (Banking Council 1997:27). In January 1996 the general manager of First National Bank stated (Anonymous 1996b): *“The new approach to retail banking is the result of increasing competition from traditional sources (including overseas banks) and non-traditional sources, including retailers.”*

### **3.6 Conclusion**

This chapter provided a description of the retail banking environment in South Africa. It discussed the legal position of retail banks in South Africa, the current environment in which retail banks have to operate, as well as the role of the South African Reserve Bank. It further provided an overview of the regulatory structure of the financial services industry and discussed the various role players in the industry relevant to the research. Finally, some exogenous factors impacting on retail banking services were discussed.

Chapters 4 and 5 investigate the behaviour of cost parameters and the demand patterns of a particular branch of a South African bank. The aim is to determine





whether the model put forward in Chapter 2 applies to the South African situation. Although a particular case is investigated, the results will be generalised to reflect the general case in the South African retail banking industry, while distinguishing between branch-specific and generic factors which apply to the situation.