

**29 May 2018**

**BRIEFING ON THE CAPITEC MATTER[[1]](#footnote-1)**

1. **Introduction**
	1. This brief aims to give a sequence of main events since the release of the Viceroy report entitled “*Capitec: A wolf in a sheep’s clothing*” (or the Viceroy Report) into Capitec Bank Holding Limited (Capitec). The aim is to assist the Standing Committee on Finance (SCOF) in engaging with presentations on the follow-up meeting of 30 May 2018, as requested in the 20 March initial briefing on Capitec/Viceroy matter. This brief highlights the main accusations/ allegations/ concerns made by Viceroy and Benguela Global Fund Managers, a South African company which raised similar concerns as Viceroy in a letter to Capitec dated 19 January 2018, and the responses by Capitec on 30 January and the South African Reserve Bank statement on the matter, as the Registrar and regulator of banks in terms of the Banks Act.[[2]](#footnote-2)
	2. The main source document used here is the Viceroy Report released on 29 January 2018, the responses to it by Capitec and subsequent exchanges through February and May.
2. **Background**
	1. On 29 January 2018, the Viceroy Report was released on the internet containing a series of allegations of malpractices by Capitec Bank. Following the release of this report, Capitec’s share price fell by about 25 percent on the Johannesburg Stock Exchange (JSE)[[3]](#footnote-3). The context of this is that Viceroy had released a report on Steinhoff in December 2017, leading to a loss of value in Steinhoff’s stock by almost 80 per cent. The PSG Group, the largest shareholder of Capitec, Capitec and the South African Reserve Bank (SARB) released statements to reassure the market that Capitec’s finances were in order and the accusations by Viceroy were inaccurate and misplaced. This was important as Capitec is a systemically important bank, as the fifth largest in South Africa in terms of assets and market share (of about 10 million customers). A continued slide of its shares could lead to a bank run and collapse reminiscent of the collapse of Saambou in 2002 and others such as African Bank. The Huffington Post Online reported that Capitec’s loss of share value from 29 January had been the biggest since Capitec was formed 15 years ago[[4]](#footnote-4). Since 2008, Capitec’s stock had risen 30-fold.[[5]](#footnote-5) The Capitec shares were trading at above R1000 a share and fell below R800 a share as a result of the release of the Viceroy Report. They are now steadily recovering and trading at about R870.00 a share.
	2. Consistent with the mandate of the Standing Committee of Finance of overseeing the work of the National Treasury and institutions reporting to the Minister of Finance, such as the erstwhile Financial Services Board, the NCR, and the SARB, it made arrangements to be briefed on Capitec and, later, the VBS Mutual Bank, as it had done jointly with the Portfolio Committee on Public Service and Administration and Standing Committee on Public Accounts on Steinhoff.
	3. A briefing for SCOF was subsequently held on 20 March 2018. The Committee was briefed by the National Treasury (Mr. Ismail Momoniat: DDG Tax and Financial Sector Policy), the SARB (Kuben Naidoo: Deputy Governor and Registrar of Banks), the NCR (Ms Nomsa Motshegare: CEO), the FSB (Mr Jurgen Boyd: Deputy Executive Officer), which all are institutions that the Committee oversees. A presentation was also received from Capitec Bank’s CEO, Mr Gerrie Fourie.

1. **Summary of the Briefing**
	1. The Chairperson opened the meeting by emphasising that the purpose of the briefing was not for SCOF to supplant the role of regulators who oversee the various activities of private institutions which, by law, do not account to the Committee. It would however be remiss of Parliament, he said, to turn a blind eye to the developments in these financial institutions. Capitec had volunteered to make a presentation and the Committee welcomed that as the public had a right to feel that their monies were safe. He also mentioned that Viceroy had been invited to attend the Committee briefing but indicated that it was unable to attend.
	2. **Presentation by Capitec Bank**
		1. The CEO of Capitec said that a full audit had been conducted regarding the Viceroy allegations and the results would be released with the publication of the bank’s annual results on the first week of March. He said that Capitec had nothing to hide but allegations by Viceroy had to be handled carefully to maintain the trust of depositors. He added that Capitec had laid a formal complaint with the erstwhile FSB against Viceroy and urged the FSB to do a full investigation on Viceroy. He explained to members that Viceroy as a company was allegedly made up of two Australian citizens (Aidan Lau and Gabriel Bernade) and a British citizen (Fraser Perring) and was linked to three hedge funds. The company was involved in a business of shorting (short-selling) stocks in order to make profits, he said. He added that Viceroy’s modus operandi was to short shares and then release a report that would cause panic in the market so that the share price drops and it makes a profit. He insisted that none of the allegations made in the Viceroy Report were valid or accurate. He said that Capitec had approached Viceroy several times for a meeting in the USA, where the company is based, to no avail. To compile the Report, Viceroy had also approached several of their staff to participate in financial research, paying them R5000.00 an hour to write about Capitec.
		2. Mr Fourie said that Capitec would reach 10 million clients by mid-April and had a share of about 25 per cent of the unsecured credit market in the country. Capitec provided credit to clients responsibly and used a model based on client behaviour, affordability and revenue source. He assured members that Capitec was regulated, although the unsecured credit market was at its nascent stages in South Africa.
		3. After members asked questions, Mr Fourie added that Capitec had provided a point by point response to the Viceroy Report on the SENS platform of the JSE. Those responses were included in the bundle of documents provided to the Committee. He said that Viceroy’s calculations and the conclusions it reached were based on incorrect assumptions. He explained that the rescheduling of loans and consolidated loans were based on prescribed criteria. He said that only 20% of loans in Capitec’s books were consolidated loans. On all these loans Capitec had conducted a full affordability assessment. He said that Capitec applied very conservative policies as credit was only provided to formally employed and salaried individuals. He said that Capitec had a centralised system of credit granting to ensure prudence.
	3. **Presentation by the South African Reserve Bank**
		1. The Registrar of Banks and Deputy SARB Governor, Mr Kuben Naidoo, said that based on the data that the SARB had, the allegations made in the Viceroy Report were incorrect. He said that Capitec’s provisioning model met regulatory requirements. Capitec had adequate capital and liquidity at 34% Capital Adequacy Ratio (CAR) and 1000% liquidity coverage ratio (LCR). This was respectively 2.5 times higher CAR and 10 times higher LCR than banks were expected to hold.
		2. He explained that the SARB believed that Viceroy got it wrong; the rescheduling of loans at Capitec was not used to hide non-payment, boost new lending and CAR and LRC provisioning exceeded regulatory requirements. Despite this assurance, Mr Naidoo mentioned that the SARB was concerned about the allegations and had taken them seriously. He said that Capitec was a systemically important bank and it was important for the SARB to quickly assure the market after the Viceroy Report and assured SCOF that SARB would continue to monitor the situation.
	4. **Presentation by the National Credit Regulator**
		1. The CEO of the NCR, Ms Motshegare, said that Capitec has a 3.24% of the banks share of debtors’ book in the country. During 2017, the NCR had received 90 complaints from consumers concerning Capitec. 86% of these 90 complaints were resolved. She said that complaints of consumers of banks to the NCR generally involved disputes on outstanding balances, reckless lending and terminations from debt review.
		2. Ms Motshegare said that the NCR had conducted compliance monitoring on banks. She said they found at Capitec that multiple loans were being issued to the same consumers within a short space of time. She said that while this conduct was not necessarily in contravention of the National Credit Act (NCA), it raised concerns about potential risks to consumers and the bank. As a result of this, the NCR shared this information with the SARB and advised the bank to stop this practice.
		3. *The Committee may wish to ascertain what the SARB did with this information from the NCR and whether Capitec is still engaging in this practice as it was advised to stop it by the NCR. This information forms the basis of accusations made by the Viceroy Group that multiple loans were being issued at short intervals to the same consumers, creating suspicions that Capitec may be refinancing delinquent consumers*.
	5. **Presentation by the Financial Services Board**
		1. The FSB explained that it had jurisdiction to investigate the violations of the Financial Markets Act**[[6]](#footnote-6)**. Based on the complaints by Capitec on the Viceroy Report, the FSB was studying the Viceroy Reports and Capitec’s responses, analyst and media reports, social media interactions, analysing trading activities in Capitec shares, derivatives and bonds from December 2017 onwards. This could be followed by the issuing of summons and interrogating of persons of interest, and liaising with fellow regulators in other jurisdictions. Mr Boyd said that their investigation was ongoing and they would report back once the investigation is finalised.
		2. The Committee may wish to be updated by the former FSB, now officially part of the Financial Sector Conduct Authority (FSCA) following the coming into force of the Financial Sector Regulation Act of 2017. The Committee may wish to learn more about short-selling, whether it is an acceptable market practice, whether it is legal or illegal in other comparable jurisdictions and if South Africa needs any legislative or policy changes in order to manage the risks of such market practices.
	6. **Presentation by the National Treasury**
		1. The National Treasury said that the reckless manner in which Viceroy released the report raised serious concerns, regardless of whether the issues it raised were valid or not. Mr Momoniat urged the Committee not to ignore the admissions of Viceroy that it had profit motives on the falling shares of Capitec as it was involved in short-selling. He emphasised that Viceroy was anonymous and unregulated. He further highlighted that NT was not defending Capitec or attacking Viceroy. He was also not arguing that Capitec is innocent of the transgressions accused of and urged the regulators to do their work and deal with the issues.
	7. **Committee Deliberations**
		1. The Committee raised concerns about Capitec presentation’s usefulness as it did not engage with the issues raised in the Viceroy Report. Instead of dealing with the substantive issues raised in the Report, it focussed on assassinating the integrity of Viceroy. The Committee said that Capitec had to clarify whether it was indeed issuing multiple loans to the same lenders at short intervals, especially in poor (mining) communities, and whether it engaged in thorough credit affordability checks before it issued loans.
		2. The Committee further urged the regulators to deal with the substance of the Report. It was recommended that Capitec Bank should be called back to answer to further questions about some of the bank’s practices in terms of the National Credit Act. The Committee noted that the allegations made against Capitec were also applicable to other banks. It noted that if Capitec was to be cross-examined, it would be fair to, as some point, call the other banks to question them on similar issues in order to ensure fair treatment and balance. The Committee further noted that Capitec had not directly participated in its Financial Sector Transformation Hearings in 2017, whereas other major banks participated despite also being represented by the Banking Association of South Africa (BASA). It urged Capitec to apply itself to the report produced by the Committee after the Financial Sector Transformation hearings.
		3. The Committee said that there should be a separation between Viceroy’s wrongdoing and the allegations made on Capitec. If Viceroy had acted unlawfully, it should also be investigated and dealt with as such conduct brought dangers of systemic risk to the South African economy.

1. **Viceroy allegations and Capitec responses to the initial report published on 29 January 2018.**
	1. Table 1 below summarises the allegations of first Viceroy Report ‘*Capitec: A wolf in a sheep skin*.’ Capitec responded on 30 January through a report which was posted on SENS, the information dissemination platform of the JSE. Capitec did not respond directly to many of the allegations made on 29 January. This may be understandable given the short time in which Capitec responded to Viceroy. It however responded more fully on 05 and 08 February 2018. Responses from these 3 response letters published on SENS are used in the table below.

* 1. **TABLE 1**

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| **Viceroy Report Allegations (29 Jan 2018): (Capitec: A wolf in sheep’s skin)** | **Capitec Reponses on 30 JAN 2018, 05 and 08 February 2018- providing a more detailed response.** | **Comments** |
| 1. **Conflict of interest**:: While large intra-company holdings exists between the PSG Group, Capitec and Steinhoff, Viceroy are sceptical of significant independence with the Capitec management. Concerns with Capitec’s business are not best dealt with by a management team that is so intertwined with its largest shareholder- presenting a conflict of interest to minority shareholders. (**See page 4 of the Viceroy Report.**

Viceroy highlighted the so called ‘incestuous” relationship between Steinhoff, the PSG Group and Capitec[[7]](#footnote-7). Capitec is majority owned by the PSG Group. Steinhoff had also been one of the largest shareholders at the PSG Group, until Steinhoff sold off a large portfolio of shares at PSG Group following Steinhoff’s stock collapse in December last year. In this web is the sharing of several executives by all these companies in their Boards. Among these was Markus Jooste (former Steinhoff CEO who served on the board of PSG and Capitec), Christo Wiese, Jannie Mouton (PSG Founder and Chairman who also served on the Steinhoff Board), Piet Mouton (CEO of PSG who serves on the board of Capitec), Ben la Grange (former Steinhoff CFO)[[8]](#footnote-8).  | On the 08 February Response by Capitec, Capitec stated that Capitec’s board is not made up of several executives from both PSG and Steinhoff. . There is no Steinhoff executive or director that serves on Capitec’s board. Piet Mouton is the only PSG executive on that serves on Capitec’s board. Chis Otto, a non-executive director at PSG, has served on Capitec’s board as non-executive director since the company’s inception. Markus Jooste served on Capitec’s board from 2011 to 2012 when he retired from the board by mutual agreement due to a possible conflict of interest created by Steinhoff’s entry into the financial services industry when Steinhoff bought the JD Group.  |  |
| 1. **Insider Stock Sales**: Management of Capitec appear to be selling shares at an alarming pace. Most notable amongst the sales are those of Capitec CEO Gerrie Fourie and former CEO Riaan Stassen. On 18 December 2017- the CEO Gerrie Fourie sold Capitec stock worth R13 million and former CEO Riaan Stassen sold R49 million worth of stock at the same time.
 | Capitec said that is has grown significantly since inception. This has resulted in total assets at 28 February 2017 of R73.4 billion (R510 million in 2004) and equity of 16.1 billion (R428 million in 2004). Directors and management sell shares from time to time to diversify their investment portfolios. Founding directors which include Riaan Stassen (NEC), Michiel Le Roux (NED), Gerrie Fourie (CEO) and Andre du Plessis (CFO) all continue to hold significant interests at Capitec (See 08 February 2018 response).   |  |
| 1. **Misrepresentation of the loan book by rescheduling and issuing new loans to delinquent clients**

Capitec materially misrepresents the balance of its unpaid loans by consistently rescheduling these loans through the issuance of new loans. (p.7) Capitec often reschedules loans which are in arrears. This happens as they collect zero principal from these delinquencies, and capitalising interest and massive fees. (p.9)Between ZAR 2.5 billion and ZAR3 billion of Capitec’s loan book balance at the end of FY2017 was payable in 2017 and discretionally carried forward via the issue of new loans to repay delinquent loans. (p.10) This activity would essentially conceal losses the size of Capitec’s earnings and elevate their loan metrics above their competitors.  | On 05 Feb, Capitec said that its loan book was incorrectly stated in the Viceroy Report. It said that its loans and advances reconciled and were not misrepresented by including rescheduled loans through issuance of new loans. It further said that it did not advance loans to clients who are in arrears with their Capitec instalments. On the 30 Jan letter, with reference to the reconciliation of the loan book, Capitec said that the estimate in the Viceroy Report does not accurately calculate client repayments. Viceroy’s estimate of capital repayments of 16.7 billion underestimates actual loan receipts net of fees of 18.6 billion by 1.9 billion. Viceroy also reduced write-offs by an estimate of the component of write-offs that originate from new sales in subsequent years. Capitec said that this was logically flawed. It further explained that default rates used by Viceroy do not take into account that written off balances include fees and that they should be compared to the sum of actual receipts.  | See both the 30 Jan and 05 Feb letters from Capitec for detailed responses.  |
| 1. By refinancing delinquents, Capitec is creating a false economy within its income statement, as it records interest and fees on delinquent loans which would otherwise be unpaid. (p.10)
 | The Committee refuted this statement. It said that it does not refinance loans that are in arrears. See further explanation on No. 5 below.  |  |
| 1. Capitec is artificially maintaining low arrears by issuing new extended term loan agreements so clients could pay off existing loans. (p.14)
 | Capitec denied this. On 05 Feb letter Capitec explained that it does not roll unpaid/ arrears loans into longer term new loans to disguise poor asset quality. The process of originating new debt and consolidations is different to rescheduling existing loans. On new loans, origination follows the credit granting process which incorporates the comprehensive assessment of the client’s behaviour, affordability and source of income. Once off initiation fee is charged and monthly service fee. On consolidations, existing clients apply for further credit, whereby a full credit assessment is conducted. If the client qualifies for such, credit can be extended as a further credit agreement in addition to the current debt or the client can have his/her existing debt consolidated into a new credit agreement. This is available to clients who are up to date with their instalments. Initiation fees are changed on the new loan- and this complies with the NCA. No consolidation of further loan is granted to clients in arrears. Rescheduling is aimed at assisting clients whose circumstances have changed since taking up credit and to manage part of the collection process. Rescheduling supports the rehabilitation of clients by improving the collection potential on such financially stressed clients. No origination fees are charged on rescheduled loans as no new credit is advanced. An existing loan contract is merely amended to stretch the remaining period of the loan. The statement that Capitec charges fees on rescheduled loans is false. Rescheduled loans are also not included in new credit granted or loans sales.  |  |
| 1. Capitec’s multi-loan or credit facility origination fee resembles loan shark tactics.
2. Offers instantly accessible credit via ATMs,
3. Has month to month payment scheme that resembles payday loans
4. Designed an “unplanned expense” facility, but short terms and frequent full repayments resemble payday loans
5. Charges a series of massive origination fees and monthly fees even if there is no balance owing.

Loan origination fees are a major boost to Capitec’s returns every year and a significant reason Capitec’s returns are so exemplary compared to competitors. While competitors origination fees are immaterial (<1% of earnings), Capitec’s origination fees contributed 21% of earnings in 2017. | Capitec said that the rationale for multi-loan product was to provide clients with an accessible solution (ATM, branch, cellphone) and replace the inefficient application for month to month loans at the branch which was costing customers and reduce the costs. Capitec ceased to offer the mutli-loan, not because it was prohibited but because the Affordability Assessment Regulations rendered the programme uneconomical. The initiation fee on the credit facility is different to the multi loan. Origination fees comprise 3.8% of Capitec’s total revenue. The credit facility makes up 0.3% of the total gross loan book of capitec.It is incorrect that Capitec’s pricing was excessive and illegal. The NCR reviewed the product in detail and concluded their satisfaction with the product, including fees and interest charged. (See 08 February 2018 response) |   |
| 1. Multi-loan product was discontinued in 2015 as a result of new credit regulations. However the multi-loan is still available but rebranded as Credit Facility. Credit Facility rates: Initiation fee: R171 for the first 1000 up to R644.10 for following transfers. Monthly fee of R35 without active balance owing, R68.40 with active balance owing. Each monthly advance attracts a minimum of 12.9% in origination fees including VAT. (See example of someone drawing R5000.00 monthly from the facility ends up paying 155% on top of 20.5% resulting in a combined interest of 175.5%. Viceroy believes Capitec’s Credit Facility charges excessive and illegal interest rates, disguised as monthly fees.
 | At paragraph 5 of the 30 Jan response, Capitec stated that Viceroy was incorrect to compare its discontinued multi-loan facility with its new credit facility. Its credit facility operates the same way as a credit card except that it terminates after 9 months, requiring a new application and comprehensive credit assessment to be made. An initiation fee is only triggered once the client uses the facility up to a maximum fee. This complies with the NCA. The monthly fee is also raised as allowed by the NCA. There is a difference between availability and use of the facility and interest is charged as contracted with the client and the full amount used, including interest and fees, is repayable on a monthly basis. On 08 Feb, Capitec added as followsOrigination fees comprise 3.8% of Capitec’s total revenue. The credit facility makes up 0.3% of the total gross loan book of capitec.It is incorrect that Capitec’s pricing was excessive and illegal. The NCR reviewed the product in detail and concluded their satisfaction with the product, including fees and interest charged. (See 08 February 2018 response) | The response of Capitec does not seem to address Viceroy’s allegation that the credit facility operates the same was as payday loans where initiation fees and service charges are made every-time an advance is made.The Committee may ask for more clarity on initiation fees and the allegation that the credit facility is no different to a multi-loan facility or a payday loan. The response that the credit facility operates in a similar manner to a credit card seem misleading. Credit cards are not intended to be settled in full on a monthly basis as Capitec’s credit facility. Credit cards also do not attract initiation/ origination fees on a monthly basis. |
| 1. Allegations on legal cases and possible violations NCR on reckless lending. See pages 18 to 21

Possibilities of class action | Capitec responded that it believed it had a solid defence on the cases against it. If further stated that it was not in violation of the NCA re: reckless lending as it performed comprehensive credit assessment consisting of documentary and other information provided by the customers such as bank statements, payslips and answers to questions posed to clients as well as information sourced externally from credit bureaux. (See full response on paragraph 4 of Capitec’s response.)Capitec dismissed the possibility of a class action suit against it.  | Substantive cases are before the courts. The Committee should therefore leave the specific issues raised in those cases to the courts and await the court decisions. The court actions could go either way. Capitec could win some, as it reportedly has won one on technical grounds. It therefore does not follow that there could be no possible class action if the plaintiffs in some of these cases win.  |
| 1. Capitec’s impossibly low arrears. They are more than 20 percentage points lower than other comparable companies providing essentially the same service to the same market. If Capitec were to accurately represent the health of its loan book, it would need to take a ZAR 11bn write off and impairment. Together with any potential class action liabilities. This is likely to put Capitec on the brink of insolvency. (p22-26)
 | Capitec said that the Viceroy Report presents information that was not clearly comparable and failed to present information. This intentionally creates a false impression that Capitec’s arrears rate is understated compared to other credit providers. Capitec’s arrears analyses are different in terms of its granting, pricing, write off and provisioning policies. Other credit providers’ arrear loan balances include debt of over three months while Capitec writes off loans exactly at 3 months and hands them over to external debt collectors. The omission of this information in the Viceroy Report furthers its cause of creating doubt and uncertainty about Capitec, instead of creating an understanding of our conservative provisioning model. No adjustment to the net loan book is therefore required. (See 05 and 08 February responses)   |  |
| 1. The possible impact of Deposit Insurance Scheme (DIS) on Capitec’s book value. Viceroy believes the implementation of DIS will have an adverse effect on Capitec’s ability to lend by placing strain on its cash reserves. (p28-29)
 | On 08 Feb, Capitec said that the conclusions arrived at by Viceroy on the DIS are incorrect. A significant proportion of Capitec’s deposits will not be covered and will not attract a funding obligation for DIS. Capitec has 27.5 billion cash reserves, which are higher than the R2.4 billion amount that is estimated by Viceroy.  |  |
| 1. Impossible cost structure: Capitec’s average staffing costs per employee are less than half those of any of its competitors.
 | Capitec disputed the average of pay for its managers. Instead of the R13, 219 per month in the Viceroy Report, Capitec pays its branch managers R22, 000 per month.  | The Committee could raise more questions about Transformation at Capitec, particularly at senior management and Board levels and its standing on the Financial Sector Code, particularly on issues of ownership and empowerment.  |
| 1. Allegations of former employees
 | Capitec denied that it fired any employees ‘for not deceiving borrowers’  | Of course, it would be unsustainable to dismiss employees ‘for not deceiving borrowers’. Other more acceptable reasons could be used to dismiss employees- for the same underlying reasons.  |

1. **SARB Statement and Viceroy comments**
	1. To calm the markets, the SARB released a statement on 30 Jan which said that according to all information available to it as the regulator, Capitec was solvent, well capitalised and has adequate liquidity. It stated that Capitec met all prudential requirements.
	2. Viceroy responded to this statement by the SARB. It urged it to conduct an adequate regulatory inspection on Capitec. It repeated its allegations that Capitec’s balance sheet, income and solvency numbers are not reliable. It said that Capitec underrepresented its losses by pretending that uncollectable loans are collectable and were still accruing an income. It suggested that ZAR10 billion worth of loans fell into this category and were largely in the long-term loans on Capitec’s balance sheet, such as 49-60 month and 61-84 month term loans. Using the example of the latter group of loans, Viceroy concluded that the losses at 1.5% per annum were astonishingly low. They were lower than the losses of prime loans of the Bank of America and Citigroup. It said that this was unbelievable for unsecured loans to perform better than prime credit of the world’s leading banks. This made Capitec’s unsecured loans *super-prime*.
	3. Viceroy repeated its charge that many of these loans seem to be performing well because staff regularly roll or restructure these loans in order to hide delinquencies. Viceroy also questioned the capital adequacy and liquidity ratios provisioning for Capitec’s loans. It further asked the SARB to perform a full regulatory inspection to confirm that the compliance information provided to them by Capitec was accurate because Viceroy does not think that it was.
	4. In the March briefing to the Committee on this issue, all the presenters, including the SARB, stated that the allegations made by Viceroy should be and were taking them seriously. The Committee may wish to find out, if the SARB takes such information seriously, has it conducted or is it planning to conduct any regulatory inspection on Capitec as suggested by Viceroy. If not, why not? Viceroy seems adamant that the information that the SARB receives from Capitec may not be accurate, especially with regards to the low rate of losses and delinquencies.
2. **Benguela Global Fund Managers Letter of 19 January 2018 to Capitec and Capitec’s responses to it on 01 February 2018**
	1. A South African firm based in Rivonia, Johannesburg, had written to Capitec’s management (CFO- Mr. AP du Plessis, CEO Mr G Fourie and Riaan Stassen, who is the Chairman of the Board and former CEO.) on 19 January 2018, 11 days before Viceroy published its first Report on 30 January 2018. The letter was written by Zwelakhe Mnguni, the Chief Investment Officer at Benguela Global Fund Managers (Benguela), with a subject matter: “**Benguela Global Fund Managers concerns around Capitec’s rescheduling of arrear loan book**.” This letter had raised some similar concerns with those raised by Viceroy on 30 January and subsequently. Capitec responded to this letter on 01 February 2018, after responding to Viceroy. In its response, Capitec dealt with Benguela’s concerns and calculations. The main response was that Benguela’s analysis and conclusions were based on incorrect or inaccurate facts and calculations. Capitec subsequently had a meeting with Benguela on 02 February 2018. Benguela later said it was satisfied with Capitec’s detailed responses as set out in the letter of 01 February from Capitec.

**TABLE 2**

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| **Benguela’s concerns on a letter dated 19 January 2018** | **Summary Capitec’s responses on a letter dated 01 February 2018** | **General Comments** |
| 1. **Aggressive arrears loan book rescheduling** (**six months**): Reschedule arrear loans and advances. Rescheduled arrears at Capitec were equivalent to 55% of reported arrears as at 28 February 2018. While loan rescheduling is a common practice in banking, Capitec’s rescheduling of arrear loans appears to be quite aggressive.
 | Par. 4 of the letter: Benguela got the calculations wrong. It omitted to factor in write-offs and cured arrears. Conclusions reached by Benguela are factually incorrect.  | For more detailed responses, see Capitec’s letter to Benguela dated 01 February 2018. |
| 1. **Aggressive arrears loan book rescheduling** (**twelve months**): Rescheduled arrears amounted to 77% of the pre-rescheduling arrears for the 12 month period ending 31 August 2017. This is cause for alarm for all stakeholders. Arrears and rescheduled arrears amounted to 9.8% of Gross Loans and Advances versus 7.8% in 2013. Bad debts written off have grown from 5.7% of gross loan book in 2013 to 12.1% in 2017. While the operating environment has somewhat deteriorated since 2013, the scale of the increase in bad debts highlights the significant role played by prior years rescheduling practices---as an example in FY2017 bad debts written off grew 19% while the gross loan book grew only 10%. This means that higher profits were taken in previous years through lower provisioning in rescheduled arrears and now the actual adverse effects are raised to the surface through bad debt.
 | Par. 4 of the letter: Benguela got the calculations wrong. It omitted to factor in write-offs and cured arrears.Conclusions reached by Benguela are factually incorrect. | For more detailed responses, see Capitec’s letter to Benguela dated 01 February 2018. |
| 1. **Contribution to gross loan book growth and revenues**: Without rescheduling arrears, Capitec’s gross loan and advances book would have been stagnant for the past four years to 2017. Origination/ initiation fees contributed to Capitec’s revenue and profits through arrear rescheduling.
 | Capitec reschedules loans by amending existing loans instead of issuing new loans. NCA (section 101 (2)) prohibits levying an initiation fee in instances where existing debt is refinanced. Rescheduling does not generate initiation fee income for Capitec. Capitec offers rescheduling to clients experiencing financial difficulties. (par.1) | For more detailed responses, see Capitec’s letter to Benguela dated 01 February 2018. |
| 1. **Provisioning impact**: Capitec’s aggressive rescheduling practice enables it to achieve substantively lower impairment provision rate than it could have had the arrears not been rescheduled. The lower provisioning rate as a result of rescheduling leads to inflated profits and book value.
 | No clear response to this point. On page 7-10 of the response under the paragraph entitled “**Loan book growth and changes in provisioning and write offs.**” Capitec provides a long analysis which in the end does not clarify whether it agrees or not with Benguella’s analysis. | The Committee may seek more clarity to this question.  |
| 1. **Impact of rescheduling on reported performance**: Excessive rescheduling of arrears materially distorts the reported financial performance of the business, We estimate that since 2013, the arrear rescheduling has contributed 10% per annum to reported annual profits. The cumulative contribution of our estimated arrear rescheduling on profits is equivalent to 38% of FY2017 reported Headline earnings.
 | No clear response to this point. On page 7-10 of the response under the paragraph entitled “**Loan book growth and changes in provisioning and write offs.**” Capitec provides a long analysis which in the end does not clarify whether it agrees or not with Benguela’s analysis.  | The Committee may seek more clarity to this issue. Does rescheduling materially distort the reported financial performance of Capitec?  |
| 1. Rescheduling has led to an increase in bad debt write offs of ZAR 4 billion in 2016 and 5.5 billion in 2017.
 | We do accept that the increase in rescheduling during 2016 and more strict rescheduling criteria applied during 2017 led to the position that some clients were written off during 2017 instead of 2016. We believe that the strategy reduced the overall losses to the Bank (page 10)  | No clear response. The Committee may seek more clarity to this concern raised by Benguela. Has rescheduling led to more debt write-offs? |
| 1. Rescheduling is done by robotic means: this could put shareholders’ capital at risk
 |  | Capitec does not seem to have responded to this question in its letter to Benguela dated 01 February 2018. |
| 1. Reckless lending: Providing a large number of clients with rescheduled loans could potentially be seen as reckless and pose a real risk of attracting a hefty fine from the NCR.
 | Capitec reschedules loans by amending existing loans instead of issuing new loans. NCA (section 101 (2)) prohibits levying an initiation fee in instances where existing debt is refinanced. Rescheduling does not generate initiation fee income for Capitec. Capitec offers rescheduling to clients experiencing financial difficulties. (par.1) | The Committee may seek clarity on whether Capitec issues new loans to clients to settle old ones. If that happens, how is it different to rescheduling? In such circumstance, does Capitec charge an initiation fee?  |
| 1. Capitec profiting on struggling clients as it charges origination/ initiation fees when rescheduling loans, thus putting struggling consumers deeper and deeper into debt.
 | Capitec reschedules loans by amending existing loans instead of issuing new loans. NCA (section 101 (2)) prohibits levying an initiation fee in instances where existing debt is refinanced. Rescheduling does not generate initiation fee income for Capitec. Capitec offers rescheduling to clients experiencing financial difficulties. (par.1) | The Committee may seek clarity on whether Capitec issues new loans to clients to settle old ones. If that happens, how is it different to rescheduling? In such circumstance, does Capitec charge an initiation fee? |
| 1. Rescheduling has helped shore up the reported performance of the Executive, thus earning them incentives at excessive risk to shareholders.
 | Executive management are significant shareholders and definitely think and act as long term investors.  | Has rescheduling helped to shore up Executive performance and incentives such as bonuses?  |

1. **Viceroy’s Open Letter to Capitec’s board of Directors dated 20 February 2018 and Capitec’s response on 22 February.**
	1. On 18 February 2018, Viceroy wrote an open letter to the Board of Directors of Capitec Bank raising the questions in the first column of the Table 3 below. Capitec Bank provided a response to Viceroy on 22 February 2018.

**TABLE 3**

|  |  |  |
| --- | --- | --- |
| **Viceroy questions to the Board of Directors dated 20 February 2018.**  | **Summary of Capitec’s Responses dated 22 February 2018.**  | **General comments** |
| 1. In the 12 months to 2017, what was the actual value of loans that were cured out of arrears?
 | Capitec has got internal information with the exact answer of how many clients were cured out of arrears. It however does not disclose information that is not already in the public domain to an investor or analyst.  | Why is this information secretive? Why not give it if you have it? Is it not information that covers the previous financial year? |
| 1. Does Capitec believe extending new loans to consumers who were only one day prior in arrears is both socially and financially sustainable?
 | Capitec considers its credit granting models to be socially and financially sustainable.  | See letter dated 22 February at paragraph 2 for more details.  |
| 1. What amount of loans are made to clients who had cured arrears over the preceding month?
 | 92% of applications from clients that were recently in arrears due to behavioural reasons are declined. Successful applications are limited to approximately 1% of loan sales. Loans are only extended when compensating risk variables indicate that the overall risk profile of these clients is acceptable.  |  |
| 1. Please elaborate on Capitec’s recently amended maximum customer loans policy
 | Capitec’s routinely monitors and updates credit policies and systems. The change in the policy had no impact on the risk profile of Capitec’s book or loans advanced. Capitec allows clients that prefer to compartmentalise their funding needs with multiple loans to do so, but limits the total number of loans in order to ensure that the cost to the client does not become excessive.  | What is the maximum number of loans that an average client can hold at the same time?Do multiple loans not increase the cost of credit? i.e. initiation fees and other admin and service charges? |
| 1. Why did Capitec not previously have internal controls to enforce the maximum number of term loans per customer?
 | Capitec’s internal controls are strong and the granting model determines what lending products and amounts could be advanced to clients.  |  |
| 1. How many loan accounts, on average, do Capitec consumers have? How has this grown over time?
 | The average number of personal loans and credit facilities has never exceeded 1.5 per client, and is stable.  |  |
| 1. Please advise which financial regulators are in discussions with Capitec, if any, in relation to research prepared by Viceroy?
 | No comment.  |  |

1. **Viceroy’s Open Letter to Capitec’s Audit Committee of 16 May 2018 and Capitec’s response of 24 May 2018**
	1. Again on 16 May, Viceroy sent further open letter to Capitec, addressing it to the Audit Committee. In that letter Viceroy said that it believed that “Capitec management have continued to mislead investors”. It said that the end-of-year announcements in 2018 were reflective of a deteriorating business conditions and misleading accounting reporting practices at Capitec. It then asked the questions in TABLE 4 below.

**TABLE 4**

|  |  |  |
| --- | --- | --- |
| **Viceroy open letter to the Audit Committee of Capitec dated 16 May 2018** | **Capitec’s responses dated 26 May 2018** | **Comments** |
| 1. Can the audit committee justify management’s analysis that Capitec loans are trending towards long term?

According to Viceroy, the longer term loan book increases are due to refinanced loans. It alleges that these rescheduled loans are depicted as new long term loans to hide Capitec’s declining business fundamentals.  | Capitec responded that it could support its analysis that its lending were trending towards long term loans. This was done through excluding credit cards in the analysis, which are totally different to term loans. This then shows that Capitec loans are trending towards long term. (See par. 1) |  |
| 1. Can the audit committee elaborate on the nature of internal consolidation and provide analysis into the net loan sales executed too customers who have consolidated existing loans?
 | Internal consolidations occur in some cases where clients with existing loans apply for further credit. A full credit assessment is conducted before a consolidation or further loan is issued. Only the new portion of the loan is counted towards loan sales. Only 3.3% of customers had taken over 80% of the credit they qualified for and then took further credit later. (See para. 2) |  |
| 1. What is the rationale in decreasing bad debt provisions while bad debt is increasing exponentially?

In 2018 financial year Capitec has responded to increase in bad debt by decreasing bad debt provisions from 13.1% to 12.2%. Bad debt written off has increased 67% since 2016, vastly exceeding the 16.7% growth of Capitec’s loan book over the same period.  | The bad debt that Viceroy refers to is the write off component which is backward looking, while debt provisioning is forward looking. It is common occurrence for provisions and bad debt to go in different directions at turning points in the economic cycles.  | **The response of Capitec further refers to the wrong methodology used by Viceroy. See para. 3 for the response.**  |
| 1. Why have Capitec changed their provisioning method?

Viceroy alleges that Capitec have introduced a vastly different arrears provision categorization system based on time in arrears as opposed to number of instalments missed. Higher risk tiers incur lower provision rate. The obvious benefit of reducing provisions is a significant bump on earnings in the current period at the cost of future earnings.  | Capitec has not changed the provisioning methodology. |  |
| 1. Deterioration in loan book quality: can the audit committee elaborate on management’s analysis of loan book quality?

Viceroy says that Capitec’s financial results show deteriorating asset quality and supports their view that Capitec’s business practices are unsustainable. Viceroy sees anywhere between 30 to 45% of the value of the gross loan book falling into arrears each year.  | Of the 1,215 billion increase in bad debts written off between 2017-2018, R639 million was due to increase in debt review balances written off. Given the relative sizes of the total gross loan book to the debt review book (roughly 20 times), the significant contribution of the debt review book to the increase in total bad debts written off does indicate causation. Capitec says that Viceroy should have used a different methodology/calculation to appreciate an improvement in balances falling into arrears as a proportion of total balances that could fall into arrears. (par 5 of the response letter) |  |
| 1. Can the company elaborate on the effects of IFRS9 implementation?

Can the audit committee state the direction of the financial impact? | IFRS9 will lead to increased provisions. The financial impact is to debit retained earnings and credit provisions. IFRS9 will be adopted and commence from January 2019. |  |

1. **Conclusion**
	1. Capitec seems to have responded comprehensively to many of the concerns raised by Viceroy and Benguela. However Viceroy seems still to be unsatisfied as it has continued to write open letters and performing further analysis. The main issues here seem to be the use of different methodologies and calculations in analysing data. This causes Viceroy and Capitec to reach totally different conclusions. The plausibility of these conclusions is beyond what the Committee could do. It depends on the regulators to investigate, verify and report back to the Committee.
	2. Capitec also responded to the questions asked by the Committee in the previous meeting by submitting detailed written responses, which is part of the documents given to the Committee. The Committee should receive a briefing from Capitec on 30 May as planned and await the unfolding court processes on the cases that are currently subjudice, concerning reckless lending and possible violations of the NCA.
	3. The Committee should carry on monitoring developments on this issue, particularly the ongoing investigations by the FSCA (FSB) and the inspections of the NCR on NCA issues, of multiple loans and the credit facility and the risks they might pose to the system, if any. These issues fit into the Committee programme on the Transformation of Financial Sector as they link to fair treatment of consumers.
	4. The Committee could further request the SARB to conduct a full inspection on Capitec (if this has not been done), as suggested by Viceroy, particularly on prudential regulatory issues and submit a report to the Committee, in order to find some closure on the SARB/ Prudential Authority issues.
1. Compiled by Zakhele Hlophe. zhlophe@parliament.gov.za [↑](#footnote-ref-1)
2. Act No. 94 of 1990 [↑](#footnote-ref-2)
3. https://www.huffingtonpost.co.za/2018/01/30/capitecs-share-price-tanks-after-viceroy-report\_a\_23347459/ [↑](#footnote-ref-3)
4. *Ibid.* [↑](#footnote-ref-4)
5. *Ibid.* [↑](#footnote-ref-5)
6. Act No.19 of 2012 [↑](#footnote-ref-6)
7. Viceroy Research Group (2018), Capitec: A wolf in sheep’s clothing, page 4. <https://viceroyresearch.org/2018/01/30/capitec-a-wolf-in-sheeps-clothing/> or <https://www.scribd.com/document/370317971/Viceroy-report#from_embed> [↑](#footnote-ref-7)
8. *Ibid.* [↑](#footnote-ref-8)