



Capitec's wholly inadequate response to Viceroy

A perfect example of why Viceroy don't "engage with management" – they don't answer our questions

Viceroy issued an open letter to Capitec's board of directors on 20 February 2018, responding to their invitation to engage with management and field our questions, a summary as follows:

1. In the 12 months to August 2017, what was the actual value of loans that were cured out of arrears?
2. Does Capitec believe extending new loans to consumers who were only one day prior in arrears both socially and financially sustainable?
3. What amount of loans are made to clients who had cured arrears over the preceding month?
4. Please elaborate on Capitec's recently amended maximum customer loans policy
5. Why did Capitec not previously have internal controls to enforce the maximum number of term loans per customer?
6. How many loan accounts, on average, do Capitec consumers have? How has this grown over time?
7. Please advise which financial regulators are in discussions with Capitec, if any, in relation to research prepared by Viceroy

A full copy of our letter can be found here:

www.viceroyresearch.files.wordpress.com/2018/02/letter-to-capitec-20-02-18.pdf

Capitec replied to our letter on 22 February, 2018 via email, however provided no straightforward responses to any of our questions. At best, Viceroy received numerous largely insignificant statistics and tangential statements.

Capitec's full response to our letter is attached to this report as Annexure 1.

Viceroy has been criticized for not engaging with management prior to publication of our reports. Capitec's response is a prime example of why we choose not to. We maintain our recommendation that Capitec should be subject to an external, independent regulatory investigation, which we believe will result in Capitec being placed in curatorship in order to protect its consumers.



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1. Actual value of loans that were cured out of arrears

Without providing exact figures, Capitec insists their calculation of loans rescheduled out of arrears – which includes an estimate of “cured arrears” – is accurate.

1. Value of loans that were cured out of arrears and reference made to our response to Benguela Global Fund Managers (BGFM)

Our response regarding clients that rescheduled out of arrears, as percentage of total clients that went into arrears, as well as the components of the calculation, is accurate. We have internal information with the exact answer. We do not as a rule provide information to an analyst or investor that is not available to the total market. In our response to BGFM we merely demonstrated that diligent analysts can derive the correct answer using information available in the public domain.

Figure 1 Capitec letter to Viceroy – 22 February 2018

Rm	Benguela Calculation	Capitec calculation
Loans rescheduled from arrears:		
Six months to August 2017	1,396	1,396
Six months to February 2017	1,583	1,583
Numerator: Balances rescheduled during the year	2,979	2,979
Loans in arrears August 2017	2,498	2,498
Loans rescheduled from arrears:		
Six months to August 2017	1,396	1,396
Six months to February 2017		1,583
Write-offs 12 months to August 2017		6,453
Estimated cured arrears 12 months to August 2017 ⁽¹⁾		5,192
Denominator: Arrears during the year	3,894	17,122
Estimated rescheduling % arrears	76.5%	17.4%

(1) Estimate of cured arrears	
Arrears balances	
Aug-16	2,561
Feb-17	2,855
Aug-17	2,498
Average arrears	2,638
Cure rate (1-provision against arrears balances of 67.8%)	32.8%
Time to cure (months)	2
Months in year	12
Estimated arrears cured during the year	5,192

Figures 2 & 3 Calculations extract from Capitec’s response to Benguela Global Fund Managers¹

If we assume the purported accuracy of this figure, we can completely discard Capitec’s prior assertion that Capitec’s average time-to-cure of two months is “conservative”. By Capitec’s own standards, this figure is **accurate**.

model 32.8% of arrears balances cure. A rough estimate would be to take average arrears for the year, multiplied by the cure rate, multiplied by 12 and divided by the average period to cure (two months would be conservative, given that arrears are written off after month 3 and the highest cure rates are observed on clients that are one month in arrears). This would add a further R5.2 billion to the denominator for the period to

Figure 4 Extract from Capitec’s response to Benguela Global Fund Managers

¹ https://www.capitecbank.co.za/resources/Capitec_response_to_Benguela.pdf



Despite managements assertion, we had already pointed out a calculation error in Figure 2 above. Loans cured, written off or rescheduled in the 12 months leading to August 2017 would undoubtedly been partially comprised of the opening arrears balance of the period. Accordingly, the end of period loans in arrears balance included in the calculation should instead be the difference of loans in arrears between the start and end of the period to avoid double counting.

This would bring the estimated rescheduling as percentage of arrears above 20%. We are perplexed as to how Capitec can justify that their information is accurate.

We reiterate that, according to Capitec's own numbers, a value equal to one-third of its gross loan book falls into arrears each year. We do not see logic with Capitec's reasoning not to provide actual figures to stakeholders, opting for "accurate" estimates instead.

2. Do Capitec believe extending new loans to consumers who were only one day prior in arrears is both socially and financially sustainable?

In a long-winded statement defining its lending practices, Capitec acknowledged that they provide no cool-off period on delinquencies, and that arrears are recognized immediately past due date.

Capitec's statement appears to attribute its massive cured arrears rate and practices of lending to clients recently in arrears to intervals between when a consumer's installment is due and delays in a consumer's payroll or interbank transfers. This is a ridiculous indirect proposition, as in Question 1 above, Capitec clearly portray that, on average, cured loans spend 2 months in arrears – clearly this is beyond a timing issue.

Capitec further notes that it would be unaware if a consumer borrowed money from other credit providers to repay a loan for up to 48 hours, making it extremely viable for consumers who have just recently gone into arrears, or about to go into arrears, borrow from Peter to pay Paul.

Management assert that 98% of such loan applications, **if detected**, are denied. **However, management fail to mention if this applies to Capitec's credit facilities, which they differentiate in future Questions.**

3. What amount of loans are made to clients who had cured arrears over the preceding month?

We asked Capitec what amount of loans are made to clients who had cured arrears over the preceding month, week and day. Again, Capitec provided no answer to this very specific question.

Capitec assert that a limited number of loans are issued to clients who meet these criteria, however again, this does not apply credit facilities, where clients can draw down more funds as long as they make-good on arrears. In fact, **management state that they "cannot stop" a client drawing down on a credit facility if that client is immediately prior in arrears!**

3. Loans to clients who had cured arrears over the preceding months

Our models distinguish between clients in arrears due to reasons outside their control (refer point 2 above), as opposed to behaviour reasons. 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.

Facility-based products such as the credit card and credit facility operate differently. Technically, for these products, we grant the facility to the client when the client is up to date. If the client falls into arrears and then pays up the arrears, where after the client makes a drawdown or a purchase, we legally cannot stop the client doing so. This is a standard feature for credit providers and we estimate the risk of this occurrence when we grant the credit.

Why even have questions on the ATM if Capitec cannot legally stop the client drawing down a credit facility installment? How is that financially and socially responsible?



4. Please elaborate on Capitec's recently amended maximum customer loans policy

Capitec responded that the amendment was prudent and has no impact on risk profiles. Management avoided commenting on the direction of the maximum loans limit. Here is the branch communication in question again:

8 February 2018

ALERT

Change to the Maximum Number of Credit Products per Client

Background

In our continuous drive to be the CEO in granting credit and to help our clients to bank better and live better, a change was made to the maximum number of term loans per client.

Note: The change is effective from **today, 8 February 2018**.

Amendments

Section 3.1.1 of the Branch Credit Granting policy (BCGP) was updated and now states:

- 3.1.1 The maximum number of credit products per client is limited to 5 which can include a maximum of 4 term loans (ranging from 2 to 84 months) plus a credit card facility or credit facility or 1 month loan.

Note: The updated BCGP document is available on the [Credit Hub](#).

Branch action required

- Branch managers **must** ensure that all branch employees are aware of this communication
- If a client does not qualify for any credit, count the number of term loans **before** contacting Helpdesk or CAT
- System changes will be done in future to alert employees granting credit that the maximum number of term loans have been exceeded

Figure 5 Extract from Capitec branch communications

In the absence of a response, Viceroy maintain our opinion that the movement of Capitec's maximum loans policy is critical to shareholder assessment.

If the maximum number of loans per customer has increased, we believe this will drastically increase the risk of Capitec's loan book and corroborates our thesis that overindebted customers finance existing loans by taking out fresh loans.

If the maximum number of loans per customer has decreased, this suggests Capitec are actively curbing the underlying risk of their underrepresented delinquencies and corroborating our thesis that the loan book is unsustainable. This outcome, in our opinion, would represent a prudent step in minimizing the financial damage caused by underrepresented loan book risk.

5. Branch level internal controls

Following from Question 4 above, the last dot point on Figure 4 above states:

"System changes will be done in future to alert employees granting credit that the maximum number of term loans have been exceeded"

We asked why Capitec did not previously have internal controls in place to enforce the maximum number of term loans extended to a customer. The company again avoided answering the question, instead asserting that the above communication will assist employees to inform clients when the maximum number of loans had been reached.

What is the difference? If this internal control was in place previously, the employee would already have a method of knowing whether the maximum number of loans had been reached and this can be communicated to the consumer. We suspect from the non-answer that this system was previously not in place and branches were not made aware of customer loan caps.



6. How many loan accounts, on average, do Capitec consumers have? How has this grown over time?

We asked Capitec advise how many loans each customer has, on average, and how much this figure has grown over time since 2013 on quarterly basis?

Capitec refused to answer our question, instead noting that this figure has never been above 1.5 per client. Capitec does not elaborate on whether the denominator client base includes all of its depositors or just clients who have taken out loans.

7. Please advise which financial regulators are in discussions Capitec, if any, in relation to research prepared by Viceroy

Local investors have asserted through media outlets that Capitec are in discussions with the SARB in relation to the research compiled by Viceroy and possible breaches of the National Credit Act:

Graeme Körner, of Körner Perspective, said yesterday he differed with Viceroy as he believed Capitec had adequate liquidity and its investment holding company, PSG, was able to capitalise it if necessary.

However, he said there were practices that were questionable or that could be in breach of the National Credit Act. "African Bank Limited (Abil) was not a problem until it was a problem," he said.

Körner also said that the Capitec management had handled previous notes by Viceroy.

"Behind the scenes, the South African Reserve Bank and the Registrar of Banks are engaging Capitec for an in-depth research on the company," said Körner.

Figure 6 Extract from Independent Online – "Capitec will ignore Viceroy's latest broadside"²

We asked Capitec confirm or deny the accuracy of these assertions, and to please advise of any other financial regulators that are in discussions with Capitec, if any.

Management refused to comment on their communications with regulators.

More recently, South African media outlets have reported that Parliament, together with the Reserve Bank, FSB and Treasury, will be briefed by Capitec in relation to Viceroy's report³. This briefing is due to occur on 20 March 2018.

8. Summary

It is clear why Capitec has issued these responses solely to Viceroy. Contrary to management rhetoric of expanded transparency, it is clear that Capitec wants these communications kept private due to their weak and inconsequential responses to our questions. The company has failed to answer any of our questions or has done so in an evasive and tangential manner.

As the bank has failed to answer our questions we reassert our opinion that Capitec Bank is fundamentally uninvestable and await the findings of a formal investigation.

² <https://www.iol.co.za/business-report/companies/capitec-will-ignore-viceroy-s-latest-broadside-13294393>

³ <https://www.businesslive.co.za/bd/national/2018-03-02-parliament-to-be-briefed-by-capitec-over-viceroy-report/>



Annexure 1: Capitec's letter to shareholders

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22 February 2018

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Dear Sirs,

Viceroy Research Letter to the Capitec Board of Directors

We refer to your letter dated 20 February 2018. We do not believe it brings any value to communicate via social and other forms of media and therefore this letter was sent to you directly.

1. Value of loans that were cured out of arrears and reference made to our response to Benguela Global Fund Managers (BGFM)

Our response regarding clients that rescheduled out of arrears, as percentage of total clients that went into arrears, as well as the components of the calculation, is accurate. We have internal information with the exact answer. We do not as a rule provide information to an analyst or investor that is not available to the total market. In our response to BGFM we merely demonstrated that diligent analysts can derive the correct answer using information available in the public domain.

We disclose the amount of arrears at every year-end and interim reporting period. The systems that provide this information have comprehensive controls and are subject to internal and external reviews.

2. Financial and social sustainability of extending new loans to consumers who were only one day prior in arrears

The nature of transactional banking frequently leads to short intervals between the point where a client's instalment is due and the receipt of the instalment. Examples include instances where employers' payroll-runs miss the daily cut-off point for electronic fund transfer payments to other banks, variations in the manner that employers schedule payroll runs around weekends and public holidays, variances in the timing where payment files are exchanged and processed between banks and so forth. This leads to deviations in the timing of repayments against expectation. The intervals may range from minutes to days. These variances are largely outside clients' control and have little bearing on the credit risk profile of clients.

Many credit products from traditional banks use a grace period between due date and statement date. Banks only reflect clients as past due on statement date, typically five days after due date. Debit orders have up to three days response time, leading to periods of uncertainty before the bank can ascertain the payment outcome and arrears status of a client. This necessitates the five-day statement grace period. In these circumstances, a cool-off period is appropriate in order to cater for the fact that updated account information is not available in real-time for a short period.



Capitec, however, updates account information in real-time in an integrated environment. The early debit order system provides intra-day responses regarding the status of instalments collected from other banks. The status of accounts is updated in real time and up to date and a cool-off period is therefore not necessary. Capitec considers an account as past due on the day subsequent to the instalment due date.

Robust credit models identify stable and predictive risk variables and filter out "noise" created by variables that do not have a bearing on the underlying risk profile of clients. We use a comprehensive set of variables that take into account various perspectives in order to create a balanced assessment of a given client's risk profile.

Credit bureaus do not update information in real-time and consequently, in the first instance that a client takes up credit from other credit providers in order to repay our instalments, we will be unaware of this fact for up to 48 hours. As a matter of interest, our scoring model declines 98% of such applications and these incidents are less than 2 loans per month. Our models will however pick this up in the following month, but also predict the likelihood that this may occur at any point in future. Furthermore, we decline 92% of applications in instances where the source of arrears repayments are unclear and these approvals are limited to cases where compensating risk characteristics indicate that the risk is acceptable. We decline 67% of all loan applications, due to the strict manner in which our models assess the level and trends in indebtedness of clients. Only 22% of applications are accepted by our clients.

Capitec consequently considers its credit granting models to be socially and financially sustainable.

3. Loans to clients who had cured arrears over the preceding months

Our models distinguish between clients in arrears due to reasons outside their control (refer point 2 above), as opposed to behaviour reasons. 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.

Facility-based products such as the credit card and credit facility operate differently. Technically, for these products, we grant the facility to the client when the client is up to date. If the client falls into arrears and then pays up the arrears, where after the client makes a drawdown or a purchase, we legally cannot stop the client doing so. This is a standard feature for credit providers and we estimate the risk of this occurrence when we grant the credit.

4. Capitec's recently amended maximum customer loans policy

Capitec routinely monitors and updates credit policies and systems. The change you refer to had no impact on the risk profile of our book or loans advanced.

Capitec considers it important to place clients in control of their finances and unless there is a compelling reason to disregard clients' wishes, we follow their requests. It is a conservative financial principle to match the duration of funding with the useful life of the underlying item that a consumer finances. Capitec allows clients that prefer to compartmentalise their funding needs with multiple distinct 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. Clients will typically be allowed to access less credit if they take up multiple loans.



5. Branch-level internal controls

Our internal controls are strong and the granting model determines what lending products and amounts could be advanced to our clients.

The extract from an internal communication simply mentioned that the system will automatically assist our staff to inform our clients where the maximum number of loans was reached. This differs from a systems control such as a limitation or restriction.

6. Average number of loan accounts per Capitec consumer

The average number of personal loans and credit facilities has never exceeded 1.5 per client, and is stable.

7. Financial regulators in discussions with Capitec in relation to research prepared by Viceroy

We cannot comment on the regulators' programmes or interactions with the bank. Furthermore, we have never spoken to Graeme Korner of Korner Perspective and therefore have no idea where his information originated.

Yours faithfully

Andre du Plessis
Director