
A marketplace without boundaries 2.0

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Digital disruption in the
South African banking sector



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Contributions

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Executive summary



The South African banking sector is increasingly moving towards a ‘marketplace without boundaries’, shaped by the fast-approaching entry of new digital players challenging the status quo and driving unprecedented levels of innovation. In response, the four universal banks (Absa, FirstRand, Nedbank, and Standard Bank) have continued to pursue large-scale transformation programmes aimed at improving customer experience, digital transformation, new ways-of-working and enterprise-wide cost reduction.

Globally, not all digital banks have delivered on the high expectations raised at their launch. However, those able to develop a clear segmentation model and differentiate themselves have achieved success in some of the most competitive banking markets across the world. They have deployed an agile development approach and established a business model based on monetising customer insights through carefully built communities. We believe digital entrants in South Africa will use this recipe to achieve the same impact in the local banking sector.

The four universal banks are not powerless to address the challenge posed by these new entrants. Unlike their challengers, they have the principal advantage of already serving a sizeable share of the country’s retail and commercial customers. To maintain this advantage, and meet the challenge posed by fast-paced entrants, the four universal banks will need to develop clear innovation strategies and operating models. They will also need to embed a culture that supports agility and measured risk-taking.

Key trends in the South African banking market

In our 2017 report, *A market place without boundaries – The future of banking, a South African perspective*,¹ we outlined three major trends shaping the local banking sector:

1. The emergence of digital solutions with lower-cost models launched by adjacent financial services players
2. The emergence of sector and industry-specific banks, closely integrated with broader supply chains, launched by non-financial services players; and
3. Ongoing transformation of the four universal banks to address changing customer, regulatory and technology needs.

The past year has broadly confirmed our initial view on the changing nature of the sector, although the pace of change has in some cases slowed down. While TymeBank has just recently soft-launched with limited services, the growth of branchless, digital banking is still awaiting the public launch of high-profile players such as Discovery Bank, Bank Zero and African Bank's 'My World' transactional offering. However, the scheduled launches of these banks and their offerings coinciding over the last quarter of 2018 to early 2019,² confirms that the South African retail banking sector will soon experience a significant uptick in competition.

These new digital players are being encouraged by the friendly regulatory environment promoted by the local banking regulator, the South African Reserve Bank (SARB). During 2018, we witnessed the SARB work with the national banking community to assess the application of distributed ledger technology (DLT), as well as drive payments' modernisation through the real-time gross settlements (RTGS) renewal project.³ In addition, the SARB has made encouraging remarks about the creation of a 'regulatory sandbox' designed to test new business models and solutions in a controlled regulatory environment.⁴ These local developments are in

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¹ See Strategy& report, "A marketplace without boundaries", <https://www.pwc.co.za/en/assets/pdf/strategyand-future-of-banking.pdf>

² "6 new banks launching in South Africa soon"; BusinessTech. 23 July 2018. <https://businesstech.co.za/news/banking/260077/6-new-banks-launching-in-south-africa-soon/>

³ "Project Khokha - Exploring the use of distributed ledger technology for interbank payments settlement in South Africa". South African Reserve Bank. 2018. https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/8491/SARB_ProjectKhokha%2020180605.pdf

⁴ Media Statement – 13 February 2018. South African Reserve Bank. 2018. <https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/8259/SARB%20FinTech%20release%2013%20February.pdf>

line with trends already at play in other countries, and are likely to result in more participants entering the local banking market.

The four universal banks in South Africa are responding to this projected increase in competition and innovation through large-scale transformation programmes focused on customer experience, digital transformation, new ways of working and enterprise-wide cost reduction.¹ The full impact of these programmes is still, in many cases, uncertain. However, the pressure to accelerate the rate of change to compete with entrants capable of launching new features every 3 – 6 months remains unabated.

In our 2017 report, we proposed a number of levers that the four universal banks could pull to remain successful and relevant in the future. In this report we focus our attention on the digital entrants threatening to disrupt the South African banking sector, highlighting four imperatives that they will need to address to realise their full potential.

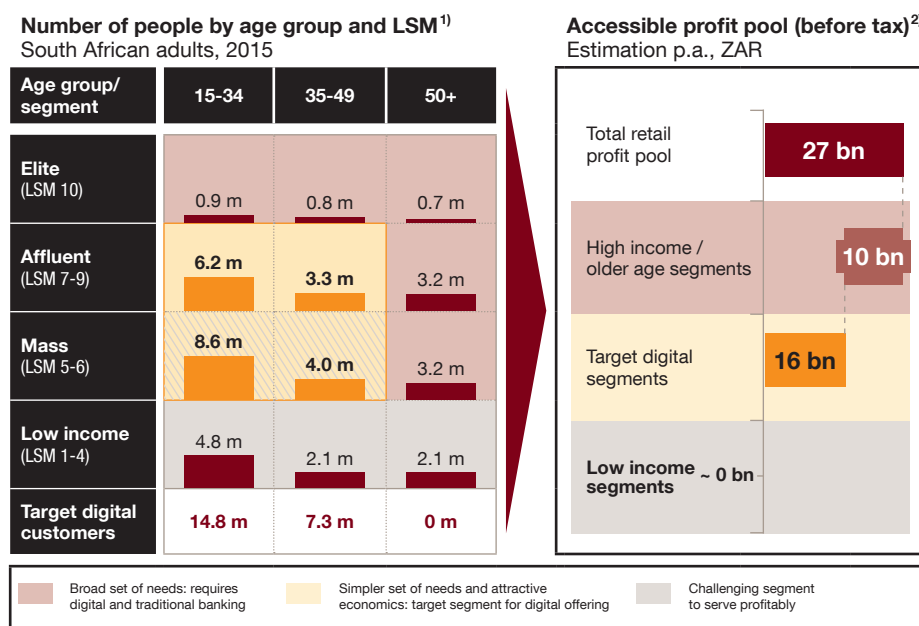
What should digital entrants do to succeed in the South African market?

The last 3 – 5 years have seen a large number of new digital-only ‘challenger’ banks launched globally, with varying levels of success. A closer look at the most successful of these banks, from a customer acquisition and market impact perspective, reveals four common factors necessary to create a scalable, differentiated proposition in an agile manner:

1. Be clear on customer segmentation and differentiation

Almost every financial institution conducts some level of customer segmentation, and can describe, in broad terms, its target market. Many organisations in South Africa rely on a combination of age and wealth, as measured by the living standard measures (LSMs) defined by the South African Audience Research Foundation as their primary segmentation drivers. However, a top-down analysis of the country’s retail market through this lens demonstrates that such a segmentation approach often results in generic segments without the level of customer insight required to develop compelling go-to-market strategies (see Figure 1).

Figure 1: Illustrative segmentation of SA market



Note: 1) Living Standards Measure; 2) Estimation based on annual avg. profit per customer of R2,200 for elite, R880-990 for affluent, R550-660 for mass and R0 for low income

Source: SAARF, AMPS 2016, eighty20 data portal, Strategy& analysis

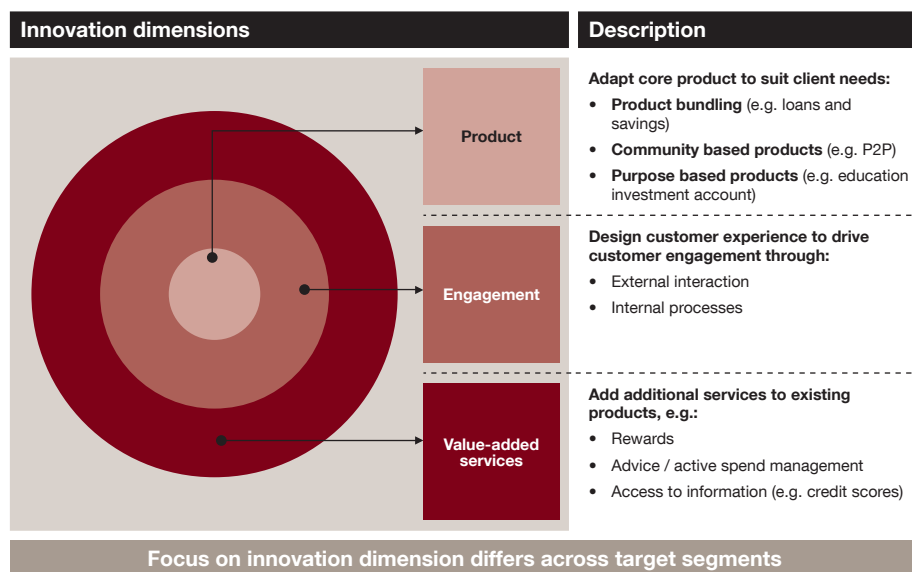
Our experience suggests that digital entrants will have to develop a more comprehensive picture of the South African population, looking at a combination of socio-economic, demographic and behavioural variables to identify discrete segments in which they can offer targeted, relevant banking services. Examples of these variables include income, average bank balance, level of satisfaction with current bank, use of digital devices, affinity with luxury or discount brands, and sources of financial advice.

With an effective customer segmentation approach in place, digital entrants can start focusing on what will differentiate their services from those of existing legacy players. Ultimately, the new entrants will need to have a compelling answer to customers asking why they should move bank account, especially considering the high levels of customer apathy when it comes to switching.

We see three potential dimensions for differentiation from a customer perspective:

1. Product;
2. Customer engagement; and
3. Value-added services (see Figure 2).

Figure 2: Differentiation framework for innovation



Source: Strategy& analysis

Many players first try to establish differentiation at a product level, only to realise that most banking products are already highly commoditised and new features only add to existing complexity. Customers do not necessarily value these new features.

Our experience suggests that successful new banking entrants typically differentiate themselves from a customer engagement and value-added services perspective. For instance, German digital bank, Fidor Bank, prioritises customer relations by using social media to create a community-based service. The company's online community platform enables customers to engage regularly with the bank and each other.

Fidor further offers financial rewards to customers that are more active on the platform, such as increased savings rates for customers who like the bank's Facebook page or cash rewards for customers that found mistakes on the bank's website when it was launched.⁵

Discovery Bank provides a good illustration of a new, local entrant leveraging a market leading rewards programme (Vitality) to differentiate its banking proposition to its mass affluent target market.⁶ Both Fidor and Discovery demonstrate that, with the right differentiation approach, even a simple transactional account can look and feel substantially different to customers.

2. Be agile: Quickly launch minimum viable product (MVP), test and adapt

One of the areas where the digital entrants will be able to establish an almost unassailable advantage over the universal banks is in their ability to launch new solutions in periods of 3 – 6 months. Unconstrained by legacy systems and often built around off-the-shelf, easy-to-customise platforms, digital banks should be able to launch new product features, price plans and channels through a limited number of design, development and testing sprints. This is in sharp contrast to the established players that can often only accommodate a limited number of oversubscribed releases in any given year, with timelines of 12 – 24 months not uncommon to finalise and launch a new product.

To achieve such quick innovation cycles, entrants must be agile and focus on understanding the minimum viable product (MVP) required to test customer adoption of a new feature or solution. The objective is not to launch a perfect product in its final form; instead, agile companies launch a minimum set of attributes required to confirm customer demand and generate initial cash flow, which is subsequently invested in improved releases based on customer feedback. The MVP also allows entrants to start building awareness and hype around their solution as part of a broader 'go-to-market' strategy (more on this later).

The increasingly supportive stance taken by regulators such as the SARB, illustrated by the creation of regulatory sandboxes³ in which MVPs can be tested and refined without the risk of regulatory penalties, is providing further impetus to the adoption of agile test-and-learn approaches. In addition, the advantage that legacy banks, with their large risk and compliance functions, historically had in navigating the complex regulatory environment of a new product launch is slowly being eroded, to the benefit of new entrants.

A good example of a new entrant successfully deploying an agile test-and-learn approach is Revolut in the UK. The digital bank adds new products and features, inspired by customer feedback, to its app weekly. To enhance the readiness of these products and features, Revolut recently announced its Revolut Beta App, available only to 1000 beta testers.

⁵ "Bank with interest rates linked to Facebook likes to launch in UK". The Guardian. 17 September 2015. <https://www.theguardian.com/money/2015/sep/18/bank-with-interest-rates-linked-to-facebook-likes-to-launch-in-uk>

⁶ Discovery Bank website. <https://www.discovery.co.za/bank/join-discovery-bank>

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Beta testers are able to try out new, weekly releases and provide feedback before official release to the entire customer base.⁷

In addition to its agile approach, Revolut challenged the conventional go-to-market strategy by applying for an e-money licence that is faster to obtain than a full banking charter, which takes up to two years.⁸ Although this approach limited the scope of services that Revolut could offer, it allowed Revolut to launch its products to the market sooner than emerging digital competitors.

3. Capture customer data insights from the outset to enable broader platform play

Successful digital entrants have differentiated themselves from established banks not only in how they deploy innovation, but also in their business and monetisation models. Universal banks make most of their money by charging a fee for the banking services they provide, or by making an intermediation margin between loans and deposits. Globally, and particularly relevant for South Africa, traditional bank fees are often perceived to be non-transparent and too high. In contrast, successful digital banks see the provision of banking services such as transactional accounts as simply the means to an end, with transparent and competitive pricing a given⁸ – when services aren't free. Up to the end of 2017, the UK's Monzo Bank made a loss of \$67 (R900 – R1,000) per customer as a result of offering certain services for free, such as overseas cash withdrawals.⁹

The ultimate goal of banks such as Monzo is often to use the knowledge garnered by processing customers' banking transactions to develop unrivalled customer insights, and subsequently use these insights to market a broader ecosystem of products and services (developed in-house or through third parties), and/or to further differentiate their offering from the traditional banking experience.

For instance, a digital bank can combine the knowledge of a customer's assets (e.g., house or car) with their monthly insurance premium payments to proactively identify cheaper insurance offerings. Similarly, a customer with a stable income and spend profile can be targeted with competitive savings and investment solutions based on projected monthly cash flows. Digital banks can even look beyond financial services and offer e-commerce and financial education solutions to their customers based on their socio-demographic profile and transactional behaviour. Although, in theory, traditional banks could also do the same, it requires a 360-degree view of the customer and insights derived from real-time data analytics – an area of focus for most established banks.

By charging a small margin for these ancillary services, successful digital banks should be able to develop a profitable business model, assuming

The ultimate goal of leading digital banks is often to use the knowledge garnered by processing customers' banking transactions to develop unrivalled customer insights...

7 "Harder, beta, faster, stronger: Help us build a radically better Revolut App". Revolut. 12 June 2018. <https://blog.revolut.com/harder-beta-faster-stronger-help-us-build-a-radically-better-revolut-app/>

8 "The Challenger Bank Playbook: How 6 Digital Banking Startups Are Taking On Retail Banking". CB Insights. 8 March 2018. <https://www.cbinsights.com/research/challenger-bank-strategy/>

9 "Britain's digital banks: profitable or just popular?" Reuters. 21 December 2017. <https://www.reuters.com/article/us-fintech-profits/britains-digital-banks-profitable-or-just-popular-idUSKBN1EF1YD>

they maintain a lean cost structure, while providing competitively priced banking services. Looking ahead, Monzo expects ancillary services to be its main source of income. Starling Bank, also based in the UK, expects these services to make up a third of its revenue in the future.¹⁰ Starling offers 'Marketplace', a platform that provides a range of integrated and easily-accessible financial services products. Accessing Starling's customer data through an open application programming interface (API), Marketplace 'partners' can optimise their products for improved impact.¹¹

However, there is a way to go: 'affiliate marketing' margins tend to be low, and scale is key to generate the kind of returns required to ultimately justify billion dollar valuations. As global concerns regarding data privacy grow, digital banks may also need to convince their customers that opting in to sharing their data is truly advantageous.

One way of doing this may be to use a platform play not to monetise customers, but to delight them. Monzo's 'If This Then That' platform allows users to personalise their banking experience by linking actions in their account to triggers in a range of apps and devices. For example, a user is able to set up an 'applet' that adds a track to a Spotify playlist when they spend money at a designated shop.¹²

4. Creatively build hype around product while minimising above-the-line marketing spend

One area where digital entrants can be at a disadvantage against more established players is marketing budgets. For instance, each of the universal banks in South Africa typically spends more than R1 billion (around \$70 million)¹³ every year on marketing alone. New entrants with limited budgets, already stretched to meet technology development costs, cannot afford to compete head-on.

Successful digital banks have overcome this seemingly insurmountable obstacle. Capitalising on growing distrust and dissatisfaction with slow-moving legacy banks, these new entrants focused on building a community of enthusiastic early adopters, often digitally-savvy millennials looking for a banking provider with a 'fresh' identity and cleverly differentiated features. As the product matures and more features are added, this community of early adopters quickly expands through word of mouth until the new entrant reaches scale and prominence at national level.

Monzo provides a good illustration of the potential impact of community-based marketing and engagement. Launched in 2015 as a prepaid card, it started offering a transactional bank account in October 2017. By restricting the initial product launch to prepaid card customers, who would proudly display their bright pink cards to friends and family,

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10 "Britain's digital banks: profitable or just popular?". Reuters. 21 December 2017. <https://www.reuters.com/article/us-fintech-profits/britains-digital-banks-profitable-or-just-popular-idUSKBN1EF1YD>

11 Starling Bank website. <https://www.starlingbank.com/marketplace/>

12 "Monzo's big smart bank move links your money to Alexa, Twitter and pretty much anything else". Wired magazine. 7 June 2018. <https://www.wired.co.uk/article/monzo-if-this-then-that-integration-ifttt-bank>

13 Annual reports of South Africa's four universal banks (Absa, First Rand, Nedbank, Standard Bank)

Monzo was able to create a six week waiting list (and a virtual queue of more than 60,000 people) for their new account.

To further incentivise loyalty and create hype among the target customer base, existing customers were given one 'golden ticket' which they could pass on to a friend to jump the queue;¹⁴ these 'golden tickets' did brisk business on eBay. Monzo was able to reach the 1 million transactional account mark in less than 12 months from launch¹⁵ – something remarkable considering the absence of any material investment in traditional marketing.

Since then, Monzo has continued to build its open and transparent culture: when deciding whether to start charging for international ATM withdrawals, the bank presented the data to its users in a blog post, and asked them to vote for one of four options.¹⁶ As competition from other challenger banks increases, Monzo's "radical transparency" could be a long-term differentiator.¹⁷

14 "What's a Golden Ticket?" Monzo. 6 June 2018. <https://monzo.com/blog/2018/06/06/monzo-golden-tickets/>

15 "1,000,000 people are now using Monzo!" Monzo website. 24 September 2018. <https://monzo.com/blog/2018/09/24/one-million-monzo-customers/>

16 "ATM Fees Abroad: Asking the Monzo Community to Decide Pricing." Monzo website. 13 September 2017. <https://monzo.com/blog/2017/09/13/atm-fees-abroad/>

17 "Transparent By Default." Monzo. 10 March 2017. <https://monzo.com/blog/2017/03/10/transparent-by-default/>

Takeaways for the four universal banks

This report has put forward a bullish view on the potential impact of digital banks in the South African banking market. Having said this, we believe that the four universal banks can, and will, rise to the challenge posed by new entrants, by learning and employing the same tactics that have made global digital banks a real threat to their traditional counterparts.

The first step for the universal banks to compete on an equal footing with fast-paced digital entrants is to develop a clear, enterprise-wide innovation strategy and operating model. We have seen large organisations promoting innovation through a variety of different models, from agile change teams developing core product and process in each business unit, to arms-length incubators and venture funds investing in disruptive innovation (see Figure 3).

Figure 3: Potential innovation operating models

	Core innovation	Adjacent innovation	Disruptive innovation	
	Innovation in business	Innovation factory	Innovation incubator	Corporate venture fund
Innovation objective	<ul style="list-style-type: none"> Empower business to continuously improve existing product, service, process 	<ul style="list-style-type: none"> Accelerate innovation aligned to core business 	<ul style="list-style-type: none"> Create new business models to disrupt core business 	<ul style="list-style-type: none"> Invest in start-ups with long-term strategic value
Innovation priorities	<ul style="list-style-type: none"> Priorities set annually by business heads 	<ul style="list-style-type: none"> Priorities set by designated executive with input from business heads 		
Operating model detail	<ul style="list-style-type: none"> Innovation delivered in business Business owner accountable for initiative and realising benefits Resources in function ring-fenced to execute initiatives Monitoring done through quarterly and monthly reviews 	<ul style="list-style-type: none"> Housed in separate function outside business units, closely aligned to business Led by Executive Initiatives require sponsor Execution done in teams drawn from business units and factory competencies (e.g. big data, analytics, content) 	<ul style="list-style-type: none"> Housed either in separate function outside of business units, within factory Initiatives require sponsor Execution is done through internal or external start-up teams, with support and guidance from incubator resources 	<ul style="list-style-type: none"> Housed in separate function outside of business units or within factory Houses portfolio managers and mentors to provide expertise and access to markets
Innovation scouting	<ul style="list-style-type: none"> Business unit staff in line with priorities 	<ul style="list-style-type: none"> Factory, business units and external partners 	<ul style="list-style-type: none"> Partnerships with start-ups and corporates to create new business models 	<ul style="list-style-type: none"> Through venture capital or private equity firms or own origination
Investment prioritisation	<ul style="list-style-type: none"> Initiatives prioritised based on mini business case completed by initiative or business owner 	<ul style="list-style-type: none"> Initiatives prioritised in stage gates, with prioritisation focused on validation of customer-related hypothesis and market potential 	<ul style="list-style-type: none"> Prioritisation focused predominantly on capabilities of founding team and novelty of idea 	

Source: Strategy& analysis

Our experience suggests that the most effective organisations employ a hybrid model, using a variety of innovation vehicles in a structured manner to pursue core (e.g. related to existing products and processes), adjacent (e.g. untested technologies or new value added services), and disruptive (e.g. new-to-business or new-to-industry) innovation concurrently.

For instance, ING in the Netherlands pursues core innovation through dedicated agile squads in each business unit, whereas adjacent and disruptive innovations are incubated in the International Customer Experience Centre (ICEC), run at arms-length from the different business units.

An enterprise-wide innovation strategy needs to be underpinned by a supportive culture to achieve its desired effect. Successful innovators consistently employ a range of formal and informal levers including vision, structure and performance management. They also use positive tone from the top in communications, to embed a culture that promotes agility, measured risk-taking and innovation across the organisation. Two banks that are employing these levers are ING Bank in the Netherlands and Scotiabank in Canada (see Figure 4).

Figure 4: Examples of innovative ways of working

		ING	Scotiabank
Formal	Vision and values statement	CEO defined ING's purpose as "Empowering people to stay a step ahead in life and business", with innovation at the core of ING's strategic priorities	CEO defined Scotiabank's vision to be "a technology company delivering banking products"
	Reporting structures	Removed siloed ways of work through an \$800m investment in agile transformation and API development	Created Rapid Labs for business and tech teams to solve problems collaboratively in 12-16 weeks
	Recruitment & selection	Changed external hiring to focus on digital skills, with a week's onboarding in call centre	Hiring focused on non-bankers, possessing skills in design, software engineering, data analytics
	Training programmes	Partnered with INSEAD to train 180 executives and 1 200 managers on corporate innovation	Retrained front-line employees in updated financial advisory tools and upgrading branches
Informal	Tone set by senior leaders	Adopted Google peer-to-peer hiring process at senior level to role model innovation, with 14 FTEs reporting to CIO	CEO removed senior executives in the business that weren't capable of adjusting to new digital environment
	Internal communications	Effective top-down communication of successful innovation examples and activities taking place in the organisation	
	Meaningful engagement		Implemented a three-day online forum between employees and management to discuss values and ideas for improving customer experience

Source: Strategy& analysis

Armed with a clear innovation vision, a structured operating model and a supportive culture, large universal banks will be able to accelerate their pace of change and compete more effectively with new entrants. As a result, we project that South Africa's banking sector will become increasingly dynamic and competitive, to the benefit of customers, companies and society at large.

Conclusion

Our 2017 report, *A market place without boundaries – The future of banking, a South African perspective*, highlighted strategies that the universal banks can employ to remain relevant in an increasingly competitive market: taking advantage of scale, driving digital transformation, developing new ways of working and leveraging existing capabilities to ensure value for clients.

Since then, new digital banks have continued to successfully enter competitive banking and financial markets across the world. Their ability to acquire large numbers of customers from legacy bricks-and-mortar banks provides an indication of how the South African banking sector could evolve. Measures taken by the SARB are providing additional impetus for change, through the establishment of a regulatory environment that promotes innovation and competition.

The future of banking in South Africa is dynamic and exciting. Agile new entrants with a differentiated value proposition and a business model focused on the monetisation of customer insights will compete head-on with universal banks reinvigorated by new innovation strategies. Not all banks will succeed in this new environment, but those quickest to adapt will benefit and capture a disproportionate share of the future banking market.

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