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# Liberalisation, Regulation and Provision: The Implications of Compliance with International Norms for the South African Financial Sector

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# Liberalisation, Regulation and Provision

## The implications of compliance with international norms for the South African Financial Sector

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# 1. Introduction

The South African financial sector, described here as the banking, insurance and securities industries, is a sophisticated enclave within widespread financial exclusion. The financial sector is generally regarded as stable and well regulated; indeed it is to the latter that the robustness of the sector has been attributed, in the wake of the Asian and other financial crises.

In recent years the sector has been opening up with greater participation from foreign and niche-seeking domestic firms. There has also been considerable transformation of the regulatory requirements of the sector, demanding greater compliance in terms of corporate governance and transparency. The regulations have also lead to greater equity in terms of regulatory treatment between and within the industries. However, while the recent promulgation of regulatory legislation in each of the industries has resulted in greater compliance with international standards, the adjustment required to meet world-class standards is not yet over. In addition, meeting international standards for compliance and regulation is only one part of the dual pressure facing the sector: the other lies in the growing political and economic imperative to address widespread financial under-provision in South Africa. The report examines the implications of compliance with international trends for greater openness and tighter regulation, within the context of domestic pressures to extend financial services to the majority of South Africans.

The paper begins by sketching the background to the sector, providing a brief overview and highlighting some of the reasons for the importance of the sector.

The paper then goes on to set the scene in terms of the current levels of compliance and regulation in South Africa. In order to facilitate future bench-marking activities with other countries, and to provide a comprehensive view of the current situation, a series of templates or questionnaires for each of the banking, securities and insurance industries was employed. The larger part of the template deals with *policies* in each industry, examining aspects of competition, ownership and regulation. The remainder of the template deals with the *performance* of the sector in terms of prices, quality and access of the poor. Not surprisingly, since most evaluations of the industries to date have focused on the earlier technical type of question, although the respondents had time to examine the questions in advance, the questions on performance were generally poorly answered.

The responses to the questions reveal a commitment by each of the regulators to comply in broad terms, if not in exact detail, with the “Core Principles” set out by their respective international standards bodies. The responses reveal that new legislation (within the past five to 10 years or so) has lead to regulatory equity between foreign and local companies. This leveling of the playing fields has resulted in increased participation of foreign companies, but only in selected market sectors and product types. For example, foreign entrants in the banking industry, to date, have exclusively targeted the public sector, the corporate sector and wealthy individuals. In the insurance industry there is considerably more foreign interest in investment business than in individual life policies. In the case of the securities markets, foreign entrants appear to be interested in investments in blue chip companies rather than newly listed companies. The implications of these trends are further explored later in the report.

The adoption of an internationally accepted regulatory framework that treats foreign and domestic firms equitably is not necessarily synonymous with meeting requests for access from trading partners. Indeed, local regulators argue that some requests from the WTO arena are not harmonious with the guidelines set out by their international standards bodies. This issue, which pushes the debate of compliance into the political realm, is discussed in the second half of section three.

Deregulation and liberalisation of a sector ought to lead to greater competition. In turn, this is associated with greater efficiency and consumer choice, and ideally, with greater equity and access. In section four, changes in the landscape of the financial sector are examined. It appears that while deregulation and liberalisation have lead to greater competition, this has not occurred uniformly across the client base. Some sections of the market are highly contested, others not. The distribution of competitive forces is examined together with the historical reasons for the current industry structure.

In section five, the nature of financial provision in South Africa is examined. A number of different sources suggest that there is widespread financial exclusion of smaller and startup businesses and poorer individuals in the country. Although financial exclusion of some sectors of the population has been highlighted in the press and in parliamentary circles in recent years, access to funding, as well as financing, remains a concern. Access to short term and export insurance, is probably also a concern for less established companies. The report goes on to highlight various initiatives taken in these three industries to attempt to address some of the needs of the unserviced. While there have been some successes, the initiatives have generally affected only a small group of individuals and the fact of widespread underprovision of the majority of the population remains intact.

The report examines the role of foreign entrants and the dynamics that this has prompted within the sector. There appear to be international trends that may prove to inhibit provision of financial services to low income clients. It appears that innovative regulation may be necessary to establish institutions that can facilitate the extension of financial services to a greater proportion of the population.

In the final section, a few themes and possible conclusions are highlighted. The contractual scope of work is discussed and areas requiring further research are highlighted, as are possible future research topics.

# 2. Overview of the Sector

The South African financial sector embraces the banking, insurance and securities industries. This classification includes both those financial service providers seen as intermediaries and those seen as facilitators (White, 2000).

Financial intermediaries are those firms that hold financial assets (such as loans, mortgages, bonds and equities) and issue liabilities (such as deposits, insurance policies and pensions) on themselves, intermediating between their liability holders and the ultimate investments to which their liability holders' funds have been devoted. Familiar financial intermediaries include banks, insurance companies and pension funds. The liabilities of these institutions are important assets for the non-financial business and household sectors.

Financial facilitators facilitate financial transactions between primary issuers of financial liabilities – governments, firms and households - and investors who purchase these instruments (and in whose hands they are financial assets). Stockbrokers, securities underwriters, investment bankers, mortgage bankers and accountants provide this function.

The South African commercial banking system is subject to the same pressures affecting developed banking systems throughout the world, one of which is a merging of different financial functions. While the functional classification is increasingly becoming blurred as firms provide multiple financial services, it remains a useful point of entry in terms of understanding the historical structure of the sector and some of the forces operating on the sector. In addition, it is useful to bear in mind that banks may still be seen as distinct financial intermediaries as they have the exclusive right to the fractional reserve banking system that characterises modern monetary economies. Hence a deposit of a certain value in the banking system can finance loans to a multiple of that value. Simply put, banks can create credit money, which at the same time increases their assets. Since credit creation exposes banks to risk, prudential regulation takes on increased importance in the banking industry.

As has been mentioned before, the financial sector and the banking industry in particular, are regarded as relatively well-regulated, and hence prudential concerns have not dominated recent regulatory changes in South Africa. Rather, compliance along a broad range of issues so as to bring the financial sector in line with international standards bodies appears to have motivated change.

The sector has traditionally been regarded as strategic, as it is the sector through which monetary policy is conducted and hence it impacts on public policy. For this reason, the institutional framework established by the relevant regulators has governed the sector. The 1980s were a period of considerable deregulation and removal of protection on the sector in South Africa. This resulted in a blurring of the distinctions between banks and building societies, and with increasing competition came a phase of rationalisation and consolidation that created the four financial giants, ABSA, Standard, First National and Nedcor, which continue to dominate the financial landscape. In the 1990s two further stimuli continued to contribute to the process of conglomeration: forces leading to 'bancassurance' – the convergence of banking, insurance and investment services - and increasing competition. The impact of these forces is examined in more detail in section four below.

As table 2.1 below indicates, the sector (together with real estate and business services) has taken on increasing importance in terms of its contribution to GDP over the past decade. In the year 2000, the financial sector contributed 20 per cent of the country's economic product. It is with this background, that the regulatory framework in the sector is examined.

Table 2.1 Contribution of the financial sector to GDP

| Year | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|
| Nominal GDP (Rm) | 390 842 | 440 147 | 500 354 | 565 978 | 625 418 | 670 383 | 723 247 | 793 993 |
| Financial sector* (Rm) | 62 861 | 70 491 | 82 162 | 94 116 | 109 601 | 123 370 | 141 929 | 160 954 |
| Financial sector* contribution to GDP | | | | | | | | |
| Per cent (%) | 16.1 | 16.0 | 16.4 | 16.6 | 17.5 | 18.4 | 19.6 | 20.3 |

*Source: SARB Quarterly Bulletin*
**Financial intermediation, insurance, real estate and business services*

# 3. Current Regulatory Framework in the South African Financial Sector

An independent regulator regulates each of the three industries that make up the financial sector. In the case of the banking industry, the Registrar of Banks is the regulatory authority, comprising the Bank Supervision Department of the South African Reserve Bank. In the case of insurance, the Financial Services Board regulates the industry. In the securities market, although the Financial Services Board regulates the industry, the Johannesburg Securities Exchange is the *de facto* daily regulator.

Since the opening of the economy associated with the democratic elections in 1994, the sector has experienced the promulgation of regulatory legislation in each of the industries. This has improved the level of compliance with each of the relevant international standards bodies: the Bank for International settlements (BIS) in Basle for the banking industry; the International Association of Insurance Supervisors (IAIS) for the insurance industry; and, the International Organisation of Securities Commissions (IOSCO) for the securities industry. The recent changes in legislation have resulted in a financial sector that largely meets the existing requirements of each of these regulatory authorities.

The new legislation has resulted in relative equity in the treatment of foreign entrants. For example, prior to the promulgation of changes to the Banks Act in February 2000, foreign banks were prohibited from opening accounts with natural persons unless they were able to deposit a minimum of R1 million. This restriction has now been removed. The Long-Term and Short-Term Insurance Acts of 1998 also wrought changes in the legislation governing the insurance industry which have ensured relative equity in treatment between domestic and foreign firms.

## 3.1 Policy and Performance and the Sector's Response

The discussion in this section is largely the outcome of the Questionnaire Assessing Services Trade Policy and Performance in the Financial Services Industry[1]. The template was used as a questionnaire in interviews with the three regulatory bodies. The full responses to this questionnaire are attached as Appendices 1, 2 and 3.

The discussion here steps through the report, highlighting areas of interest and additional comments provided by the respondents that are not catered for on the questionnaire itself. The questions for each of the industries are broadly similar and are discussed by category. Questions 1 through to 6 deal with Policy and Regulation, while the last three questions examine performance in terms of employment, prices and quality of services.

### 3.1.1 Sector's Response: Market Access

In all three industries, the regulator pointed out that there are no policy restrictions on the new entry of service providers, either for foreign or domestic firms. However, in each case, a company wishing to provide banking, insurance or securities services must meet the requirements set out by the regulator. These requirements generally involve setting up separately capitalised legalised entities and meeting prescribed market conduct and prudential requirements. Domestic and foreign companies are treated similarly.

There are some restrictions on the *legal forms* permitted within the three industries. In the banking industry, foreign banks may open subsidiaries, branches or representative offices. Registered banks operating as branches or subsidiaries may trade fully as banks, whereas representative offices may only play a facilitating and marketing role, and may not accept deposits. Foreign banks prefer to set up branches rather than subsidiaries as branches are given the same international rating as the parent bank. Generally, this is

[1] This questionnaire is based on a template designed by the World Bank, in response to a request from developing countries

higher than the national South African rating, which applies to subsidiaries. As a consequence, foreign banks have established no subsidiaries. In the insurance industry however, only subsidiaries are recognised as legal entities, although legislation to be promulgated in 2002 will allow branches of foreign firms to be legally recognised and hence trade in the country. In the securities market only subsidiaries are recognised as legal entities for all (both domestic and foreign) securities firms.

In terms of cross-border trade, cross border services are permissible, subject to exchange control regulation, but the foreign company must be established locally. For example, foreign banks and insurance companies without any local presence may not advertise their services locally. (Of course the advertisement of these services on the Internet cannot be restricted).

### 3.1.2 Sector's Response: Ownership

In all three industries, both domestic and foreign private ownership of equity in the provision of financial services is permitted. In the case of the securities market, there is no maximum private equity percentage, but in the insurance and banking industries, once private ownership exceeds a threshold of 25 per cent, the company is obliged to notify the regulatory authorities. Private ownership exceeding this threshold has to be reviewed in the public interest and requires approval of the regulatory authority and the Minister of Finance. Institutional rather than private ownership is generally preferred for prudential reasons.

### 3.1.3 Sector's Response: Market Structure

The list of the six largest companies in each of the industries of the financial sector reveals a significant level of concentration. In the insurance industry, the top six companies, in order of size, Old Mutual, Sanlam, Liberty, Forbes Life, First Rand and Fedsure, account for 66 per cent of the total market share of life (long-term) insurance.

Santam, Mutual and Federal, SA Eagle, Hollard and Lloyds account for over 58 per cent of short term insurance (1999 data).

In the banking industry the level of concentration is even higher, with ABSA, Standard Bank, First Rand, Nedcor, BOE and Investec making up 83,2 per cent of the market share (end of 2000).

In terms of state ownership, in the insurance industry, there are three fully state-owned insurance companies. These companies essentially provide insurance services not provided by the private sector, these include: South African Special Risk Insurance Association (SASRIA), which provides riot cover; Khula Credit Guarantee, which provides insurance for finance providers to small businesses; and Home Loan Guarantee Company Ltd, which provides insurance for mortgage lenders to the low income end of the market. (The government also owns the Motor Vehicle Insurance Fund, which is not registered with the FSB, as it is a non-profitable organisation.)

There are 91 private short-term insurers in South Africa, of which 21 are foreign owned. There are 63 private long-term insurers registered in the country, of which 10 are foreign majority owned. The foreign long-term insurers include the Old Mutual Life Assurance Company, which was recently listed on the London Stock Exchange. Foreign participation in the industry is not particularly remarkable, until one separates out the re-insurers in each of the two categories of insurance. Of the 7 short-term re-insurers in South Africa, 6 are foreign owned and *all* of the 6 long-term re-insurers are foreign owned. This penetration of foreign firms in the re-insurance market may be attributed to lack of experience on the part of domestic firms, given the closed nature of the industry prior to 1994, as well as lack of capacity to underwrite the risk. Reinsurance is a global business requiring spreading of risk globally.

By the end of 2000, there were 41 private fully domestically owned banks in South Africa and 15 foreign majority owned banks with branch structures registered in South Africa. In addition, there are 61 foreign banks with representative offices in South Africa.

### 3.1.4 Sector's Response: Regulation

Each industry has an independent regulator, whose head is appointed by the Minister of Finance. In the case of the banks, the Regulator is the Registrar of Banks, who manages the Banking Supervision Department of the South African Reserve Bank. This independent unit was established in 1989 and currently employs over 80 regulatory and prudential staff. The Registrar of Banks allocates banking licenses according to the conditions stipulated in the Banks Act of 1990. This involves the payment of a license fee, submission of a detailed business plan and compliance with the regulations and prudential requirements of the Banks Act. There is no discrimination in the treatment of domestic or foreign applicants for a banking license, however, foreign banks wanting to operate in South Africa must meet the capital requirements without recourse to parent capital offshore.

In the case of the insurance industry, the Financial Services Board (FSB) is the regulator. The FSB was established in 1991 and currently has some 160 employees, however, on the recommendation of the IMF, it is currently expanding its staff to around 185. In order to apply for an insurance license, a company must pay the license fee and meet various prudential and solvency requirements and corporate governance criteria. Again, foreign entrants are not treated differently, but are required to establish subsidiaries rather than branches. There are no government controls on insurance prices, nor are there any state requirements as to the re-insurance that must be ceded to the State, as in other emerging markets and African countries. The dominance of foreign companies in the re-insurance industry suggests the lack of restriction in this market.

The FSB is the regulator of the securities market. However, the Listings and Surveillance Divisions of the Johannesburg Securities Exchange (JSE) perform the day-to-day monitoring of the market. The JSE is licensed on an annual basis by the FSB. The JSE allocates operating licenses to securities firms on the basis of payment of a license fee and presentation of a detailed plan of risk management, together with the meeting of various membership requirements regarding technical competence and capital adequacy. Again there is no discrimination against foreign firms.

In terms of prudential requirements, banks in South Africa must meet a minimum capital adequacy requirement of R250m or 8 per cent of their risk weighted assets. The adequacy requirement is likely to be increased, in line with BIS revisions in 2002, to 10 per cent. In South Africa, the loan classification requirement is 120 days, and the foreign exchange risk exposure of a bank, referred to in South Africa as the net open position, may not exceed 10 per cent of its capital and reserves. The net open position has recently been tightened (from 15 per cent) as from 1 January 2001. While the Lender of Last Resort is available, the Banking Supervision Department points out that this facility is not automatic and certainly precluded where there is suspicion of fraud.

In the insurance industry, prudential requirements differ for the Short-term and Long-term industries. In the case of the short-term insurance industry, the minimum capital requirement is R5 million and a capital adequacy of 15 per cent of premiums applies. In the case of the Long-term insurance industry, a minimum capital requirement of R10 million applies and the capital adequacy requirement is determined by a formula dependent on the activities of the insurer. The insurance industry is also governed by Asset Spread Regulations in terms of the Act. In South Africa, there is no Insolvency Guarantee Scheme in place, although the regulator is considering this. It remains however, ‘a long way away’.

In the securities industry, the capital adequacy ratio differs depending on whether brokers handle clients’ scrip. In essence, the minimum capital requirement is R400 000 if the broker only trades for clients and does not handle clients’ scrip. If the broker handles clients’ scrip then the minimum capital requirement is R3 400 000. Capital adequacy is computed on the following general risk categories: member’s positions, counterparty risk, foreign currency risk and large exposure risk. Generally the JSE’s risk computation factors are more demanding than European standards but its minimum capital requirement is a bit lower. Minimum capital is required to cover 13 weeks overheads and overhead structures of the JSE are cheaper than in Europe.

### 3.1.5 Sector's Response: Regional Integration Agreements in Services

The question deals with preferential regional arrangements, which in this case deals with the 14 member states of the Southern African Development Community (SADC)[2]. In order to facilitate moving towards its general aim of ensuring a sound financial system in the region, SADC works through a series of high-level committees, establishing memoranda of understanding regarding financial services in the regional community.

The Committee of Insurance, Securities and Non-Banking Financial Authorities, CISNA, is a sub-committee of the Committee of Senior Treasury Officials, which, in turn, reports to the SADC ministers for Finance and Investment. Through this body, delegates from other countries in the region regularly visit the South African Financial Services Board, in order to learn from its experiences.

In the case of the securities markets, the SADC countries are working towards common requirements for listings in order to attract foreign investment and to facilitate capital movements by encouraging cross border investments through dual listings. In October 1999 a number of stock exchanges in the SADC region harmonised principles extracted from the JSE listing requirements.

The Banking Council of South Africa provides secretarial services to the SADC Banking Association. The Association was founded in July 1998 with 11 of the 14 countries in the region as active members. All the SADC countries accept and support the Basle regulatory principles and practices, although there are different levels of compliance. The SADC Banking Association reports directly to the Committee of Central Bank

Governors, which meets bi-annually. During 1999, the members of the Banking Association agreed to launch three regional projects:

- The development and implementation of SADC norms of good banking practice;
- The introduction of common money-laundering legislation for the region; and,
- The development of a process to jointly combat crime robberies and fraud.

### 3.1.6 Sector's Response: Past and future changes of policy

This question deals with major policy changes with regards to ownership rules, regulation and entry of foreigners. The details of the changes are shown on the replies in the Appendices, however, it is notable that in each industry, there has been considerable regulatory change since 1985. In the first instance, independent regulatory agencies were established in 1989 and 1991. New legislation regarding the regulation of the industries was promulgated, dealing with, in particular, changes in prudential regulation, market conduct and foreign competition. In the case of the securities market, for example, the changes implemented in November 1995 allowed for foreign participation. Prior to this, membership on the JSE was limited by three conditions: that the member was a South African citizen; older than 21; and not a corporate identity. Foreign membership of the JSE only became possible in 1995 after the new rules of membership where put into place.

In terms of expected new legislation or regulation still to be enacted, it is expected that the trends for tighter regulation and greater access of foreigners are likely to continue. In the insurance industry, the forthcoming Financial Advisories and Intermediaries Act will stipulate the supervision and regulation of intermediaries, while the pending guidelines on conglomerate supervision will provide means for dealing with complex financial entities. In addition, legislation allowing branch business by foreign entities will facilitate greater foreign access to the insurance industry.

[2] The 14 SADC countries are: Angola, Botswana, Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia, Zimbabwe.

In the case of the JSE, the implementation of the new STRATE (Share Transactions Totally Electronic) system for electronic trading, clearing and settlement will ensure guaranteed contractual settlement within 5 days of the transaction. This system, which is already partly implemented, will reconcile daily transactions on a rolling basis, and will obviate what has been seen as ‘failed’ or ‘delayed’ transactions on the exchange. This will do much to address the problem of an ‘unacceptably out of date clearing and settlement system’ (Falkena et al, 2000: 10).

Another fundamental change that may come to the JSE soon is the demutualisation of the stock exchange, which will transform the exclusive members only management structure to that of a company. This cutting of the umbilical cord between members and the exchange should result in a more dynamic and inclusive management style.

### 3.1.7 Sector’s response: Employment

This is the first of the questions that gauges performance of the industry. The employment for the entire financial sector, including banks, non-bank financial intermediaries and the insurance industry is in the region of 200 000 employees (Statistics South Africa, 1999 figures). The latest figures available for the total labour force are from the 1996 census. Employment in the financial sector amounts to around 2.2 percent of the total employment in the non-agricultural sectors. Data for the three individual industries is slightly more difficult to obtain, as the regulators have not seen employment as part of their disclosure requirements. However, as from the year 2000 this will change in the insurance industry.

Around 125 000 people were employed in the banking sector in 1999. This amounts to 2.6 percent of non-agricultural employment[3]. Foreign banks currently employ 711 people.

[3] Based on an estimated non-agricultural labour force for 1999 of 4 801 640. Figure calculated from SARB Quarterly Bulletin, June 2001.

Statistics SA estimates that the insurance industry employs 64 000 people, down in 1999 from 78 000 in 1998. The regulator suggests that this decline may have to do with recent take-overs, foreign competition and rationalisation.

### 3.1.8 Sector's Response: Prices and Performance Indicators

This is the most poorly answered question of the template. The regulator in each case stressed that there was no control of prices or charges, and hence there was little official monitoring of charges. Respondents also suggested that it was difficult to answer questions regarding the 'average' insurance policy or the 'average' charges on a checking account, as this requires additional definitions not provided in the template. The JSE was able to provide average figures for brokerage commissions, but stressed that these prices were negotiated with clients.

As to the non-performing loans as a percentage of total bank assets, this amounted to around 3.5 per cent.  The loss ratio for the short-term insurance industry is around 75 per cent of premiums. Insurance companies with even higher loss ratios can continue to make a profit on the basis of their investments.

### 3.1.9 Sector's Response:<br>Quality and Access to Financial Services

Foreign ownership in the financial sector now amounts to around 30 per cent of all banks, 23 per cent of all short-term insurers and 16 per cent of all long-term insurers (including the figures for re-insurers). The share of foreign listed companies in the total stock market capitalisation of the JSE amounts to 38 per cent (including SA companies recently listed abroad). While there has been foreign entry of firms in each sector, this has been limited in terms of range of services and the target client base.

In the insurance industry, for example, foreigners provide neither private health insurance nor private pension insurance, but are now dominant in re-insurance. New entrants in the life insurance industry are applying to engage in investment business only, and not provision of life insurance policies. Similarly, foreign banks have provided neither ATM networks nor debit cards, but do provide credit cards and online banking. In the securities market, foreign interest is limited to the top 40 counters. Throughout the sector, there been no foreign interest shown in provision of services to poor and rural households.

## 3.2 Regulatory Harmony versus WTO Compliance

A recent report on regulation in the financial sector in South Africa (Falkena et al, 2000), suggests that there are a number of outstanding regulatory concerns. They include private sector issues, such as the need for better standards for corporate governance and accounting and disclosure requirements. The public sector concerns raised by Falkena et al touch on co-operation between non-bank supervisors and the Reserve Bank, accountability of the regulators, and home and host regulatory co-operation in dealing with complex financial groups, such as the Old Mutual. While these aspects are not raised in the questionnaire, are not discussed further here, this list suggests that the regulatory framework of the financial sector is not yet finalised.

Nonetheless, the responses to the template described above, seem to suggest broad harmonisation with the industry's international regulatory standards. However, there are a couple of outstanding issues; these arise mainly because of exchange controls in South Africa and the negotiating position of trade partners in the forum of the World Trade Organisation.

The issue of exchange controls is pervasive in its effect on the financial sector. Liberalisation of the financial account of the balance of payments and relaxation of exchange controls would allow for unrestricted cross-border financial flows. Hence there would be greater scope for foreign exchange dealing and long-term borrowing and investment abroad, hence increasing the exposure of the country in terms of capital outflows. While foreigners are exempt from exchange control, there is apparently a perception that exchange control legislation could be re-instated on foreigners and hence potentially place restrictions on future outflows. Domestic firms see exchange control as a constraint on their ability to invest abroad and create the best spread of assets.

Exchange control restrictions have been relaxed in recent years for both domestic individuals and companies, although this impetus has slowed in the latest budget. Some commentators have seen the recent recall of the asset-swap facility, which was widely used by the corporate sector as a mechanism to gain foreign assets, as a regressive step.

Be that as it may, the existence of these controls means that while cross-border transactions are permitted, they are restricted. It is estimated that there is something in the region of R20 million in blocked rands still outstanding and a forward cover book of US $ 10 million, which underlines the dangers of a 'Big Bang' approach to lifting exchange controls. Nonetheless, there remains considerable pressure to lift the controls as soon as possible. The insurance industry, for example, maintains that lifting of exchange controls is essential to allow for adequate portfolio diversification.

The integration associated with greater liberalisation of exchange controls is likely to lead to greater exposure to the foreign sector. This suggests that the analysis of the macroeconomic impact of liberalisation needs to take into account the potential for financial vulnerability. The recent experience of other emerging market economies has raised concerns regarding the consequences of financial vulnerability associated with the unfettered exposure to financial flows. An evaluation of the countries at the time of the East Asian crisis, for example, reveals that those countries most affected were most exposed to possible withdrawal of financial capital (Hawkins, 2000). This issue remains both a political and technical one. Lifting exchange controls needs to be accompanied by careful consideration of the regulatory structures necessary to minimise the vulnerability that comes with openness to financial flows.

The predominant concern regarding requests from trading partners, apart from removal of all restrictions on cross-border trade, appears to relate to capital requirements that deny foreign entities the ability to include the capital of their head office in meeting local capitalisation and liquidity requirements. The requirement for locally capitalised entities means that foreign entities holding capital in South Africa potentially face currency risk. It is argued that this process ignores the security provided by the support of the parent company. The suggestion is that the parent company would not allow a branch to go into liquidation for fear of loss of credibility. The Citibanks of this world would claim that the capital of the whole bank is available to meet the obligations of each and every branch, and therefore do not see why they should put part of their capital in a branch. They balk at meeting local solvency requirements as there are advantages to having the capital sitting in New York and allocating it variously around the business according to a changing risk profile.

The issue of local capital requirements also affects prudential limitations on foreign exchange exposure. In South Africa all banks are restricted in the size of their foreign exchange position, or net open position. The limitation currently amounts to 10 per cent of the capital reserves, and in the case of foreign banks this percentage refers to 'local' capital rather than the capital of the whole bank.

Because branches of foreign banks are regarded in South Africa as entities to be regulated in their own right, foreign banks complain that they suffer duplication of regulation. Parent banks have to meet home liquidity requirements at the same time that branches have to meet the host requirements defined in South Africa. This has lead to pressure on South Africa to change these regulations that are seen by foreign banks to raise their costs in a discriminatory way. In response, the South African Reserve Bank maintains that its stance on this issue adheres to the Basle Core Principle ensuring that banking entities are adequately capitalised on both a consolidated and a solo basis. A source in the IMF confirms that this is common practice elsewhere in the world, even in the US.

The response of the South African Reserve Bank suggests that the demands of trading partners requires more of the local regulators (as they argue it) than is required of them by their international standards bodies. This pushes the debate into the political realm, as further concessions require political decision-making.

Still requiring analysis and evaluation is the degree to which South African financial entities are likely to use the WTO forum as a means to facilitate access to other trading nations, and the possibility of exporting financial services. In particular, it may be necessary to establish the degree to which domestic firms requiring access to foreign markets are themselves prohibited by regulation that is not in accordance with either Basle or WTO standards. These aspects of trade in services are not dealt with in the questionnaire.

# 4. Competition, Efficiency and Access

Increasing competition in a sector is generally associated with lower prices and cost-reduction, elements that lead to greater cost-efficiency and hence better performance of the sector. Ideally, increased competition should also lead to greater equity and consumer access. The purpose of this section is to highlight some of the trends brought on by increased competition in the industry. The landscape of the industry is examined, followed by a discussion on the distribution of competition across the client-base. The discussion concludes with an overview of the structure of the sector and likely future trends.

## 4.1 Impact of Competition on Market Share

Table 4.1 provides an overview of some of the headline changes in the banking sector. The value of industry assets has more than doubled in nominal terms between 1994 and 2000, which is reflected in the increasing contribution of the sector to GDP.

Table 4.1: Changes in the South African Banking Industry

| | 1994 | 1999 | 2000 |
|---|---|---|---|
| No of fully registered banks and mutual banks<br>• *plus* Branches of foreign banks<br>• *plus* Foreign Representative offices | 37<br>6<br>40 | 44<br>12<br>57 | 44<br>15<br>61 |
| Market share attributed to foreign and niche banks | 7% | 14% | |
| Number of ATMs | | 7600 | 8027 |
| Number of employees in sector | 194 111 | 204 071 | 194 924 |
| Sector contribution to GDP* | 16% | 19.6% | 20.3% |
| Total banking industry assets | R323.5m | R694.7 m | R766.8m |

*Financial intermediation, insurance, real estate and business services

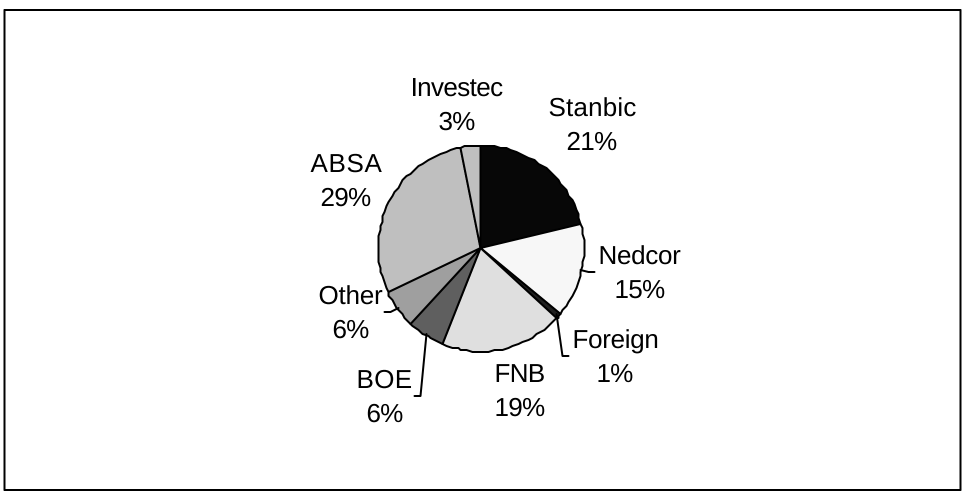
Source: SARB Quarterly Bulletin; Registrar of Banks Annual Reports

Table 4.1 provides a sense of the increased foreign participation in the banking industry over recent years. There has been an increase in both the number of foreign bank branches opened and the number of representative offices (which may market their services – but not accept deposits). The number of new niche banks has also increased. Together, these two categories of banks made up 14 per cent of market share in 1999, double the market share attributed to them in 1994.

The data for number of employees relates to banks, insurance and securities firms and the data for the sector contribution includes real estate and business services. The increase in sector contribution to GDP, together with an employment increase is gratifying, although the decline in employment in the year 2000 from 1999 reverses this trend. The decline in the number of employees over the past year has to do with closure of bank branches and rationalisation in the insurance industry. The number of employees in the sector has fallen, at the same time that the number of ATMs has increased.

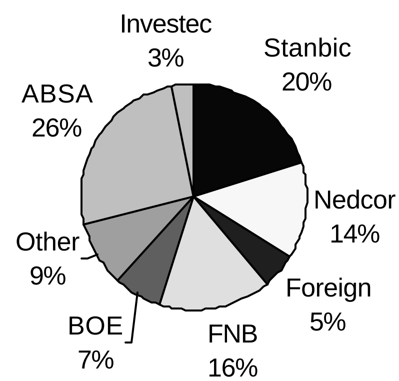
The pie charts, Figure 4.1 and 4.2 below, provide some insight as to how the market share of South African banks has changed over this period.

Figure 4.1 Market share in SA Banking Industry - 1994




Source: Banking Council Annual Report 1998

Figure 4.2 Market share in SA Banking Industry - 1998




Source: Banking Council Annual Report 1998

While the pie charts reveal the increased market share won by small, niche banks and foreign banks, the four major banks remain the dominant players. In 1994, the four major banks made up 84 per cent of the market, but by 2000; this had slipped to just over 70 per cent. The shift away from the 'big four' is likely to comprise corporate and wealthier clientele, as these have been the target markets of 'other' banks and the foreign banks. (Until recently, foreign banks were restricted to the upper income end of the scale as they were prohibited from opening accounts with natural persons with deposits less than R1 million.)

Domestic banks, meanwhile, have recently begun to compete for the low-income market with informal micro traders, who have the advantage in lower costs and better local knowledge. Some niche banks (like African Bank) have been targeting low income, formally employed, individuals previously excluded from financial provision. This accounts for some of the increases in the market share of 'Other' banks and the maintenance of the share of the big four. Commercial banks operating in this market operate by setting up debit order facilities that ensure repayment. While the entry of commercial banks into the low-income market provides more choice for those formally employed, there is little improvement in the options available to those in informal employment, including taxi drivers, gardeners, construction workers etc.

Table 4.2 shows the changes in interest income over the past three years. While the interest margin to loans and advances and total assets has remained relatively stable, the interest margin has increased as a proportion of gross interest income. This implies that interest expenses have fallen, as can be seen in the ratio for interest expenses to total assets.

Table 4.2 Changes in Interest income and expenses

| | 1998 | 1999 | 2000 |
|---|---|---|---|
| Interest income as % of loans & advances | 17.7% | 15.7% | 12.5% |
| Interest margin as % of loans & advances | 4.1% | 4.2% | 4.1% |
| Interest margin to gross interest income | 18.8% | 22% | 27% |
| Interest margin to total assets | 2.9% | 3.0% | 2.9% |
| Interest expenses to total assets | 12.7% | 10.3% | 7.8% |
| Total banking industry assets | R611.5m | R694.7 m | R766.8m |

*Source: Registrar of Banks, Annual Report, 2000*

## 4.2 Distribution of Competitive Forces and Efficiency

The South African financial sector displays considerable concentration of economic power, with a handful of dominant firms in each industry. However, this is not to say that there is a lack of price competition in the market. Certainly, some market segments are fiercely competed. The public and corporate sectors and high-net value individuals are actively solicited with competing bids from foreign and domestic firms.

Since the opening of the economy in 1994, competition from international companies has grown. The growth of the market share of niche and foreign banks since 1994, shown above, may under-represent the extent to which business is being shifted to foreign banks, with transactions such as corporate finance not reflected on the balance sheets of banks (*Financial Mail*, 1998: 395).

In its 1998 Annual report, the Banking Council summed up the outcome of the increased competition:

*'The additional competition created by the entry of the foreign banks has provided clients with greater choice. It has spurred all the banks to improve cost efficiencies and develop new products. It has also compelled them to stop cross-subsidising less profitable business'.*

The measurement of efficiency in the financial sector appears to stem from the theoretical view that in a perfect world with perfect information flows (and presumably perfect foresight); capital would be allocated to the most profitable and productive projects. In such a world, financial intermediation would be unnecessary, as firms would be able to raise capital from investors directly. Financial intermediation and facilitation hence only exist because we live in an imperfect world where there is uncertainty and information asymmetry, which to some extent can be reduced by those firms that specialize in evaluating risk and performance (Feeney, 1995). Given the perfect world model of allocative efficiency, any process or innovation that improves the allocation of financial resources ought to be positive. Included in this would be the reduction of the costs of bank intermediation, or an improvement in banks' cost efficiency.

In the banking industry, cost-efficiency can be determined by expressing operating expenses as a percentage of total income. Currently, the international benchmark for efficiency is 60 per cent, meaning those banks having a ratio higher than 60 per cent are regarded as inefficient. The cost-to-income ratios of the South African banks have been declining since the mid-1990s. In 1999, of the four largest commercial banks, ABSA had the highest cost ratio of 63.3 per cent and Nedcor the lowest, at 51.7 per cent. In the aggregate, the banking sector recorded a cost efficiency of 62.7 per cent by the end of 1999 and 62.5 per cent in 2000; some five-percentage points lower than that achieved in 1997 (Registrar of Banks, 1999, 2000). These ratios include the costs associated with crime prevention and the costs of crime. In 1998, these costs exceeded R1 billion.

While increased competition does appear to have had the expected impact on cost-ratios or cost-efficiency in South Africa, the benefit of competition appears to have been unevenly distributed. Highly contested sections of the market enjoy lower interest rates and unsolicited offers of credit, while lower income sections of the market remain disadvantaged. A level of opaqueness, in terms of the conditions offered to high-worth clientele and those offered to lower income individuals, continues to exist.

Part of this is due to the lack of foreign participation in the low-income market. In the insurance industry, for example, foreigner insurers provide neither private health insurance nor private pension insurance, but are now dominant in re-insurance. New entrants in the life insurance industry are applying to engage in investment business only, and not provision of life insurance policies. Similarly, foreign banks have not moved into the retail market, citing high entry costs and crime as factors keeping them out of the market. Hence in spite of the minimum deposit regulation being removed, the likelihood of foreign banks changing their target market substantially is small. In the securities market, foreign interest is limited to the top 40 counters.

While cost-efficiency is often used as a prime evaluator of industry, it remains only one possible measure of performance and other issues need to be considered. As has been suggested above, cost-cutting efforts by banks may not make them more efficient in terms of extending services for those on the margins of financial provision. In this context, it is important to ask 'More efficient for whom?' While there may be greater competition for well-heeled clientele, others less fortunate, and indeed more dependent on finance, may be gradually excluded from formal financial activities. A more comprehensive way of evaluating the performance of the sector would be evaluate it in terms of a broader concept of efficiency that includes, provision and access to services, as well as cost-efficiency.

This issue of provision of services to the large sector of the population excluded from financial services needs to be explicitly addressed if it is to improve. This issue is taken up below, where it is suggested that innovative approaches to regulation that not only maintain the stability of the financial sector, but also reduce widespread financial exclusion of lower income groups, need to be considered.

## 4.3 Liberalisation, Provision and Structure of the Industry

The report has examined the consequences of liberalisation and the entry of foreign firms for competition within the sector. It appears that while the competition for high income and corporate clients has increased, foreign entrants do not appear to be interested in the low-income market. Crucial to understanding the change in the financial sector over the recent years is the parallel process of democratisation. Since 1994, there has been an increase in the number of domestic banks willing to offer services to those in formal employment who were previously unbanked. To a large extent, the servicing of the client base in South Africa has reflected political hegemony, and with the advent of democracy, provision of services to low-income individuals has become more pertinent.

In the banking sector, competition from both foreign entrants and new niche banks does not appear to have affected the level of concentration in the industry, a situation that has existed for most of the previous century. The concentration in the industry can be seen as the consequence of both regulation and competition (Skinner and Osborn, 1992). Given the industry's perceived strategic role in the implementation of public policy, it has been rigorously regulated. The regulators have played a dominant role in determining the structure of the industry, in terms of admission of new entrants and the operation of existing firms.

Throughout the history of the sector, when the entrenched banks have been threatened by competition, say from new entrants, building societies or other non-bank financial intermediaries, the response has been to seek agreement with or purchase of the competitor. Hence it appears that competitive forces have not been associated with an increase in the number of providers. This response is hardly unique to the South African financial sector. Indeed, the process of financial conglomeration, often associated with increasing levels of concentration in the sector, appears to be associated with the challenges of deregulation, intensifying competition and financial innovation - the world over (Gardener, 1990). The historical income and wealth disparities in South Africa, which have contributed to widespread financial exclusion, however, make the consequences of financial conglomeration more challenging than in countries that have more equitable income and wealth distribution.

The following section examines how the industry is currently responding to the dual challenge of foreign entrants poaching wealthy clients and the calls for greater inclusion of those currently unbanked.

# 5. Financial Provision and the South African Financial Sector

South Africa's financial sector may be seen as a developed financial enclave surrounded by large areas of financial under-provision. The developed banking sector has largely served the needs of the public sector, the sophisticated business sector and the well-off (predominantly white) individuals. The insurance and securities markets have also largely remained the preserve of the wealthy.

There is widespread agreement that a large sector of the South African population is financially excluded from banking services. A recent report from the largest commercial bank (ABSA, 1999) suggests that only 20% of the country's economically active population of 16.5 million have an 'active banking relationship'. Data on the degree of service provision to different population groups or even different regions are not publicised, either by the four dominant banking groups or by the Reserve Bank, and so the extent of financial exclusion remains estimated. There is currently no legislative requirement regarding disclosure of credit extension, for example, and this is regarded as competitive information and closely guarded. The Home Loans and Mortgages Disclosure Act came into force in December 2000. At the time of writing (August 2001), the regulations governing the mortgage disclosure requirements had not yet been drafted, and the banks continue as before, arguing that they have no disclosure guidelines.

In the case of the insurance industry, there is no data available regarding the share of households covered by life insurance contracts. In a special survey conducted in 1995 by the Central Statistical Services (now Statistics South Africa), it was found that a very small portion (3.3 per cent) of total expenditure of the average household was on insurance. Households in the lower income brackets spent only 0.3 per cent of their income on insurance (mainly funeral policies) and wealthy households spent on average 4.3 per cent of their income on insurance products (Registrar of Long-Term Insurance, 1999: 8). The following section highlights the degree of financial exclusion in the country.

## 5.1 Access to Financial Services

In the absence of data from official banking sources, the annual survey data published by the South African Advertising Research Foundation (SAARF) on the use of financial services and products provide a sense of the degree of financial exclusion. This survey is based on a cross section of the adult (older than 16 years) population. Over the past five years, the survey has involved a sample of between 14 600 and 29 300 respondents. The data for financial services are shown here by the SAARF Living Standard Measure classification, which is briefly summarised in Table 5.1. The Living Standard Measure classification is based primarily on monthly income.

Table 5.1 South African adult population by Life Style Measure

| Life Style Measure Group | Adult Population | | Ave. Monthly Income in 1998 | Proportion with a savings account |
|---|---|---|---|---|
| | Millions | Per cent | Rand | Per cent |
| ***TOTAL*** | ***25.7*** | ***100*** | | |
| LSM1 | 2.1 | 8.1 | 670 | 2 |
| LSM2 | 2.5 | 9.9 | 700 | 10 |
| LSM3 | 3.0 | 11.7 | 852 | 16 |
| LSM4 | 3.6 | 14.0 | 1033 | 24 |
| LSM5 | 3.8 | 14.8 | 1491 | 32 |
| LSM6 | 3.7 | 14.4 | 2328 | 57 |
| LSM7 | 3.6 | 14.0 | 5071 | 71 |
| LSM8 | 3.4 | 13.2 | 9274 | 78 |

*Source: South African Advertising Research Foundation. All Media and Products Survey*

The data show that access to financial services –indicated here as access to a savings account – improves with higher income. The data show there is widespread and comprehensive financial exclusion of the lower living standard measure groups, with over half of the population, as represented by LSM groups 1-5 (some 58% of the population), having very little exposure or access to formal banking. In LSM group 1, access to any formal banking service is unlikely, although some people in this group may belong to *stokvels*, or community savings association, which are in widespread use, apparently as a consequence of financial exclusion.

Only for the LSM groups 6-8, do over half of the respondents have savings accounts. Savings accounts are generally thought of as the entry-level product to banking services. Nonetheless, the very poorest adults are completely excluded from holding even these accounts. The poorest adults are likely to be formally unemployed, and may be involved in subsistence agriculture. The average figure for each LSM grouping provides a sense of the degree of exclusion from even entry-level financial accounts.

In Table 5.2 the average exclusion for a range of banking products surveyed, is given. The five-year average for all LSM groups is shown. ATM card use appears to have increased since 1995, but use of other services has remained largely unchanged. The reasonably stable access to financial products over this period is probably accounted for by some banks claiming thousands of new customers per month (as a consequence of new ventures to attract low income customers, discussed below), while others reported large numbers of clients closing their accounts following increases in administration and transaction fees (Banking Council, 1998a). On average, over the five years, less than 40 per cent of the population has had access to savings accounts. More than half of those with savings accounts have ATM cards. Access to cheque accounts appears to be restricted to less than 10 per cent of the population, almost exclusively in the highest income brackets (LSM groups 7 and 8).

Table 5.2 Financial exclusion by financial product

| Per cent of population with access to financial services | | | | | |
|---|---|---|---|---|---|
| All LSM Groups | ATM Card | Cheque a/c | Credit card | Loan | Savings a/c |
| 1995 | 22.8 | 9.1 | 5.3 | 3.2 | 38.2 |
| 1996 | 24.9 | 9.5 | 5.5 | 3.2 | 37.7 |
| 1997 | 25.6 | 9.4 | 5.3 | 2.4 | 35.8 |
| 1998 | 25.5 | 9.0 | 5.1 | 3.0 | 38.5 |
| 1999 | 31.7 | 8.9 | 5.2 | 3.0 | 37.0 |
| ***Average level of provision*** | ***26.1*** | ***9.2*** | ***5.3*** | ***2.9*** | ***37.4*** |
| *Average level of exclusion* | *73.9* | *90.8* | *94.7* | *97.1* | *62.6* |

*Source: South African Advertising Research Foundation. All Media and Products Survey*

The data presented above suggest that the formal banking sector does not adequately provide for the financial needs of the majority of the South African population. It might be argued, however, that, while the data above give us some sense of the level of services, we cannot assume that this level is supply-constrained. But there is good reason to suggest that there is indeed widespread exclusion and unmet demand for financial services and credit extension. Two issues lead in defence of this position. Firstly, there appears to be widespread use of the informal financial services available to the excluded. Secondly, it appears to be a characteristic of marginalised borrowers that they display a high degree of insensitivity to interest rates (Yaron, 1994: 34). In the South African case, there is evidence that the need for liquidity overrides price considerations, as the high price differential between formal and informal institutions shown in table 5.3 indicates.

Most of the alternatives available to the excluded are informal savings and loan schemes. Until recently, a banking licence has been required to take deposits, although lending has not been similarly regulated. The recent amendment of the Usury Act has allowed exemptions to the law regarding deposit taking where organisations can show the ‘common bond’ principle (Banking Council, 2000:10). In this case, a banking licence is not required to take deposits. Among those exempt are the community savings and credit groups, known as *stokvels*.

A *stokvel* is the colloquial term for community savings groups or rotating credit and savings associations (ROCSAs), and are a traditional mechanism by which a group of people save for some specified event or celebration. The average profile of a *stokvel* is a group of 8-10 women who pledge their mutual support to attaining some financial objective (Collair, 1992). Such groups tend to exist for a year at a time, with difficulties experienced in keeping groups together beyond this time. *Stokvels* are seen to provide speedy, accessible financial assistance in emergencies. Banks have provided some back-up to these community savings groups by opening group accounts, which are common, particularly in the urban centres.

While *stokvels* are seen as 'the first step on the ladder to more formalised services' (Banking Council, 2000: 10), formalised alternatives are likely only to be accessible when members have become formally employed. There is no suggestion of formal banking institutions using regular membership of an informal scheme such as a *stokvel* to evaluate individual creditworthiness of borrowers.

The sources of credit to which the financially excluded have recourse are likely to be more expensive and are largely unregulated (Kempson & Whyley, 1999:2). These sources of credit are generally referred to as micro-lenders that provide small loans for a range of needs, and do not traditionally take deposits. The absence of legislative barriers to entry for the loan market has contributed to the mushrooming of micro-lenders of various stripes in recent years. In 1997, an estimated 30 000 small and micro-lenders were active in South Africa (ABSA, 1999).

An exemption in the Usury Act of 1992 provides for the possibility of micro-lenders in South Africa to become formally organised and registered. Formal micro-lenders are registered with the Micro Finance Regulatory Council (MFRC), and as a consequence, will be exempt from the Usury Act, allowing greater freedom to charge higher interest rates (although the capacity of the state to ensure that those practitioners that do not register only charge an interest rate of up to 33% p.a. is somewhat unrealistic). Those practitioners registered with the MFRC may charge up to a cap of ten times the prime interest rate. Since its inception in 1999, some 5 380 micro-lenders have registered with the MFRC (MFRC, 2000). Both the formal and informal micro-lenders use a host of mechanisms to ensure repayment, and local knowledge and threat of coercion are not unheard of. Formal micro-lenders tend to restrict their clientele to the formally employed, using payroll deduction facilities to ensure repayment.

Table 5.3 shows the range of interest rates charged by formal and informal institutions. The rate for informal lenders is an industry estimate (*Mail & Guardian*, 1999).

Table 5.3 Interest rate charges of formal and informal lenders

| As at January 2001 | Interest rate charges |
|---|---|
| Commercial banks: Prime interest rate | 14.5% p.a. |
| Commercial banks: Rates on installment sale agreements | 16.18% p.a. |
| Registered Micro-lender (e.g. Nubank) | up to 145% p.a. |
| Unregistered Micro-lender | > 145% p.a. |

*Source: South African Reserve Bank Quarterly Bulletin, Nubank, MFRC*

The widespread use of micro-lending services, in spite of the high charges by both registered and unregistered micro-lenders, suggests a high degree of unmet demand.

The exclusion of low-income groups is a complex issue, and involves not only banking practice, but also attitudes of borrowers. The excluded cohort lacks exposure to financial institutions and may fear the bureaucracy involved. These are issues that arise even in mature economies such as the US and the UK (Kempson and Whyley, 1998). In the South African context, illiteracy is also likely to contribute to financial exclusion. In addition, the identification of the financial sector with white hegemony may contribute to lack of trust in the banking sector and contribute to what is perceived as an 'alienating and unsympathetic' environment (*Business Day*, 2000).

## 5.2 Response of the Formal Financial Sector

It is estimated that the micro-lending industry provides between R5.7 billion – R15.5 billion in advances per year (*Mail and Guardian*, 1999). This makes the micro-finance market potentially lucrative. At its largest, micro-lending represents close to 3 per cent of the extension of credit to the private sector in South Africa (R533 billion in 1999) and 6 per cent of the extension of credit to households (R262 billion in 1999) by the formal monetary sector (South African Reserve Bank Quarterly Bulletin, December 2000).

In order to provide for those excluded from formal finance, new affiliates have been established to meet the needs of lower income groups. Standard Bank, for example, launched E Bank, which aims at providing a simplified set of saving and transmission products to low-income clients using modified ATM technology. It is this technology, which won E Bank a Smithsonian award for innovation in 1997. E Bank has attracted some 1.4 million clients since the mid-1990s (Paulson and McAndrews, 1998:21).

While E Bank has focused on payment and saving facilities, ABSA has launched Nubank, which provides small loans to the formally employed. Nubank is a registered micro-credit provider, utilising payroll deduction methods, with employers playing an intermediary role. The relatively small loans (the largest single loan is R12 000) are predominantly consumer loans for consumer durables, but may also include loans for education expenditure and home improvements.

South African banks have also developed new methodologies by which to categorise clients. South Africa's history of denying the vast majority of the population ownership rights has meant that financial provision based on fixed collateral has automatically led to financial exclusion of this majority. It is only since the formal banking sector has shifted its creditworthiness criterion to formal employment, that some of the excluded have been re-categorised as potential borrowers. The criterion of formal employment allows for repayment by means of payroll deductions. Pension funds, rather than fixed property, are used as collateral (Banking Council 2000: 13).

However, the forays into the low-income market by commercial banks have had mixed success. There appear to be three requirements for success in the low-income market, low overheads, a close relationship with clients and rapid follow-up in the event of default. The world over, formal banking attempts to provide for the poor have generally been difficult, unprofitable and largely unsuccessful (Yaron, 1994: 32). This suggests that the lending technology of formal banks may be inappropriate when extended to the previously excluded. In the case of Nubank, for example, even with formal wage deductions facilitating repayment, default is still higher than desired. The prohibition of further payroll deductions from public sector employees in February 2000 by the Minster of Finance, disrupted both registered and unregistered micro businesses. Nubank's activities are still being evaluated for their profitability by its parent, ABSA.

E Bank has taken a number of years to break even, and its pilot loans of R500 are still making a loss. Extension of mortgages to the previously excluded has also led to disappointment, with in excess of 50 000 properties in receivership (Tucker, 1999:13).

While the use of pension funds, rather than fixed property, as collateral has been innovative, it also potentially raises other concerns. While all assets may vary in value, the possibility that the value of pension funds is more variable than fixed collateral also raises the possibility of increased fragility of the banking sector as it continues to venture into this market.

The re-evaluation of the client base in terms of formal employment has meant that the most excluded group remains the unemployed. Even African bank, which deals exclusively with the low-income market, has not yet offered loans to those in informal employment. Banks acknowledge their refusal to open accounts for the unemployed (Banking Council of SA, 1998). The high level of formal unemployment in South Africa, estimated at around 30 per cent of the economically active population, underlines the problem of basing financial provision on this criterion. A large cohort of financially excluded remain.

Start-up businesses are likely to be denied access to financial services, particularly loans. Generally, the literature discriminates between small enterprises with an annual turnover of R150 000 to R20 million and micro-enterprises with turnover of less than R150 000. Small enterprises are more likely to be part of the formal economy and potentially employment generating. They are also potentially part of the fringe of potentially eligible borrowers served by formal banking institutions. The micro- enterprises are more likely to be survivalists, and remain in informal trading and services. Worldwide, large banks are seen to have little incentive to serve small informal clients (Steel and Aryeetey, 1994:37). Generally, banks in South Africa do not see their role as serving this sector of the population. The lack of collateral or security is stressed as a particular problem in terms of loans to micro-enterprises.

> *'There is a huge difference between venture capital and loan capital and …it is not the role of banks to use public savings to provide venture capital for high risk micro-enterprises' (Banking Council, 1998:5).*

Hence unsecured loans are seen as venture capital and eschewed by the formal banks.

The lack of provision of financial services to the unemployed and start-up enterprises remains a thorny issue in the political arena. Criticism of the 'overly conservative' stance of the commercial banks in meeting the needs of the over-excluded has recently re-emerged (*Business Day*, 2000). The commercial banks have attempted to divert some of this criticism through involvement in projects and joint initiatives, which involve government support and other sponsorship. Among these is a dual initiative that provides loans and mentoring for start-up entrepreneurs, *Sizanani*. This recent joint venture involving the major banks provides micro-enterprise loans ranging from R5000 - R50000, once mentors have approved the loan (*Alliance Update*, 2000: 3). The loans granted by the banks are 95 per cent guaranteed by a sister scheme, *Sizabantu*. Nonetheless, since its inception 18 months ago, the *Sizanani* scheme has provided relatively few loans, with on average only 3 applications being successful for every 1400 received (Coovadia, interview, February 2001). Of the 2000 start-ups that have been mentored by the project to date, only 200 have been granted start-up financing by the banks. Just over 30 per cent of these have already failed (Johnson, interview August 2001). On the positive side, however, 130 new businesses have been established and 1000 jobs created.

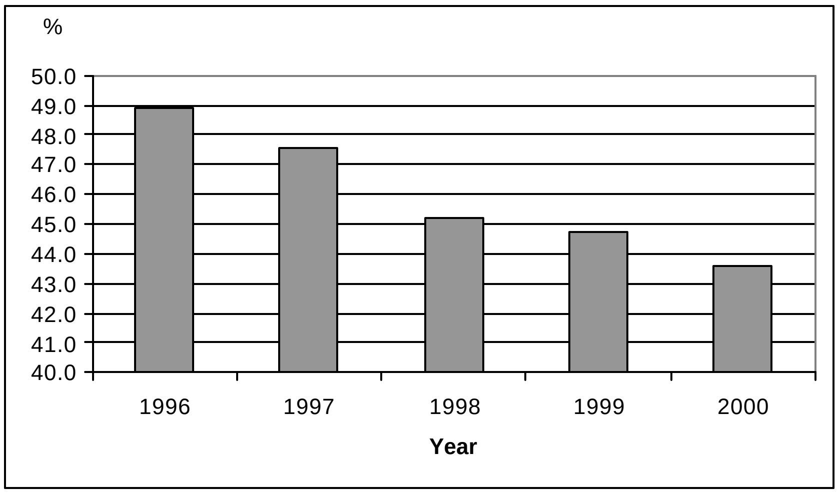
## 5.3 Current International Trends that work Against Further Inclusion

The South African commercial banking system is subject to the same pressures affecting developed banking systems throughout the world. The current international trend in the financial sector toward conglomeration has been linked to a reduction in the access of services by smaller businesses and poorer households. Two contributory factors are examined here: the shift towards fee-based income and the centralisation of decision-making.

Conglomeration within the financial sector is associated with mergers and acquisitions between banks and between banks and non-bank financial intermediaries. Increasingly, banks offer a suite of services including investment banking, insurance and bond and derivatives trading. This diversification into non-bank financial services leads to a shift towards fee-based income. Earnings through interest differentials tend to become less important and non-interest income becomes a greater proportion of their income. In the US, for example, fee income amounts to around half of operating revenue (Radecki, 2000). In South Africa, interest income as a percentage of total assets has declined from 15.6 per cent in 1997, to 10.7 per cent in 2000. Together, interest income plus transaction fees make up around seventy percent of banks' income. Transaction income, knowledge-based income, fund management and investment- and trading income make up an increasing proportion of bank revenues (Registrar of Banks, 1999).

Figure 5.1 below shows the declining share of interest income in the total income of South African banks over the past four years. The declining share from around 49 per cent in 1996 to 43.5 per cent in 2000 suggests that like their US counterparts, South African banks are finding that interest income is gradually becoming less significant in their earnings. There appear to be two factors eroding interest income in South African banks: the shift into new activities and the increase in expenses associated with offering loans. The Banking Council suggests that the cost of offering banking services has increased, as banks have been required to comply with more stringent standards.

Figure 5.1 Interest margins of South African Banks as a share of their Total Income




*Source: Registrar of Banks, Various Years*

This emphasis away from interest income to other non-interest income sources over a period of time tends to change the emphasis of staff skills away from evaluating the creditworthiness of clients to brokering financial deals. Gradually, this leads to a process of standardised evaluation of clients, and less traditional personal evaluation. This tends to reduce costs of evaluation, but may lead to exclusion of individuals and smaller firms that may have qualified for credit given more personal evaluation (Dymski, 1996: 93). The 'organisational distance' between banks and low-income households and small businesses grows (Porteous, 1995: 11), as borrowers requiring special attention are excluded, as the extra attention is deemed too costly.

With conglomeration also comes the tendency for centralisation of processes and methodologies. The standardisation of evaluation procedures, as stipulated by the bank's head office, tends to downplay the role of 'local knowledge' that a bank manager in as small town may possess. This process tends to discriminate against the marginal or unconventional client.

It is difficult to ascertain the degree to which standardized evaluation is disadvantaging marginal clients in South Africa, given that there is no disclosure of client base information. Nonetheless, the Banking Council acknowledges that greater competition from non-bank financial service providers and international banks has contributed to the growing focus on transaction volumes to improve non-interest earnings, and reducing costs through automation. Twelve per cent of the 3820 national branches closed between 1994 and 1998, with a further 15 per cent expected to close by the end of 2000 (Tucker, 1999:11). The reduction in branches and personnel is likely to impact negatively on the provision of savings accounts, where people are far away from bank branches. In addition, the tendency away from face-to-face contact between loan officers and clients is likely to impact negatively on the access of low-income earners and start-up businesses to loans.

## 5. 4 Possible Future Trends and Proposals to Encourage Extension of Provision

The above discussion of international trends and the current state of provision in South Africa suggest that a concerted effort is required to address the situation. Three key areas are highlighted below: dealing with the micro-finance institutions; innovation within formal sector markets; and, re-examining current financial sector institutions.

### 5.4.1 Dealing with the micro finance institutions

The wide network of micro lending institutions already in existence provides a means by which provision can be improved. As has been mentioned above, micro-lending organisations are provided for by an amendment to the Usury Act. The success in the registration of micro-finance organisations, as an outcome of this Amendment, suggests that this sub-sector is not completely averse to regulation. Nonetheless, industry sources suggest that the Amendment is inadequate as a basis to regulate what is a growing sub-industry. While a review of the regulation governing the microfinance industry has begun, the process has stalled. Further legislation that deals with the whole range of non-formal financial services, be they lending or saving, in order to encourage the sector and providing better consumer protection and market conduct, needs to be drafted, through a process of adequate consultation.

It is generally assumed that loans by micro-lenders are for consumption, however, the discussion above suggests that micro-finance may be the only way for start-up entrepreneurs to obtain seed capital for their business. This raises their importance in terms of addressing South Africa's growth and employment goals.

Regulation of micro finance institutions within the formation of an appropriate institutional structure could form the basis for the establishment of community-based banks, which are further discussed below. Registration and regulation could be encouraged by the linking of the network of registered micro lenders to a sector-wide network currently being considered by the banking sector. This system would replace the State Payroll system, Purcell, which was abandoned when the Minister of Finance intervened in the light of unmanageable debts accumulated by state employees. The envisaged debit order system would not be restricted to the public sector, enabling controlled and automatic monitoring of the deduction of repayments from all salaried individuals. This would ensure that the maximum agreed level of deductions could not be exceeded, which would reduce the level of over-borrowing. Potentially this provides microlenders and banks targeting the low-income sector of the market with automatic repayment facilities while reducing the level of risk associated with this market.

### 5.4.2 Innovation within formal sector markets

The development of the money market in South Africa raises the potential for securitisation of loans, a popular technique used elsewhere in the world. By this process, existing loan assets are pooled and repackaged into securities that are then sold to market investors and removed from the balance sheet of the banks. In this way, credit-rating agencies, rather than banks, rate the creditworthiness of borrowers. The bondholder's exposure to any one private borrower is likely to be small, as their asset spreads are wider. Since the bondholder is dealing with tradable paper, this makes risk management easier. In addition, securitisation ought to lower costs, as given that banks are required to comply with capital requirements that may make them less competitive than other market players, market facilitation ought to be less costly than bank intermediation. Potentially, then, securitisation of loans may lower the costs of raising funds and of providing financial services. Increasing development of the securities market into venture capital may provide a mechanism to provide funding for small businesses and even mortgages for the low-income end of the market. Although the development of this form of securities market has been inhibited through current legislation, in the future, access to the securities market may provide an additional source of finance and funding for some of those currently excluded from these services.

Securitisation of loans may also encourage the development of parallel venture capital schemes on the stock exchange, specialising in small business funding. The JSE already has such a pilot project, named EEZ, Emerging Entrepreneurs Zone, which has secured potential investors into new companies. The success of EEZ has been modest though, with seekers of funding hampered by lack of knowledge as to how to structure high-level business plans. The poor results of the scheme to date emphasise the organisation distance between small, innovative designers and entrepreneurs and the sophisticated world of finance and stock markets.

### 5.4.3 Re-examining the current financial sector institutions

Creating the institutional framework for community-based banks (or what are referred to as core banks by Falkena et al (2000)), may also encourage greater provision. While in the past, different types of banks and non-bank financial intermediaries were licensed, the Banks Act of 1990, essentially provides for only one type of bank. Together with the revamping of the micro finance amendment to the Usury Act, there is room for the recognition of different types of banks.

One suggestion is to allow core banks to maintain lower capital requirements. These core banks could be licensed to take deposits from the general public and invest all their assets in low risk instruments (such as the money market). The lower capital requirement could potentially lower entry barriers, and the lower requirements could be justified in terms of the lower asset risk.

In addition, there is potential for the facilitation of credit unions and other community banks, which would have the advantage of local knowledge. Potentially, wholesale arrangements with the commercial banks could be established – with the latter providing not only financial but also management advice.

In addition, the insurance industry also needs to be re-examined in terms of the access average individuals have to life (and disability) policies. It may also be that a dual system similar to the one proposed for the banking institutions may be appropriate for the insurance industry, however, this requires more consideration.

# 6. Themes and Conclusions

The financial sector has been represented as follows:

- The sector is generally regarded as well regulated, with regulations largely harmonious with international standards.
- The sector has undergone a process of gradual liberalisation, which has resulted in similar treatment of foreign and domestic firms.
- Certain issues of compliance in terms of the treatment of foreign firms remain outstanding.
- The market share of the individual industries has not changed dramatically in spite of new niche and foreign entrants.
- Foreign competition has raised the stakes in providing services for the public and corporate sectors and wealthy individuals, but increased competition for the lower income market has not been simultaneously forthcoming.
- This suggests that certain markets may remain uncontested in spite of increasing liberalisation.

The report has provided insight into the current regulatory and institutional environment of the South African financial sector. The use of the questionnaire has facilitated the collection of detailed information not previously collated, and has revealed the deficit of an easily accessible source for much of the detailed information provided. Some areas of deficit remain – such as in the area of readily comparable data on pricing within each industry. This suggests that there remains a significant level of opaqueness in some areas of the sector, which adds to the difficulty of this type of exercise.

The process has revealed some deficiencies in the template design. Questions on performance of the sector could, as the above discussion suggests, also examine issues such as provision of services and innovative means to address an issue that appears to be common in developing countries. In addition, proactive use of the WTO forum for promotion of domestic industry is not considered in the template. Nonetheless, the process has proved to be instructive and has provided both a foundation for further research and pointers for the direction of such analysis.

The report suggests that the process of gradual liberalisation has generally been positive in the sector, although the entry of foreign competitors and domestic niche players has done little to challenge the high levels of concentration in the sector. Historically, competition has tended to result in merger and acquisition that has, if anything, increased concentration.

Four themes around which further research may be considered emerge from the discussion. First, further openness to foreign participation and compliance with access requests appears to be linked to the issue of liberalisation of financial flows. Second, there is room for a broader evaluation of the performance of the sector, which may provide the rationale for a re-examination of the current institutional and regulatory framework existing in the sector. Third, the focus of the template has been designed with regulatory compliance and access of foreigners in mind. It remains to be considered to what extent the financial sector has the capacity to export services, and to what extent the WTO environment may facilitate access to other markets. Fourth, revamping institutions in the sector with a view to providing greater access to financial services for the majority of the population need not impinge on the stability of the financial system. The themes are discussed in turn.

## 6.1 Foreign Competition and Liberalisation

The entry of foreign competitors, as a consequence of democratisation, has provided the stimulus for introducing new products at lower cost to certain sectors of the population. As the playing fields have gradually been leveled and barriers to entry have gradually been removed, there has been a steady inflow of foreign investors. Regulatory changes have, in large part, ensured compliance with international regulatory authorities as well as with trading partners. The outstanding issues, discussed in section 3.2, appear in large part to be linked to issues relating to exchange control and the liberalisation of financial flows. It appears that South Africa has now reached the stage where further foreign activity in the sector is largely predicated on decisions regarding the exchange control issue.

This moves the debate from the sector level, where the Department of Trade and Industry or National Treasury has jurisdiction, to a broader macro-political level. The debate now revolves around the implications of liberalisation for the economy as a whole, rather than for the sector only. In addition, any concessions need to be seen in the light of greater access of domestic firms to foreign markets, an area that needs further research.

## 6.2 Revamping of Institutions in the Light of Broader Performance Criteria

The promulgation of new legislation and regulation has largely been prompted by the need to get the prudential standards of the sector in line with international standards and to facilitate entry and regulation of foreign competition. Little attention has been paid to re-formulating regulation so as to address widespread provision of financial services.

This points to a need to raise debate on the performance evaluation of the sector beyond that of cost efficiency or prudential adequacy. This is not to minimise the importance of cost efficiency and prudential adequacy, but to point out that they do not encompass all that is required of the sector. Once it is accepted that access to financial services is a legitimate performance criterion, innovative regulation can begin to be formulated that creates the environment where this can take place. Without this, in spite of greater liberalisation, financial exclusion is likely to continue to persist.

## 6.3 Using the WTO Forum for the Benefit of the Domestic Financial Services Sector

The design of the template employed in this study focuses primarily on establishing the existing levels of regulatory compliance in the sector. As a result there is no emphasis on establishing the capacity of the sector to export services or the degree to which the WTO might be a useful environment to address the expansionary aims of the domestic financial sector. Currently, service receipts on the balance of payments (i.e. exported services) exceed net exports of gold at around 18 to 20 per cent of total merchandise export receipts (SARB Quarterly Bulletin, March 2001). However, payments for services (or imported services) exceed service receipts, so the 'service account' of the balance of payments remains in deficit. The degree to which potential exists to earn service receipts in the industry remains to be examined and is related to decisions regarding the further liberalisation of the financial account of the balance of payments.

Future research could examine the demands of the domestic sector for access and equity in a future WTO forum. This may provide insight into the potential benefits of meeting the ultimate demands for liberalisation. These benefits would need to be clearly articulated as further liberalisation is likely to be associated with increased financial vulnerability of the country, without necessarily promoting further financial provision.

## 6.4 Innovative Regulation and the Stability of the Sector

A change in the institutional framework for the sector need not affect the stability of the sector adversely. As has been suggested above, the establishment of banking forms that encourage community banks, for example, which have advantages of local knowledge, do not threaten the stability of the system. Unlimited extension of finance is not what is being advocated. Rather, innovative regulation should provide the environment where access to financial services of the ordinary citizen is a possibility. This approach of access to finance and local re-investment schemes might be the social framework within which upliftment can begin. Indeed, if such a scheme can be promoted, there may be far less long-term risk, not just of the financial sector, but the economy as a whole.

Another issue that emerges as a potential area for future investigation beyond the scope of the report is that of the *organisational* distance between the excluded and the financial sector. The report points to a number of areas where the issue of exclusion is not simply a one–way street. For example, those who are excluded from banks, and are unfamiliar with banking procedures are likely to remain excluded unless they are given access to programmes, which will familiarize them with these institutions. This is an issue currently being debated elsewhere in the world, even in developed societies. One way that services to low income, formally employed, individuals are currently being offered is via retail outlets. For example, both African Bank and BOE are offering services from desks set up within clothing retail outlets.

The lack of success of the EEZ programme of the JSE, which is targeting small business entrepreneurs, has also encountered educational deficits, with seekers of funding unable to develop the high-level business plans required and also being unfamiliar with the concept of funding versus financing.

These issues suggest the need for more research with a possible facilitating educational role for the government.

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