AN INCLUSIVE FINANCIAL SECTOR FOR ALL

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Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

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LIST OF ACRONYMS

ABSIP	Association of Black Securities and Investment Professionals
AML/CTF	Anti-Money Laundering and Combating the Financing of Terrorism
ATM	Automated Teller Machine
ASISA	Association for Savings and Investment South Africa
BASA	Banking Association South Africa
B-BBEE	Broad-Based Black Economic Empowerment
BIAC	Black Insurance Advisors Council
BIOA	Black Insurance Owners Association
CFI	Cooperative Financial Institutions
DFI	Development financial institutions
FIA	Financial Intermediaries Association
FICA	Financial Intelligence Centre Act
FSC	Financial Sector Code
FSCA	Financial Sector Conduct Authority
GDP	Gross Domestic Product
G20	Group of Twenty
G2P	Government to Persons
IDC	Industrial Development Corporation
IMF	International Monetary Fund
I-SIP	Inclusion, Stability, Integrity, and Protection
MNOs	Mobile Network Operators
NASASA	National Stokvels Association of South Africa
NT	National Treasury
NDP	National Development Plan
NEF	National Empowerment Fund
OECD	Organisation for Economic Co-operation and Development
RICA	Regulation of Interception of Communications and Provision of Communication-Related Information Act
SAIA	South African Insurance Association
SEDA	Small Enterprise Development Agency
SEFA	Small Enterprises Finance Agency (SEFA)
SMME	Small, medium and micro-enterprise
SWIFT	Society for Worldwide Interbank Financial Telecommunication

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EXECUTIVE SUMMARY

The objective of this document is to establish the overarching Policy for financial inclusion in South Africa. The document outlines Government's policy to shape regulatory approaches, the evolving Financial Sector Code (FSC), and sector market practices in general. It further outlines Government's plans to respond to the global coronavirus (COVID-19) pandemic from a financial inclusion perspective.

Financial inclusion refers to a state in which all individuals and small, medium and micro enterprises (SMMEs) have access to and can effectively use a range of quality[1] products and services provided by the regulated financial sector. In the context of South Africa, this includes reaching those segments of society who are historically excluded from the formal financial sector as well as those who underutilise financial products and services.

At an individual and household level financial inclusion is a necessary component towards reducing inequality and improving the quality of life of low-income earners. The appropriate use of financial products and services by small, medium and micro-sized enterprises (SMMEs)[2] improves their prospects, and positively impacts on the economic environment of the societies in which they operate. The benefits of financial inclusion in South Africa speak directly to positively addressing some of the effects of past historical imbalances – that have prevented previously economically marginalised South Africans from participating in the mainstream economy – and the resultant societal inequalities and high levels of unemployment.

The headline data on financial inclusion in South Africa reflects positively on the country's achievements in this area over the last decade. At least 91 per cent of South African adults have access to formal financial products and services, with only about 3.6 million still excluded. Of those included, 81 per cent have a bank account and 78 per cent use other formal non-bank financial products and services. However, significant underlying problems still prevail. The way financial products and services are utilised, as well as inadequate access to and use of a wider range of financial products and services, are problematic. Low-income earners, although said to be included, still do not engage meaningfully with the financial sector whilst SMMEs are only marginally served. As a result, high levels of financial inclusion, driven by high access to bank accounts, have not adequately translated into improvements in the quality of life and economic environment of low-income South Africans and SMMEs.

This policy document assesses the current state of financial inclusion in South Africa and provides general principles to guide sustainable improvement in financial inclusion. Two Strategic Policy Pillars and a Supporting Pillar that speaks to key enabling foundations for financial inclusion, are delineated. The assessment will feed into the Implementation Strategy and corresponding Action Plan that will establish a clear framework to address the main barriers and identify opportunities to bolster financial inclusion in South Africa.

To complement the policy, the Financial Sector Conduct Authority is expected to improve the use of financial products and services by developing a strong national focus on financial literacy and market conduct. The Twin Peaks[3] regulatory model has strengthened the regulatory and supervisory framework and should further improve appropriate access to, and usage of, financial products and services by the low-income market and SMMEs, in support of the policy objectives.

It is intended that a Financial Inclusion Sub-Working Group will guide the development and implementation of the

1 *"Quality" is an encompassing feature that includes the level of appropriateness of products and services to different customer profiles and needs, including in terms of affordability, suitability, convenience, fairness of terms and conditions and business practices, and responsible delivery.*

2 *The National Small Business Amendment Act, 2003 (Act No. 26 of 2003), and amendment to the National Small Business Act, 1996 (Act No. 102 of 1996) defines (SMMEs) according to five categories, namely; industrial sector and subsector, size of class, equivalent of paid employees, turnover and asset value – excluding fixed property.*

3 *South Africa has started implementing a new regulatory regime for the financial sector. Known as the Twin Peaks, the new approach is designed to address weaknesses in the other models commonly used to regulate banks and the financial services sector.*

Implementation Strategy with support from a Financial Inclusion Forum. The strategy development process will include the identification of specific activities under each priority identified in this Policy, and their subsequent sequencing to inform the Action Plan. A monitoring and evaluation framework will also be developed to help evaluate the impact of the adopted policies over time. A focused approach to sustainably improve financial inclusion will not only benefit low-income and vulnerable South Africans, and SMMEs but all of society.

Table 1: List of the financial inclusion policy pillars and priorities

PRIORITY
PILLAR ONE - DEEPENING FINANCIAL INCLUSION FOR INDIVIDUALS
Priority 1: Promote the beneficial use of transactional accounts
Priority 2: Position remittances as a springboard for further financial inclusion
Priority 3: Supporting increased formal savings for low-income earners
Priority 4: Promote appropriate credit for assets and investment over consumption
Priority 5: Promote appropriate, affordable, and quality insurance
Priority 6: Increase the financial inclusion impact of social grant distribution
Priority 7: Improve efficiencies in the onboarding of financial services clients
PILLAR TWO - POLICY PILLAR TWO – EXTENDING ACCESS TO FINANCIAL SERVICES FOR SMMEs
Priority 8: Broaden the range of financing instruments available to SMMEs
Priority 9: Promote the use of transaction accounts and payment services by SMMEs
Priority 10: Suitable insurance for SMMEs
PILLAR THREE - IMPROVING THE ENABLING FOUNDATIONS – LEVERAGING A MORE DIVERSIFIED PROVIDER AND DISTRIBUTION BASE
Priority 11: Build appropriate payment options to drive usage
Priority 12: Building a credit infrastructure to improve access to credit for SMMEs
Priority 13: Enable and strengthen the capability of new and small financial institutions, with increased focus on strengthening the financial co-operatives and developmental microfinance sector.
Priority 14: Explore the role of the state in supporting sustainable financial inclusion
Priority 15: Enable a broad base of agents in the provision of financial services
Priority 16: Leveraging fintech disruptors to promote and support financial inclusion

1. INTRODUCTION

South Africa has a well-developed and well-regulated financial sector, with a wide range of financial products and services, typically offered and supported through a national network of an increasing range of access points of service. This provides a solid base for sustainably and beneficially extending financial inclusion. Over the past two decades, the financial sector has developed in line with the changing domestic and international environment, and it remains a key contributor and enabler in the South African economy. The regulatory structures, aimed at improving the stability, safety, efficiency, and integrity of the financial sector, have been developed and strengthened to meet international standards and to serve South Africans better. South Africa's financial sector was able to weather the 2007/8 global financial crisis better than many other countries, particularly some developed nations, and it is viewed as a key and able partner in taking financial inclusion forward in the country.

South Africa's implementation of the rigorous Twin Peaks system of financial regulation entrenches financial inclusion as a core priority for Government and the sector regulators. Besides taking a tougher and more intrusive approach to market conduct, and prudential and stability risks, the regulators are required to support and promote financial inclusion through their respective regulatory and supervisory frameworks. While financial inclusion has been on the policy agenda for some time, the Twin Peaks reform provides for a more strategic and deliberate response.

This Policy outlines Government's approach to shape regulatory and supervisory measures, the evolving Financial Sector Code, and sector market practices. The introduction defines financial inclusion and its role in transforming the country's financial sector landscape. Chapter 2 then outlines the range of South Africa's population that is most directly in need of financial services and provides context on the current state of financial inclusion in the country. Chapter 3 provides background on the evolution of financial inclusion in the global environment and considers regulatory developments and interventions relevant to financial inclusion in South Africa. In Chapter 4 the three policy pillars that support financial inclusion are discussed. Chapters 5 and 6 provide a plan for implementing the policy and a guide on how progress towards meeting the policy objectives will be measured. Finally, Chapter 7 identifies the immediate next steps that should be taken to start the adoption and implementation of the policy.

1.1 WHAT IS FINANCIAL INCLUSION AND WHY IS IT IMPORTANT?

Financial inclusion is defined as a state in which all individuals and SMMEs have access to and can effectively use a range of quality products and services provided by the regulated financial sector. In South Africa, this definition targets segments of the historically excluded from the formal financial sector as well as those who underutilise financial products and services. Cognizant of the fact that, even when a wide range of quality financial products and services is available, not all individuals and SMMEs will have access to all of them. Financial inclusion makes a call for the availability of mutually beneficial and sustainable financial products and services for the target population; and for financial services providers; it stresses the existence of an enabling environment for competition, innovation, product development, delivery, and greater diversity in the types of regulated financial services providers.

Financial inclusion is an important tool for inclusive economic growth in a country, and a necessary component towards reducing economic inequality and improving the financial well-being of low-income earners, as well as supporting growth and greater resilience of SMMEs.4In recent years, financial inclusion has gained increased international recognition and prominence. During the last 10 years, globally the number of financially excluded adults has decreased from approximately 2.5 billion to 1.7 billion,5 a figure that is still concerningly high as the financially excluded rely on less efficient, inadequate, and higher-risk financial products and services. Appropriate access to financial products and services can empower individuals and entrepreneurs – particularly those with low incomes such as Natalie, Rolphy, and Jane in Box 1 – to better integrate into the economy, actively engage in their development, and protect themselves against economic shocks and financial risks.

Box 1: The un- and under-served market[6]

Natalie (41) is a grandmother of 11. Her husband and three of her children passed away a few years ago leaving her with six orphans. She has a part-time cleaning job that pays her R1,500 per month and is also entitled to foster care grants for the six orphans.

With a monthly household expenditure of around R3,500, Natalie's income hardly covers her living expenses. To make ends meet, Natalie started borrowing from banks and has since been borrowing from different institutions. One of her largest loans (R14,000) was used to buy a water tank and to put electricity in the house and another recent one was used for a burial. Natalie now looks for smaller institutions to borrow from as she believes they are the least concerned about her credit history. Natalie is paying just over R1,200 per month to service her loans. She recently borrowed R400 from a loan shark that lives in her village to feed her family.

Rolphy is a 31-year-old entrepreneur from Blood River in KwaZulu Natal Province. He established his tombstone business with a group of friends five years ago and sells headstones mainly to customers living in his neighbourhood. The sustainability of his business has not been easy, given how competitive the funeral business has become with many new players in recent years. In addition, his customer base is shrinking – most of his customers are older. When he receives his income, Rolphy pays for all the expenses and banks the remaining amount. Rolphy keeps a record of his business activities in a book that he keeps at his home, and he has one financial product: a transactional account with a bank in a town near his place of business. His largest business spend is buying material for the tombstones and paying for electricity for his business premises.

Rolphy is worried that one day he will not be able to continue his business and believes the only way to get out of this predicament is to expand into other funeral parlour services and obtain new customers. He has considered borrowing from banks to expand his business, but he thinks they will not lend to him. Rolphy is also worried that he will not be able to make payments on time should he get funding. Currently, he borrows from his friends to sustain the business.

4 *Numerable studies support the link between financial inclusion and economic inclusion and development. For example: In Malawi access to accounts increased savings among farmers which translated into greater agricultural output and household spending whilst digitising social transfer payments in Niger significantly reduced travel and wait times for recipients receiving the funds and also lowered the government's administrative costs.*

5 *Word Banks's Global Findex Report, 2017.*

6 *Natalie and Rolphy's stories were extracted from "The personalities of the underbanked: A point of view on financial inclusion in South Africa", FINMARK TRUST and FROG, November 2012.*

Jane is a 24-year-old cashier at the local supermarket in Ga-Rankuwa, Tshwane who earns R3,500 per month. She started working immediately after completing matric, at 19, as she needed to earn an income to help her mother and father who were struggling to make ends meet and to make some money to study further. After getting her first job Jane realised that her income was not enough for her to start studying whilst helping her parents, so she decided to start saving for her studies through a savings group in her local community where she has been saving R500 per month since her first job. A year ago, Jane's home was broken into and most of her family belongings were taken during the break-in. To replace the essential things that her family needs on a day-to-day basis Jane withdrew R20,000 from her savings and was only left with R4,000 as her savings group keeps all their money in a small safe at the appointed Treasurer's house, thus none of the members earn interest on the money they save.

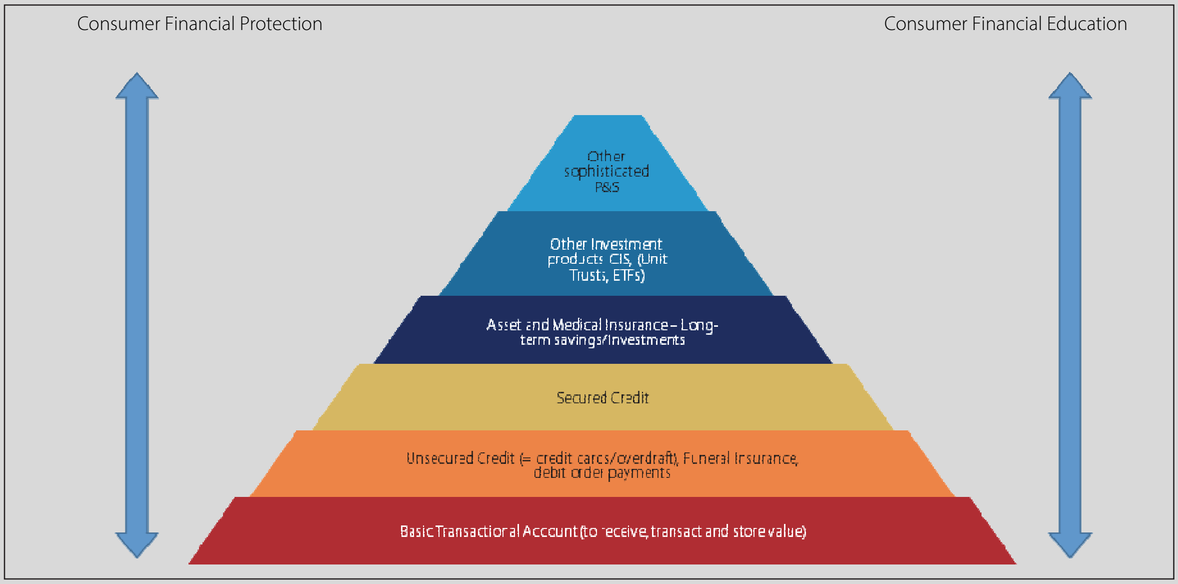
Jane planned that as soon as her savings reached R30,000 she would find a higher education institution where she can study and would work part-time instead of full-time to continue to help her family out. Now she is worried that she will never realise her dream of studying further as her savings have now been reduced by R20,000 which was used to cover an incident that she did not anticipate would happen.

The path to financial inclusion differs according to individual circumstances. In the South African context, this path will most likely include the dual use of informal and formal financial products and services as complementary services with initial interaction with the formal financial sector starting with the acquisition of a basic transaction account[7] as depicted in Box 2.

7 *Transaction accounts are defined as accounts (including e-money/prepaid accounts) held with banks or other authorised and/or regulated institutions including payment service providers, which can be used to make and receive payments and to store value (Committee on Payments and Market Infrastructures (CPMI), 2016).*

Box 2: Pathway to full inclusion

Figure 1: Financial inclusion pathways



In South Africa, the pathway to full financial inclusion begins with the acquisition of a basic transaction account and is generally followed by take-up of credit, insurance (e.g., medical) and long-term savings in the form of retirement. The pathways, however, are different for those employed, unemployed or self-employed and depend on an individual's level of income and other socio-economic circumstances. For example, employed individuals may access medical insurance and retirement savings products whereas the unemployed and self-employed may have difficulty accessing these. Sophisticated products such as collective investment schemes remain out of reach, mainly because of their complexity and a lack of financial education among most people.

Financial inclusion must be supported by effective consumer financial education and consumer protection at all levels of the financial inclusion pyramid. Enhancing financial consumer protection and improving business conduct more broadly remains fundamental to the financial sector's role of ensuring that positive consumer outcomes stem from the improvements in the design and delivery of products and services design, and improvements in the financial infrastructure aimed at promoting greater usage of a wider range of products and services.

Major concerns in South Africa are to tackle the issue of over-indebtedness, the reckless provision of consumer credit, and the complexity of the financial sector ombuds system, but with the rapid advancement of technology innovation in financial services, new risks may emerge and crystalize together with the opportunities provided by technology, potentially with negative impacts on large swaths of the South African population. The design of risk-based approaches to regulation and supervision is an important step and should, moreover, be flexible enough to cover emerging new types of nonbank financial services providers.

Enhancing financial consumer protection and market conduct should be coupled with consumer financial education to ensure that individuals and entrepreneurs have the knowledge, understanding, skills, and confidence to make sound financial decisions and take actions that are appropriate to their circumstances. These are the basis for increased trust in the financial services sector and a necessary step for long-lasting financial inclusion.

Financial inclusion is deemed a key enabler in improving the quality of life of households and individuals, and promoting growth, and increasing the resilience productive capacity of SMMEs, thereby reducing poverty and inequality, especially for disenfranchised groups. The policy statements and policy implementation approach in this document should be seen against this wider developmental agenda, in support of Government's National Development Plan 2030.

1.2 POLICY OBJECTIVES AND SCOPE

1.2.1 OBJECTIVES

Government acknowledges that the nature and extent of financial exclusion in South Africa pose a significant social and economic challenge and warrants a dedicated policy response. The objectives of this policy are:

- To promote improved and sustainable access to, and the use of quality, appropriate, and affordable financial products, and services.
- To ensure that financial inclusion delivers measurable socio-economic benefits in improving the quality of life for all South Africans, particularly that of low-income earners, and that the economic prospects of SMMEs and the communities in which they operate improve.
- To transform the financial sector in a way that supports the responsible delivery of financial products and services to low-income earners and SMMEs.
- To improve cooperation and coordination amongst stakeholders to promote financial inclusion.
- To improve the measurement and monitoring of financial inclusion.

Achieving financial inclusion requires both the widening and deepening of the engagement of individuals and SMMEs with financial products and services compared to current levels. Widening implies both the inclusion of new providers in the marketplace and more people, and SMMEs using the services. Deepening implies greater beneficial usage of a variety of quality products and services by a wider spectrum of users over time. By widening and deepening the reach of the financial sector, financial inclusion also serves an important transformative role. Transformation is thus a fundamental and complementary objective of financial inclusion.

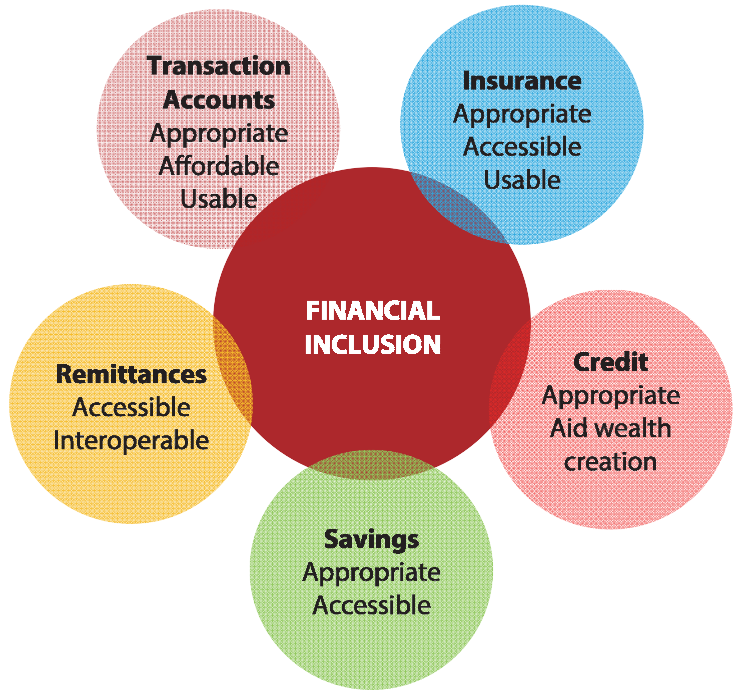
1.2.2 SCOPE

This Policy focuses on access and usage of financial products and services by the South African adult[8] population and SMMEs. The Policy will therefore deal with the financial sector landscape, the financial infrastructure, and the classes of financial products and services as they pertain to the un-and under-served.

[8] *Adults are in this context defined as people who are 16 years old and above and living in South Africa.*

The classes of financial products and services include the following:

Figure 2: Product categories



- **Transaction accounts** have become the anchor product for participating fully in the economic and social life of modern society. The key enabler in engaging with financial products and services is to have and use a transaction account from, and to which funds can be transferred. It is therefore critical for the financial sector to provide needs-oriented and affordable transaction accounts with full-service capabilities to individuals and SMMEs.
- **Credit** is critical for individuals and SMMEs in financing productive capacity and smoothing consumption. The key policy objective is to ensure that there is responsible access to quality credit. This would support economic development by ensuring the sustainability and growth of SMMEs and improving the quality of life of individuals and households.
- **Insurance** provides a cushion against costly and unforeseen life events and, as a result, is particularly important for low-income, SMMEs, and other vulnerable segments of the population.
- **Savings products** are important, as they allow individuals to spread their income over lean earning periods, as well as for the accumulation of wealth for the future acquisition of services and goods.
- **Remittances,** both domestic and cross-border, are crucial mechanisms for channeling funds to low-income and vulnerable households, including migrants working in South Africa and people in rural areas. It is often the first use of financial products and services by immigrant remittance recipients, and therefore, an entry point for the use of additional financial services.

2. SOUTH AFRICA'S SOCIO-ECONOMIC AND FINANCIAL INCLUSION CONTEXT

2.1 SOCIO-ECONOMIC CONTEXT

South Africa has an estimated population of 62 million.[9] Although South Africa's poverty levels have improved since democracy, a combination of international and domestic factors such as low economic growth, continuing high unemployment levels, higher consumer prices, and greater household dependency on credit has seen the financial health of South African households decline over recent years. More than half of South Africans were poor in 2015 with the poverty headcount increasing to 55 per cent from 53 per cent in 2011.[10]

In the fight against poverty, Government's main priority is job creation. South Africa's unemployment rate stands at over 34 per cent with youth unemployment estimated at 47 per cent in the last quarter of 2022.[11] Based on the Gini index[12] estimates from the World Bank, South Africa with a Gini coefficient of 0,65 has the highest inequality in the world.[13] This is reflected through its dual economy where the richest are almost 10 times wealthier than poor households and have incomes comparable to the Organization for Economic Co-operation and Development (OECD) countries, and the poorest nearer levels observed across Sub-Saharan Africa.[14] Just below 50 percent of employed South African households earned an average of R3,326 in 2019 (as depicted in Table 2 below). With an average household size of 3.3[15] the situation remains dire for most households even for those who derive their income from employment.

Table 2: Average household income by social class

	Chronic Poor (48.79%)	Transient Poor (11.75%)	Vulnerable (15.09%)	Middle Class (20.75%)	Elite (3.62%)
Average income (R)	3,326.16	4,682.41	5,366.17	1,3127.37	3,8223.13

Source: National Income Dynamics Study, 2019

Redistribution taking place through the tax and social grant systems, and the B-BBEE framework is a necessary and important "balancer". However, current domestic production and income constraints mean that a significantly raised employment level is the most sustainable and meaningful way to bring South Africans out of poverty, eliminate inequality and empower individuals to determine their futures, thereby taking pressure off the state as a safety net. Consider for example that in 2017 over 17 million grant beneficiaries were paid over R150 billion, representing almost 10 per cent of the national budget. This amount has increased by over 25 per cent over the past six years, straining a declining tax base and escalating the budget deficit and debt-to-GDP ratio.

South Africa will need to grow at 5 per cent per annum if it is to generate sufficient jobs to absorb new entrants to the job market every year. This will require an increased investment rate of over 30 per cent, compared to the current 19.5

9 *Population Census, Statistics South Africa, 2022.*

10 *Poverty trends in South Africa: An examination of absolute poverty between 2006 and 2015, Statistics South Africa, 2017.*

11 *Quarterly Labour Force Survey, Statistics South Africa, Q2 2022.*

12 *The Gini index or Gini coefficient is defined as a statistical measure of distribution often used as a gauge of economic inequality, measuring income distribution or wealth distribution among a population: https://www.investopedia.com/terms/g/gini-index.asp*

13 *The "Poverty trends in South Africa: An examination of absolute poverty between 2006 and 2015" report released by Statistics South Africa in August 2017' indicates that South Africa's Gini-coefficient ratio based on per capita income is 0.68.*

14 *South Africa Country Report No. 17/189, ARTICLE IV, Annex II - Financial Inclusion, IMF, 2017.*

15 *South Africa Average Household Size, esri, 2019*

per cent. But South Africa also falls short in domestic savings, with the savings rate[16] at around 16 per cent, significantly below the 30 per cent required to support higher levels of investment.[17] What is worrying is the observed low savings rate at the household level, meaning that households are not only poorer today, but will most likely not be able to escape the poverty trap in future.[18]

Structural realities outside and within the financial sector also impact South Africa's potential to grow the economy and thereby increase jobs and reduce inequality. Firstly, South Africa's dual economy is a major factor in this context. It manifests in the financial sector, in the sophisticated and well-established formal sector operating in parallel to an underdeveloped and largely informal "township or rural" economy. Cash remains the dominant means of payment for a significant percentage of the country's population, even for those that already have transactional accounts.[19] Despite the high level of the banked population, 52 per cent of the total value of all consumer transactions in South Africa were conducted in cash in 2018.[20] Secondly, the economy in general and the financial sector, in particular, is highly concentrated, with the top four banks[21] holding over 80 per cent of banking assets. The top five insurers[22] account for over 70 per cent of the long-term insurance market, and the seven largest fund managers[23] control 60 per cent of unit trust assets. Thirdly, as a critical contributor towards economic growth and employment, the SMME sector is underdeveloped relative to its peers. In OECD countries formal SMMEs account for 55 per cent of GDP and 60-70 per cent of employment, while in emerging markets these enterprises account for 40 per cent of GDP and 80 per cent of new jobs[24]. South Africa's performance, although below OECD countries, is on par with emerging markets levels with SMMEs contribution towards GDP estimated at 40 per cent, and contribution towards employment at 87 per cent.[25] However, the sector remains informal with only 37 percent of firms classified as formal.

Given South Africa's socio-economic make-up, this Policy is geared toward enabling job creation and balanced wealth generation. To achieve this, Government interventions should foster entrepreneurship and enterprise development. Improvements to the structural make-up of the financial sector – bringing together the formal and informal sectors, reducing reliance on cash, and supporting SMMEs and black owned businesses – can reduce the concentration of asset ownership that exists in the financial sector and promote competition and innovation, in-turn supporting better value and high-quality financial products and services.

2.2 SOUTH AFRICA'S FINANCIAL SECTOR

South Africa's financial sector is large and sophisticated, consisting of banking and non-banking financial institutions (NBFIs).[26] It contributed 23.5 per cent to GDP in 2021 and the banking sector had total assets worth R6.8 trillion as of 31 March 2022. The sector remains highly concentrated with the five largest banks holding 90 per cent of total assets of as 31 March 2022. The banking landscape is changing rapidly as banks face increasing competition from technology-based financial services, newly established banks, and growing credit granting from other credit providers. This is forcing

16 *The savings rate refers to the amount of money, expressed as a per centage or ratio, that a person deducts from his disposable personal income to set aside and save through formal institutions.*

17 *Inclusive economic growth: Key stylised facts on capital, investments and savings, National Treasury, 2017.*

18 *The household savings rate in South Africa was at 0.20 per cent in the third quarter of 2017, https://tradingeconomics.com/south-africa/personal-savings.*

19 *Individuals and microenterprises operating under conditions of informality rely exclusively or almost exclusively on cash for receiving and making payments.*

20 *Consumer cost of cash in South Africa, Genesis, 2016.*

21 *Standard Bank, FirstRand, Barclays Africa (Absa) and Nedbank.*

22 *Old Mutual, Sanlam, Liberty, Momentum Group (MMI), Discovery Life.*

23 *Public Investment Corporation, OMIGSA, Stanlib, Allan Gray, Sanlam Investment Management, Investec, Coronation.*

24 *Small business, Job creation, and Growth: Facts, Obstacles and Best Practices, OECD, 2009.*

25 *FinScope MSME Survey - South Africa, 2020*

26 *Non-banking institutions are defined as institutions that do not have a full banking licence and are not supervised by a national or international banking regulatory body. These include institutions that provide insurance, securities, pension and provident funds.*

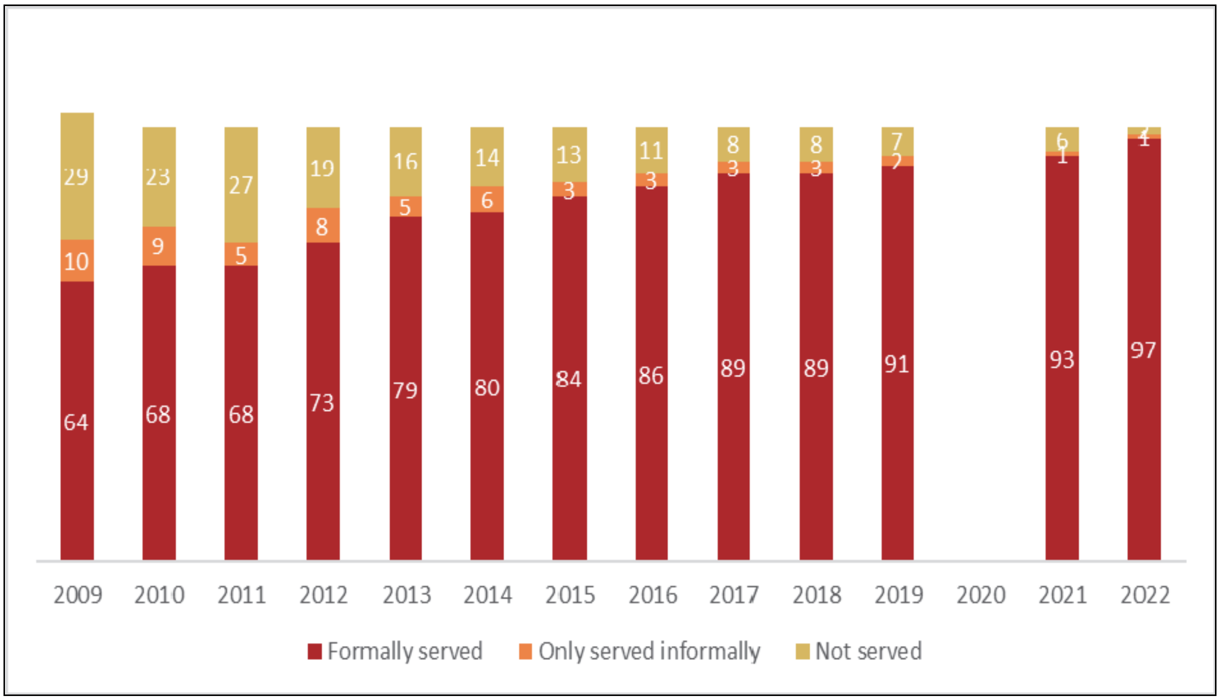
the big five banks to place increasing emphasis on growing customer numbers with innovative product offerings to attract lower-income earners. Competition from newly established banks – i.e., Discovery Bank, Bank Zero, and TymeDigital – aims to disrupt the sector and it is forcing big banks to intensify their efforts to modernise technology platforms to satisfy customers' demands.

NBFIs in South Africa comprise about two-thirds of financial assets, which is large for emerging markets. Of these, pension fund assets comprise 110 per cent of GDP. Long-term insurers (mostly life) hold most of the insurance sector assets, which comprise 64 per cent of GDP. Short-term insurers hold a significantly low proportion of this. Unit trusts or collective investment schemes (CISs), the fastest growing segment in the financial sector, hold assets to the value of 42 per cent of GDP.[27]

2.3 THE EVOLUTION AND CURRENT STATE OF FINANCIAL INCLUSION

Financial inclusion has improved considerably over the past decade, with more than 41 million (97 per cent) adult South Africans using some form of formal financial product or service in 2021, compared to just over 21 million (64 per cent) adults in 2009 (see Figure 3).

Figure 3: The financial inclusion landscape in South Africa



Source: FinScope SA surveys (2010 - 2021)

[27] *South Africa Financial System Stability Assessment: Country Report No. 14/340; IMF, 2014.*

Factors that have contributed to this improvement include:

- the introduction of the Mzansi[28] bank account in 2004 (see Box 7) and the subsequent improvement of appropriate and affordable products by financial services providers;
- the existence of a well-established banking footprint and a financial services network infrastructure in South Africa;
- technological innovation in the provision of financial products and services;
- a focus on consumer literacy; and
- a new system of distributing social grants to beneficiaries that move from using pure cash to transferring money to bank accounts.

When taking stock of progress, it is important to not only look at access to financial products and services but also the take-up and usage of these by both individuals and SMMEs. This involves an assessment of the quality of financial services available. Box 3 below explains the assessment method.

Box 3: Assessment approach

Assessment and monitoring of financial inclusion are typically done in three dimensions, namely access to, and usage and the quality of financial products and services.

- ***Access*** refers to the acquisition or potential acquisition of financial products and services. It relates to the capacity that financial institutions must provide financial products and services, which translates to the ease with which consumers can acquire them. It includes both the physical and electronic reach of service provisioning.
- ***Usage*** refers to the uptake of products and services, and to what extent are used after acquisition.
- ***Quality*** refers to whether financial service provisioning produces positive outcomes for consumers, which will depend on the level of consumer financial literacy and capability and consumer protection. More specifically, "quality" covers the suitability of products and services to different customer profiles and needs, including in terms of affordability, convenience, fairness, and responsible delivery.

Indicators for the measurement of access, usage, and quality calculate the direct effect of financial inclusion policies and are reasonably well established, both locally and internationally. However, these indicators do not provide a measure of the practical impact of financial products and services on end-users. The methodology for the impact assessment should be further developed and strengthened.

The South Africa situational analysis of financial inclusion points to the following main challenges:

- The use of an entry-level banking account is frequently reduced to a simple monthly cash distribution service, where the account behaves more like a "mailbox" (cash-in/cash-out).
- The national payment network is underutilised.
- There are too many instances of unproductive credit extensions to consumers.
- Individuals' propensity to save in the formal financial sector is low.
- The use of insurance products by individuals points to a relative over-reliance on funeral plans and a lack of appropriate asset-insurance products for the low-income market.
- SMMEs are underserviced and business owners are compelled to over-rely on their access to financial services in their individual capacity.[29]

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[28] *The Mzansi Account is a low-income transactional banking account that was developed in line with the commitments of South Africa's Financial Sector Charter. The Financial Sector Charter requires banks to make banking more accessible to the nation and, specifically, to increase banking reach to all communities.*

Affordability, product design and the limitations of the distribution network to support interoperable low-value digital payments for low-income individuals, and SMMEs may be the main drivers of weak uptake and usage. Poor market conduct practices may further compromise the positive effects of financial inclusion and increase the risks faced by vulnerable individuals and SMMEs. Overall, South African SMMEs significantly lag individuals in terms of their access and take-up of financial services. These issues are examined in greater detail below.

2.3.1 ACCESS TO FINANCIAL SERVICES

Access to financial products and services refer to the acquisition or potential acquisition of financial products and services and includes both the physical and electronic reach of service provisioning. Access is closely related to diversification and competition among providers operating in the regulated financial sector. Improving access thus requires the continual assessment and removal of unnecessary barriers to bringing services to the low-income market and SMMEs, which may include barriers to the diversification of the provider and distribution base.

Providers of financial services in South Africa. A diversified financial sector usually bodes well for the provision of market-oriented financial products and services. Table 3 gives an industry breakdown of financial services providers in South Africa since 2014. While the fundamentally sound and sophisticated banking sector provides a solid platform for financial inclusion, the market remains highly concentrated. The number of banks has been stable over the past three years, with the five big banks dominating the market with 90 per cent of market share in terms of assets, according to the South African Reserve Bank (SARB). These banks have branch distribution across the country but mainly in urban and semi-urban areas.

Table 3: Number of financial services providers

Financial service providers	2014	2015	2016	2017	2018	2019	2020	2021
Banks	17	17	17	19	19	19	18	18
Mutual banks	3	3	3	3	4	4	4	4
Co-operative banks	2	2	2	3	4	4	5	5
Registered co-operative financial institutions	24	28	28	28	22	23	24	24
Non-life insurers	97	92	89	88	86	83	74	70
Life insurers	74	75	74	72	73	76	67	69
Credit providers	5,724	4,577	4,569	5,591	6,191	6,895	7,837	8,237

Source: SARB Banking Supervision Reports (2014 –2019), Prudential Authority Annual Report (2021) FSB Annual Report (2014 –2019), NCR Annual Reports (2014 – 2021) and CBDA Annual Reports (2014 –2019)

The number of registered mutual banks remained static between the period 2014-2019 with only one additional bank, Bank Zero, registered in 2018. The registration of new co-operative banks has been steadily rising with three new banks registered during the 2016 – 2020 period. The number of registered co-operative financial institutions (CFIs) [30] however, has remained steady as new entrants were offset by exits. Due to the dominant position of the major commercial service providers in South Africa and the relative lack of capacity of CFIs, the latter institutions' penetration is not at the same

[29] *There is a very blurred line between the business and the business owner. For example, sole proprietorships are owned and run by one natural person and there may not be any distinction between the owner and the business entity. Micro- or "survivalist" entities, discussed under Pillar II, may be informal but nonetheless may have financial services' needs that are different from those of the people who run them, especially in respect of credit.*

[30] *Co-operative Financial Institution (CFI) refers to member-based deposit-taking financial co-operatives, owned and controlled by their members who have a common bond and whose members choose to call themselves either a Credit Union, Savings and Credit Co-operative (SACCO), Financial Services Co-operative (FSC) or Financial Co-operative (FC), CFI start-up guide, www.treasury.gov.za/coopbank.*

level that is witnessed in other African countries, such as Kenya (175)[31] and Malawi (153)[32]. However, the role of these member-based organisations in South Africa should, not be discounted.

South Africa's formal insurance sector, on the other hand, is relatively large and diverse, with 70 non-life insurers and 69 life insurers registered as of the end of 2021. They offer a variety of products including funeral policies, endowment policies, savings products, life insurance policies and short-term insurance products, such as household insurance and motor vehicle insurance.

The number of registered credit providers in South Africa (8,237) is much higher in relation to other financial services providers, as it is easier to register as a credit provider compared to acquiring a banking or insurance licence. However, in terms of the overall gross debtor's book, the credit market in South Africa is still dominated by the banking sector, which holds just over 80 per cent share of the total consumer credit book. Of concern is the high prevalence of unregistered credit providers, or "mashonisas", who serve the most economically vulnerable South Africans, often with harmful lending and debt collection practices.

The role of physical versus digital infrastructure. The achievement of financial inclusion is directly linked to the physical presence and geographic penetration of financial institutions and the availability of digital channels through which interoperable transactions can be conducted. Physical and digital access to financial products and services has improved significantly over the last decade. However, the rate of expansion in the physical "main street" branches has slowed, with only limited use of non-traditional infrastructure, for example offering financial services through the branch networks of retailers.

Looking at different markets, the South African banking services infrastructure has a well-developed services network and makes extensive use of technology to enable and extend the service reach. Since 2010 more than 90 per cent of households had access to physical points of presence within a 10-kilometer radius (according to the Banking Association of South Africa). Physical points of presence consist of bank branches, ATMs[33] and point-of-sale (POS) payment devices. The focus on access in the financial sector codes[34] has led to both an increase in the number of points of service as well as in the geographic distribution of such points. The increase in the transactional capabilities of POS[35] payment devices, enabled by both banks and retailers, is particularly relevant for the low-income market. These devices enable consumers to withdraw cash and make payments for goods and services and allow SMMEs to accept digital payments, increasing for their clients.

Although the physical reach and use of technology have improved financial access in South Africa, there is still much scope for improvement compared to other developing countries, as can be deduced from Table 4 (Australia has been included as a developed economy for reference purposes only).

[31] *World Council of Credit Unions, https://www.woccu.org/newsroom/covid19_resources?post_id=1811*

[32] *Makiyoni, K, file:///C:/Users/6849/Documents/ditc-ted-21112019-Malawi-CDF.pdf*

[33] *Automated teller machine that dispenses cash or performs other banking services when an account holder inserts a bank card.*

[34] *Previously Financial Sector Charter*

[35] *A point of sale (POS) is the point where sales are made. On a micro level, retailers consider a POS to be the area where a customer completes a transaction, such as a checkout counter. It is also known as a point of purchase.*

Table 4: International comparison of physical banking infrastructure

Access Indicator	South Africa	Brazil	India	Mexico	Australia
Commercial bank branches per 100,000 adults	10.5	20.7	13.5	14.1	28.7
ATMs per 100,000 adults	69	114.3	19.7	51.1	163.6
POS terminals per 100,000 adults	940.6	3,233.7	120.7	1,093	4,939.3

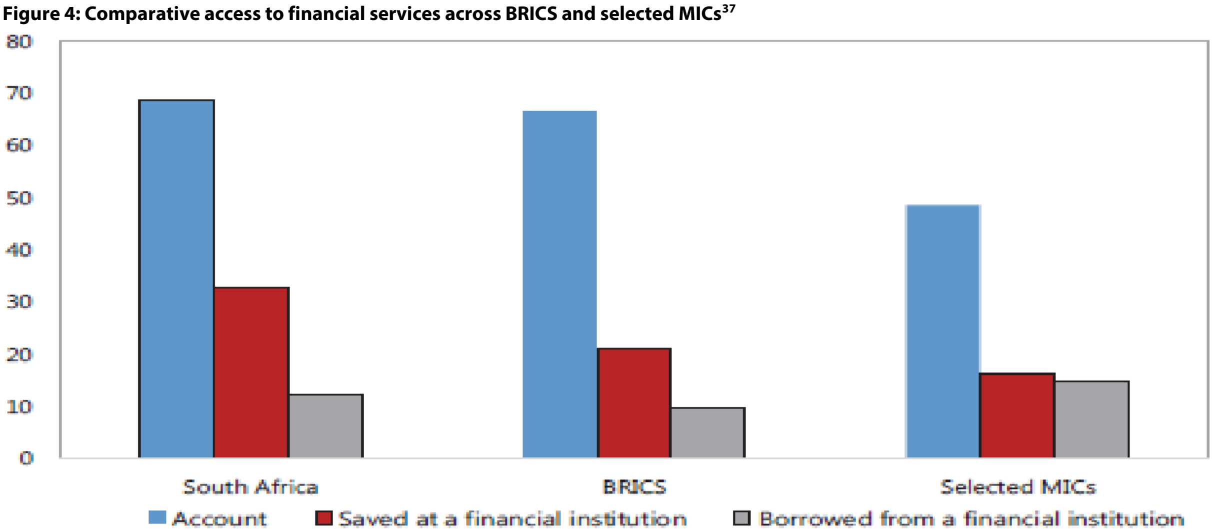
Source: G20 Financial Inclusion Indicators 2015, World Bank

The relatively deep physical reach achieved in Brazil is arguably attributed to the success of its agency banking model in promoting financial inclusion. In South Africa, while purchasing banking products and services predominately done through traditional bank branches, most banking transactions are executed through direct electronic transfers, ATMs, POS, cellular phones, and online services. To further extend financial inclusion, the adoption and greater use of a variety of distribution models are required.

2.3.2 TAKE-UP AND USAGE OF FINANCIAL SERVICES

While South Africa compares favourably to other major emerging economies like Brazil, Russia, India and China and other countries, in terms of overall product take-up (see Figure 4), its level of financial inclusion relative to financial development is comparatively low. Inequalities in financial inclusion are significant considering, for example, that about 80 per cent of the highest quintile have bank accounts compared to about 60 per cent in the lowest quintile, reflecting South Africa's dual economy.[36]

Figure 4: Comparative access to financial services across BRICS and selected MICs[37]



Source: South Africa Country Report No. 17/189 ARTICLE IV 2017

Transaction accounts

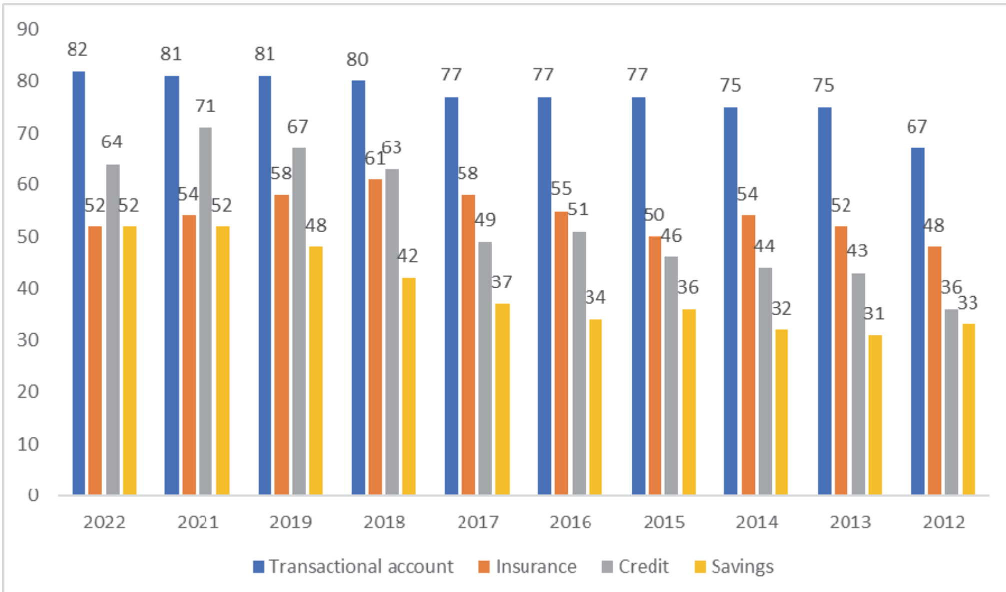
The proportion of South Africans who hold a transaction account has increased from 67 per cent in 2012 to 82 per cent in 2022 and is well above the acquisition of all other financial products. The take-up of transaction accounts – particularly

[36] *South Africa Country Report No. 17/189, ARTICLE IV, Annex II - Financial Inclusion, IMF, 2017.*

[37] *Per centage of Population (age 15 & above): With an Account at a financial institution, South Africa Country Report No. 17/189 Article IV Consultation, Annex II. Financial Inclusion, IMF, 2017*

bank accounts – could be an entry point for financial inclusion. It can facilitate the use of a range of other financial products and services and can thus be seen as a gateway to accessing other financial products and services. In South Africa, however, the use of an entry-level banking account is frequently reduced to a simple monthly cash distribution service (cash-in/cash-out) with only 31 percent of the banked population using their account more than three times a month[38].

Figure 5: Financial product uptake levels



Source: FinScope Survey (2012 to 2022)

Insurance

After a decline in the use of insurance products during the period 2009 - 2012, mainly due to deterioration in disposable income because of the global economic crisis, the percentage of the adult population who use some insurance product has increased from 48 per cent in 2012 to 52 per cent in 2022. Of those with an insurance product, only 39 percent had non-funeral insurance in 2022. Informal insurance remains a vibrant market for the average South African adult with a 30 per cent penetration rate. As consumer household income remains constrained it is likely that the proportion of the insured population will remain low.

Credit

As of March 2022, there were 26 million formal credit-active consumers and more than 10 million of these were behind on their payments.

[38] *FinScope Consumer Survey South Africa, 2019*

Table 5: Credit granted by credit type

Agreements	2021-Q1 R000	2021-Q2 R000	2021-Q3 R000	2021-Q4 R000	2022-Q1 R000	2022-Q1% Distribution
Mortgages	40 946 326	43 178 082	45 442 043	50 646 758	47 407 415	30%
Secured credit	54 267 609	56 585 027	66 153 370	62 736 197	55 705 855	35%
Credit facilities	20 132 666	22 449 467	22 635 714	27 585 649	26 687 775	17%
Unsecured credit	19 655 584	20 838 968	21 273 387	23 765 101	24 712 560	16%
Short-term credit	1 971 947	2 212 598	2 115 350	2 171 478	1 992 181	1%
Developmental credit[39]	1 834 610	1 609 851	1 502 787	1 604 506	2 653 813	2%
Total	138 808 743	146 873 994	159 122 651	168 509 689	159 159 599	100%

Source: NCR Consumer Credit Market Report, March 2022

As indicated in Table 5, the unsecured credit share of total credit granted increased from R19.66 billion for the quarter ended March 2021 to R24.71 billion for the quarter ended March 2022, which was reflective of the improved macroeconomic environment, recovering from the effects of the COVID-19 global pandemic. The increase in the take-up of credit over the years mirrors the decline in savings.

Savings

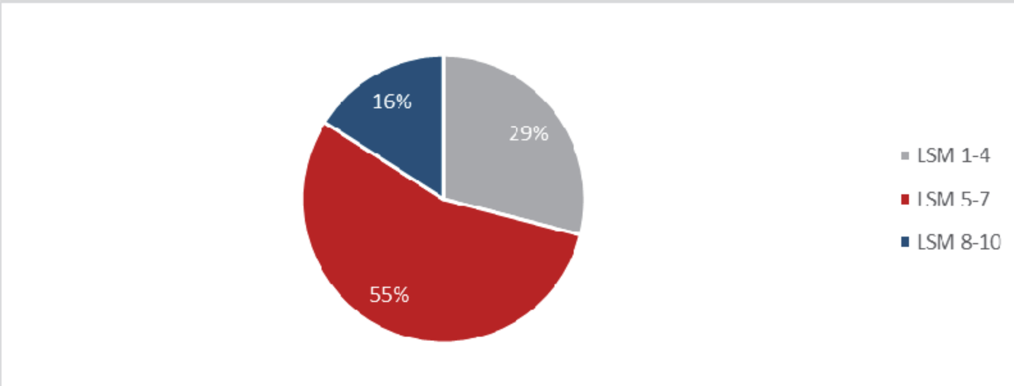
Most of the adult population that saves in the formal financial services sector falls into the higher Living Standards Measure (LSM) categories (6-10), implying that the savings rate for lower LSMs (1-5) in formal financial institutions is well below the average. However, if the size of the stokvel market as depicted in Box 4 is taken into consideration, then it is clear South Africans do save, just not through regulated formal institutions.

[39] *Developmental credit is a special type of credit that is created and defined in the National Credit Act. Currently the Act makes provision for three types of developmental credit: loans for educational purposes, loans to build, expand or improve low-cost housing and loans to set up small- and medium-sized businesses.*

Box 4: Savings Stokvels in South Africa

The word "stokvel" is often used to refer to various "groups" such as social clubs, informal savings groups, burial societies, syndicates, mogodisano, mgalelo, makgotla and gooi-gooi. Contrary to the general belief that stokvels are a financial structure only for the poor, data indicate that stokvel membership is distributed amongst all LSM categories (see Figure 6) with those in LSM 5-7 make up the largest share of the stokvel market.

Figure 6: National Distribution of Stokvel Members[40]



Source: NASASA, 2017

Stokvels are joined for fund pooling with a primary mandate to either save for a particular goal, or to help one another, especially where individual financial means fall short, or are unbudgeted for, as in the case of an emergency. As of the end of 2017, there were 810,000 registered stokvels with 11.5 million individual members distributed across all nine South African provinces, with approximately R49 billion in savings.

Remittances

In South Africa, there is significant use of remittances, both domestically (transferring funds within the country), as well as cross-border (transferring money outside the country). The 2019 FinScope Survey indicated that people were using a combination of formal and informal channels to send money. Of those who use remittance services, 48 per cent are remitting via banks, 55 per cent via retailers and 35 per cent via informal channels.

Data from the OECD[41] shows that South Africa contributed more than 51 per cent to the GDP of the 16-member SADC region. South Africa, a destination country for many in the SADC looking for better opportunities, continues to be the largest recipient of migrant labour in the region with an estimated 2.9 million migrants residing in the country.

40 *National Distribution of Stokvel Members, 2017, NASAS*

41 *OECD, Economic Survey, 2017. https://www.oecd-ilibrary.org/economics/oecd-economic-surveys-south-africa-2017*

Box 5: Financial Inclusion of Refugees

A refugee in South Africa is entitled to all rights, except the right to vote. However, refugees continue to face challenges when accessing formal financial services.[38] South Africa currently hosts 266,694 persons of concern whose cases are active with the Department of Home Affairs. Of these 78,398 are refugees and 188,296 asylum seekers (UNHCR). A significant barrier is presented by the lack of familiarity that financial services providers (FSPs) have with this market segment. Providers lack information on livelihood opportunities for refugees, the business case for serving them, their rights and their credit risk. Many enterprises that are run or owned by refugees need access to microcredit loans to expand their activities. These loans are very limited and almost non-existent in South Africa. In addition, there is a demand for other types of financial services to the refugee population, such as access to savings accounts, payment or remittance services and insurance.

Fintech

Though still nascent, fintech development in South Africa has already been catalysed by consumers and businesses seeking novel financial products and services to store value, make payments, save, and borrow and insure against daily risks. To date, Government has embraced a pro-innovation stance, working across agencies to develop harmonised approaches to fintech and clarifying the regulatory stance on emerging technologies and products, with the goal of benefiting all South Africans. An inter-governmental fintech working group (IFWG) was formed in 2016, comprising representatives from the National Treasury, South African Reserve Bank, Financial Sector Conduct Authority, National Credit Regulator, South African Revenue Service and Financial Intelligence Centre. Moreover, the Conduct of Financial Institutions (COFI) Bill's priority will be to manage consumer risks in digital financial services, ensuring continued trust in the financial sector. Flexibility exists within the COFI Bill, with provisions for a supportive and proportionate approach to fintech entrants even while prioritising fair customer treatment.

2.3.3 QUALITY OF FINANCIAL PRODUCTS AND SERVICES

The quality dimension of financial inclusion relates to the outcomes to consumers over all the phases of service provisioning (from marketing to post-sales). In this context, quality includes issues pertaining to financial consumer protection and market conduct, encompassing fundamental aspects such as the appropriateness and utility (suitability) of the product or service, affordability, fairness, transparency and access to effective redress mechanisms. Although these aspects apply to all users or potential users of financial products and services, the focus is on the low-income market segment and SMMEs, given their vulnerability.

Box 6: The importance of financial education

Financial education is a key factor in ensuring sustainable and effective financial inclusion, as it provides individuals and entrepreneurs with knowledge, understanding, skills and confidence to make sound financial decisions and take actions which are appropriate to their circumstances. Therefore, increased financial literacy[42] levels are a prerequisite to both improving usage of products and services amongst existing users and extending financial inclusion to the currently un- or under-served. A considerable number of South Africans still display very low levels of financial literacy. The 2015 South African Social Attitudes Survey (SASAS),[43] which measures financial control, planning, knowledge, and product choice, showed an average overall financial literacy score of 55 per cent. This implies that only half of the decisions made about the use of financial products and services in South Africa are well-informed.

The increasing availability and use of digital information and the continued development of artificial intelligence in making such information available provides an opportunity to add to the existing channels used in financial education. The use of digital financial education, if appropriately tailored to the individual needs has the potential to increase financial literacy levels in South Africa.

Affordability, especially the entry costs for accessing financial products and services, is a key element in assessing the quality of financial products and services. If services are easily accessible but the entry cost to the end-user is too high, then the services will be out of reach for low-income earners and SMMEs. A World Bank diagnostic into the market conduct of South Africa's retail banks, conducted on behalf of the National Treasury, found that bank accounts became prohibitively expensive for low-income earners the more they used the physical rather than digital infrastructure. Similarly, remittances in South Africa, which are a dominant way to transfer funds to loved ones for low-income earners, are deemed the most expensive amongst G20 peers, with fees at an average of 17.78 per cent - well above the global average of 7.45 per cent. This indicates that even when products and services are easily accessible those products and services are not affordable then the objectives of financial inclusion cannot be achieved.

2.3.4 SMME FINANCIAL INCLUSION

Relative to individuals, SMMEs are poorly served, with most of their financial needs served in the owner's personal capacity or outside of the formal financial sector. According to the FinScope 2020 survey, 80 percent of SMMEs are banked however, of those who are banked only 30 per cent of SMMEs have a business bank account with the remainder using the owners personal account as a dual account for both business and personal usage. Even with the use of a personal account for business purposes 18 percent of micro enterprises (which are mainly informal) are still excluded from the formal banking sector.

Access to formal credit, which is one of the primary drivers of this segment's growth, remains low with 33 per cent of SMMEs having some form of a line of credit from formal financial institutions in 2020 – up from only 9 per cent in 2016. This places South Africa significantly behind many emerging market peers (Figure 7).[44] The total exposure of the major retail banks to SMME lending made up about 12 per cent of their total loan book in March 2021.[45] According to a 2018 BASA commissioned report, "Hurdles faced by financial institutions in SMME financing" the main reasons for low SMME lending by banks is largely driven by their strong risk aversion towards SMMEs as they are perceived to be riskier and less profitable. The International Monitory Fund (IMF) has observed that banking operations in South Africa focus on servicing the wealthier.[46]

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[42] *Financial literacy is the outcome of financial education.*

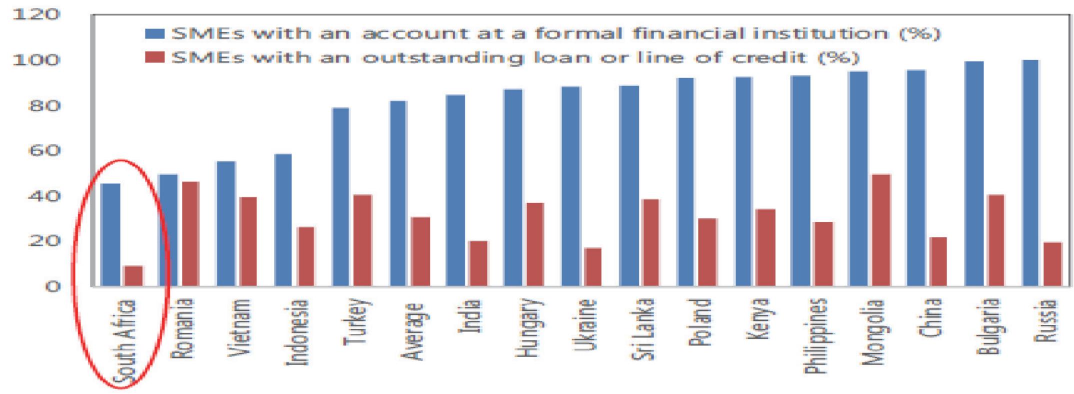
[43] *The SASAS is part of the ongoing study of financial education in South Africa and its objective is to provide the Financial Sector Conduct Authority (FSCA) with information about the financial knowledge, attitudes, skills and behaviour of adult (aged 16 and older) South Africans.*

[44] *South Africa Country Report No. 17/189 Article IV Consultation, Annex II. Financial Inclusion, IMF, 2017.*

[45] *BA200, SARB, March 2021*

[46] *South Africa Country Report No. 17/189 Article IV Consultation, Annex II. Financial Inclusion, IMF, 2017.*

Figure 7: SMME credit access

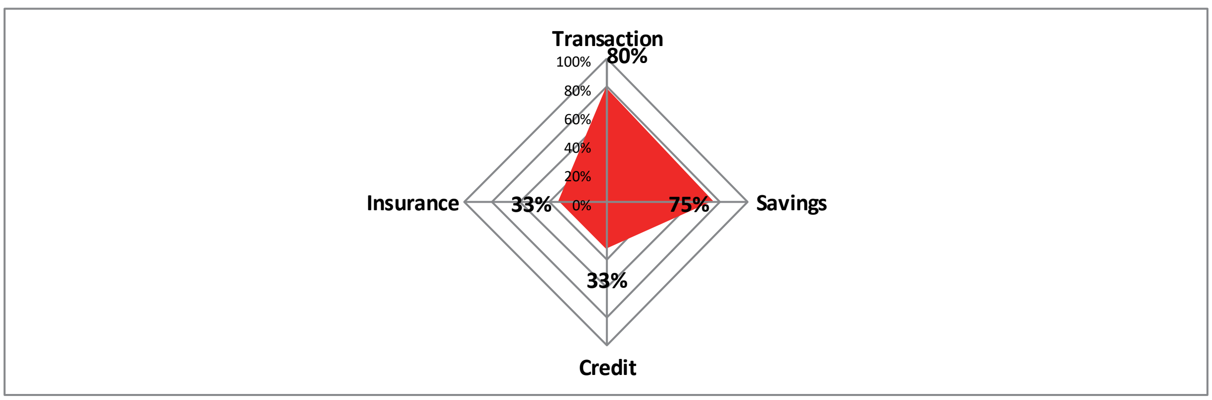


Source: South Africa Country Report No. 17/189 ARTICLE IV 2017

Savings uptake is higher among business owners, with 75 per cent of them having some form of savings product. Only one in three business owners have an insurance product that could be used for business purposes with the majority of those with such insurance in the medium business category and 95 percent of micro-enterprises excluded from the formal insurance sector. Overall, insurance penetration among businesses was dominated by workmen's compensation cover (20 percent) followed by personal accident cover (15 percent).

The majority of SMME business transactions still take place in the business owners' personal capacity thus conflicting business interests and personal interests. This necessitates an understanding of the needs of this market and the development of appropriate products and services for SMMEs. Figure 8 below shows the main financial services used by SMMEs.

Figure 8: SMME financial inclusion landscape



Source: FinScope MSME Survey South Africa 2020

Several development financial institutions (DFIs) and support agencies have been created to try and address the lack of financial services for SMMEs, by providing finance where there is a funding gap and developmental support to aid their growth and sustainability. However, many SMMEs do not know about the services available.

As with individuals, financial capability, especially among micro- and informal enterprises, remains an impediment to the productive acquisition and use of financial products and services. The improvement of financial capability among SMMEs should be a major focus area, for the providers of business support services and the financial sector. The use of digital financial information, tailored to the situation of the enterprise, has the potential to alleviate this problem and could act as a major lever to improve the levels and the productive use of financial products and services in the SMME sector.

3. FINANCIAL INCLUSION: LOCAL AND GLOBAL POLICY DEVELOPMENTS

3.1 POLICY AND REGULATORY DEVELOPMENTS AND INTERVENTIONS RELEVANT FOR FINANCIAL INCLUSION IN SOUTH AFRICA

This section highlights the main policy and regulatory developments across South Africa's socio-economic landscape that are relevant to financial inclusion and have been considered in the development of this Policy.

3.1.1 THE NATIONAL DEVELOPMENT PLAN

In 2012 Government developed and published the National Development Plan (NDP) with the aim of eliminating poverty, reducing inequality, and achieving full employment, decent work, and sustainable livelihoods for all. The NDP acknowledges financial inclusion as one of the important tools that will contribute toward the realisation of its goals. The NDP goals are therefore key objectives in the framework of the collaborative effort to take financial inclusion forward.

The NDP includes a target of 90 per cent of the population achieving banked status by 2030. However, financial inclusion goes beyond being just banked, it also includes access to and use of all financial products and services by both individuals and SMMEs.

The focus of this policy is therefore to support interventions that will meet the NDP's target whilst ensuring that the usage of quality financial products and services benefit the life of low-income households, and create economic opportunities for SMMEs.

3.1.2 FINANCIAL SECTOR CHARTER AND THE SUBSEQUENT CODES[47]

The Financial Sector Transformation Council (FSTC)[48] is a unique forum in which the financial sector, Government, organised labour, and community representatives collaborate to set transformation targets for the financial sector through the Financial Sector Charter (FSC). Areas on which the FSC focuses include ownership within the financial services sector, management, control and employment equity, infrastructure investment, empowerment financing and enterprise development. Recognising the transformative impact of the financial sector and leveraging it to change the way black South Africans participate in the financial sector, access to financial services, and consumer financial education also a key component of the FSC.

Interventions undertaken because of the FSC have contributed meaningfully towards financial inclusion in South Africa, especially for transactional banking (see the Mzansi account experience in Box 7). Much less progress has been made in relation to insurance except for funeral and credit insurance.

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[47] *The Financial Sector Charter was a voluntary Charter from 2004 to 2008 which was then replaced in 2012 by the Financial Sector Code (the Code) and revised to be aligned with the B-BBEE generic codes in 2017. This Code was renegotiated, gazetted and structured in accordance with the B-BBEE Act, and is legally binding.*

[48] *Previously known as the Financial Sector Charter Council.*

Box 7: The Mzansi account

In 2004 the Mzansi account was jointly developed by South Africa's four major banks and the South African Post Office's Postbank, as a basic bank account intended for the low-income segment of the economy. The development of this basic account was a result of the banking sector's commitment to the Financial Sector Charter.[49]

Each bank developed its own pricing and product features for the Mzansi account based on the following agreed principles:

- Prominent use of the Mzansi brand;
- The account had to have an associated debit card, with normal debit card functionality and operational ability in the fully interoperable South African payment system;
- No "penalty" was imposed for using other banks' infrastructure;
- It would have a defined basket of transactions not exceeding an agreed amount that was deemed affordable by the target market. This upper limit was significantly lower than the cost for typical bank products;
- No monthly or management fees were charged;
- There would be one free cash deposit per month;
- Withdrawals and basic enquiries could be done at all Post Office branches, irrespective of the bank involved in issuing the account; and
- Exemption 17[50] of the AML/CTF legislation was incorporated into the opening procedure of all Mzansi accounts.

From a global perspective, the Mzansi account was the first industry-wide basic bank account and also heralded the beginning of risk-based AML/CFT regulations in South Africa. Being the first in the market meant that there were no examples to learn from. However, the Mzansi account achieved some of the major objectives intended by the banking sector:

- Increased access to bank accounts increased the level of financial inclusion in the country from 46 percent to 63 percent in the period 2004 to 2008. More than 6 million accounts were opened, with 72 per cent of the users being first-time banking clients[51].
- People in low-income communities were given the opportunity to take up and use the product and to engage with the financial sector. However, the willingness to engage required significant market awareness campaigns, incorporating basic financial literacy in the process. The extensive market engagement by the banks over a period of time, resulted in an active product rate[52] of 82 percent – a reasonable rate for an entry-level product.
- The risk-based approach to AML/CFT did not expose the financial system to any undue risk, as the level of suspicious transactions were lower than for other bank accounts.

When the product was introduced, there were other products expectations which were not met including:

- The product uptake was not followed by an expansion of the payments network in low-income communities. This inhibited the use of the account and the growth of digital payments in the communities where users of the Mzansi account lived.
- The low level of usage (typically less than 3 transactions per month) meant that users did not get the full benefit of the account, while the financial service providers received less than expected revenues from the product.

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[49] *The Financial Sector Charter (the Charter) came into effect in January 2004 because of a voluntary offer to develop an industry transformation Charter by the financial sector at the National Economic Development and Labour Council (Nedlac) Financial Sector Summit.*

[50] *Exemption 17 of the FIC Act exempts designated accountable institutions from compliance with certain client identification and verification obligations required by the FIC Act.*

[51] *National Treasury and AFI FIDWG, The Mzansi Story and Beyond, GPFI 2014*

[52] *The active product rate indicates the number of active accounts (or not dormant) at a particularly point in time.*

The expectation that the account would develop and that more functionality, particularly digital delivery channels, would be added did not materialise timeously.

The functionality on the account was initially quite limited and then gradually expanded, but due to the lack of further investment the account lacked some of the emerging functionalities offered by other transaction accounts, leading to a perception of the Mzansi account being a 'poor man's account'. The marketing drive behind the product diminished over time and the FSC subsequently opted for an approach of agreeing basic attributes for products in the low-income market, enabling banks to develop access products as defined in the FSC.[53]

Apart from the issues mentioned above, other lessons emerged from the Mzansi initiative:

- The product was developed and launched as a cooperative venture by the four major banks at the time and the Postbank. This created momentum in the market and allowed the **agreement to forego interchange on some interbank transactions, leading to the initial market success of the product.**
- The acceptance of the account in the market demonstrated that there is a need for such **basic transactional products with features like a low minimum balance and no fixed fees** and a willingness to engage the financial services industry in the low-income communities.
- Although the product took the **market needs into account, this was not done in a holistic manner**. Consequently, a full set of products and services designed to address all needs were not developed, leaving significant gaps in the market, e.g., savings and basic insurance products.
- Although some account holders had a desire to save, **the interest rate structure and balance limits on the Mzansi accounts did not incentivise the accumulation of funds.** The lesson here is product design and features are important for low-income earners.
- The banks demonstrated that it was possible to **collaborate, develop and roll out a major initiative** that added lots of lower-income earners to the banking sector.

The close relationship between transformation and financial inclusion means it is imperative that these policies are aligned and designed to be mutually reinforcing, though noting that transformation may not necessarily result in financial inclusion, and vice versa. Future revisions of the FSC should consider this policy and be leveraged to promote financial inclusion, particularly in lagging areas that can be addressed within the elements defined in the FSC

3.1.3 TREATING CUSTOMERS FAIRLY FRAMEWORK

In 2010 the Financial Services Board (FSB) – it is now called the Financial Sector Conduct Authority (FSCA) – introduced the treating customers fairly (TCF) framework.[54] This framework focuses on an outcomes-based approach, requiring financial service organisations to incorporate the fair treatment of customers throughout a product's lifecycle, including the design, marketing, advice, point-of-sale, and after-sale stages. Given additional, legal backing from the Financial Sector Regulation Act and the anticipated Conduct of Financial Institutions Bill, the framework should support more-optimal outcomes from the perspective of regulators, consumers, and financial services providers. The framework is a key element in driving the expansion of sustainable financial inclusion.

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[53] Financial Sector Codes Product Access Standards were adopted in 2005 and are defined in terms of physical access, appropriateness, affordability, simplicity and understandability for the target market. AQP are savings and transactional products. Each bank has a single target for Access Qualifying Products (AQP), which may include any combination of transactional products, savings products and hybrid products (which are both transactional and savings products). In other words, each bank can decide whether to focus on one or two or all three types of AQP to meet their product access targets, based on their individual strategy and product design.

[54] For a comprehensive list of the TCF outcomes see link: https://www.fscaconsumered.co.za/Consumer/Pages/Treating-Customers-Fairly.aspx.

3.1.4 FINANCIAL SECTOR REGULATION ACT

In 2011 Government announced a shift to the Twin Peaks model of financial regulation. Since then, two regulators have been established under this model with strong powers to monitor emerging risks and take action to manage them,[55] as provided for in the Financial Sector Regulation Act 2017. The Prudential Authority is focused on prudential oversight, while the Financial Sector Conduct Authority is focused on market conduct.

National Treasury's document *"A safer financial sector to serve South Africa better"* outlined South Africa's approach to the Twin Peaks model and identified the primary aims of the country's policy pertaining to the financial sector, which are financial stability, consumer protection, access to financial services, and the combating of financial crime.

The Twin Peaks model is being implemented in such a way as to strengthen, amongst other things, financial inclusion. The two authorities established under the model are required to support and promote financial inclusion in the performance of their respective functions. This means that the effects of their respective activities on financial inclusion should be routinely considered as well as efforts to support and promote inclusion identified in each authority's regulatory strategy. The Ombud Council – established to strengthen the ombuds' system and ensure that financial customers have access to and can use affordable, effective, independent, and fair alternative dispute resolution processes – will also be required to support financial inclusion in carrying out its functions.

The Financial System Council of Regulators will establish a workgroup to focus on financial inclusion matters relevant across Government. However, given the wide range of stakeholders involved in the planning and implementation of national financial inclusion strategies, the National Treasury, supported by the envisaged Financial Inclusion Sub-Working Group and the Financial Inclusion Forum (see Chapter 5), will remain the lead organisation responsible for financial inclusion.

3.1.5 PARLIAMENTARY ENQUIRY INTO TRANSFORMATION OF THE FINANCIAL SECTOR

Scrutiny of financial sector transformation intensified during the review of the Financial Sector Regulation Act (FSR Act) by the Standing Committee on Finance of parliament's National Assembly. Most committee members expressed concern over the apparent lack of meaningful transformation across the sector, and they asked how the FSR Act would take steps to address this. Although it was recognised that the FSR Act could not be the main instrument to effect transformation, the Act was strengthened to entrench the principle of transformation, by:

- making transformation an object of the Act;
- referring to the Financial Sector Code in the Act; and
- requiring that a transformation working group or subcommittee be established in terms of structures for coordination between the various regulators and national departments responsible for regulating the financial sector.

The Standing Committee on Finance and the Portfolio Committee on Trade and Industry at the National Council of Provinces held public hearings on transformation. These were designed to get a deeper understanding of and stimulate debate around the state of transformation in the financial sector, the main barriers to transformation, and the options that are available to drive improved transformation. Three public hearings took place between March and May 2017 in which 53 submissions were heard from Government, its agencies and regulators, bodies for constituency negotiation

55 *The Financial Sector Conduct Authority will operate alongside the NCR to protect financial consumers.*

and agreement, political parties and associations, civil society, financial sector providers and industry representative bodies. The first report on the Transformation of the Financial Sector[56] by the Standing Committee on Finance and the Portfolio Committee on Trade and Industry makes recommendations relating to:

- Reporting on transformation in the financial sector;
- The Financial Sector Transformation Council's visibility to stakeholders and capacity to perform its duties;
- Transformation targets;
- The role of the Broad-Based Black Economic Empowerment Commission[57] in ensuring transformation in the financial sector;
- Market concentration and ownership patterns in the financial sector;
- Accessibility of non-banks to the national payment system;
- Financial inclusion;
- The conduct of financial institutions;
- Support for smaller and other black businesses, with a particular focus on new entrants, into the financial sector; and
- The financial education of financial customers and the public in general.

The National Treasury played an important role in supporting the Committee on Finance and the Portfolio Committee on Trade and Industry in these deliberations. In support of the recommendations from these deliberations and South Africa's transformation objectives, the National Treasury will address issues on transformation in all future policy developments in the financial sector.

For financial inclusion in particular, transformation speaks to the sustainable provision of financial products and services to all South Africans by a diversified financial sector that should reasonably represent the demographics of South Africa in terms of ownership, control, management, and employment. It also implies structural reform of the sector to enhance competition and broad-based participation by black South Africans in the financial sector.

3.1.6 THE FINANCIAL INTELLIGENCE CENTRE ACT

The Financial Intelligence Centre Act (FIC Act) has been strengthened by introducing a risk-based approach to customer due diligence. The Act embraces a more customer-friendly and cost-efficient approach to the implementation of anti-money laundering and combating the financing of terrorism (AML/CTF) in line with the Treating Customers Fairly Initiative. The application of a risk-based approach to customer due diligence can support financial inclusion objectives. This allows for a more flexible application of customer due diligence measures to certain categories of financial products or customers who are considered low-risk, and might otherwise struggle to meet rigid identification and verification requirements. The FIC Amendment Act further places an obligation on accountable institutions to develop, document, maintain and implement a risk management and compliance programme that will enable them to be more innovative and use new technology to apply simplified due diligence in cases of lower risk exposure.

[56] *1st Report on the Transformation of the Financial Sector, Standing Committee on Finance and the Portfolio Committee on Trade and Industry, 2017.*

[57] *The B-BBEE Commission became operational in 2016 and was established by Section13B of the B-BBEE Act 46 of 2013 to oversee, supervise and promote adherence to the Act in the interest of the public.*

National Treasury's *"A New Approach to Combat Money Laundering and Terrorist Financing"* document provides a set of principles to guide the implementation of the risk-based approach. It emphasises the need to ensure that customers are not burdened unnecessarily with a bureaucratic or tick-box approach to compliance and are not excluded from the financial system solely because the customer is unable to produce a particular document that may not be readily available or easily accessible.

3.1.7 INSURANCE ACT

In 2011, National Treasury issued a policy document "*The South African Microinsurance Regulatory Framework*" that made provision for the introduction of a proportionate and appropriate regulatory and supervisory framework for micro-insurers. The policy framework was developed in response to a discussion paper issued in 2008: "The future of Microinsurance in South Africa," which investigated the low penetration levels of insurance among low-income earners. The policy framework was intended to achieve the following objectives:

- Extend access to a variety of good-value formal insurance products appropriate to the needs of low-income households;
- Facilitate the provision of formal insurance by currently informal service providers and, in the process, promote the formation of regulated insurance providers and SMME development;
- Lower barriers to entry, which should encourage broader participation in the market and promote competition;
- Enhance consumer protection within this market segment through appropriate prudential and business conduct regulation;
- Improve the enforcement in the case of regulatory transgressions;
- Increase consumer education interventions that are targeted at aiding consumers to understand insurance and its associated risks and benefits; and
- Facilitate effective supervision thereby supporting the integrity of the insurance market as a whole.

The Insurance Act, No.18 of 2017, subsequently introduced a risk-based legal framework for micro-insurers through appropriate prudential and market conduct regulations. The Insurance Act introduces micro-insurance[58] as a class of insurance business in South Africa that forms part of the broader insurance market. However, it is distinguished by its particular focus on the low-income market, which translates into distinct product design and distribution channels that aim to increase insurance penetration levels in its target market.

3.1.8 REVIEW OF BANKING AND PAYMENT METHODS IN DISTRIBUTING SOCIAL GRANTS

South Africa's social security system is one of the largest social welfare transfer systems in the developing world,[59] transferring over R150 billion in social assistance to over 17 million grant beneficiaries (about 12 million people).[60] It is likely the single largest impact on how the poorest South Africans interact with the financial sector. In line with findings by the constitutional court, the South Africa Social Security Agency (SASSA) introduced a new solution for the payment of grants. The previous payment model, which took place through a single dedicated service provider (Net1), was

[58] *The National Treasury's South African Microinsurance Regulatory Framework issued in 2011 defines microinsurance as insurance that is accessed by the low-income population (also known as the mass market), provided by a variety of different providers and managed in accordance with generally accepted insurance practice.*

[59] *A 2009 report from CGAP estimates that 170 million people receive regular G2P payments globally, this makes the South African grant distribution scheme comparatively significant.*

[60] *http://www.sassa.gov.za/phocadownload/december%202017.pdf; the number of beneficiaries exceeds the number of grant recipients as many receive multiple grants.*

phased out and replaced by a "hybrid model" where social grant payments are now paid through the South African Post Office and banking network. It is important that any solution adopted for the payment of social grants maintains and builds on the financial inclusion of beneficiaries achieved thus far, takes into consideration the needs of the recipients, and encourages more beneficial use of transaction accounts as well as other financial products and services.

3.1.9 OTHER INTERVENTIONS

Other interventions undertaken are set out below.

- The FSCA's review of retail distribution to improve transparency and accountability of financial services providers and intermediaries, for example, improving disclosure and confronting conflicts of interest.
- A retail banking diagnostic conducted by the World Bank for National Treasury to understand market conduct practices in the retail banking sector and make recommendations for improvements.
- Introducing comprehensive conduct of business returns for insurers, for the FSCA to better understand and monitor their market conduct practices and emerging conduct risk.
- The development of a regulatory framework for financial institutions to manage complaints. This is currently at various stages of implementation across market segments, and it will be standardised through the Conduct of Financial Institutions Bill.

3.2 GLOBAL TRENDS TOWARDS COORDINATED FINANCIAL INCLUSION POLICY

The Leaders of the G20 are promoting reforms in support of an inclusive financial sector, endorsing a financial inclusion action plan (FIAP),[61] and have established the Global Partnership for Financial Inclusion (GPFI) as a coordinating platform. The GPFI coordinates the implementation, by signatory countries of the FIAP and the G20 Principles for Innovative Financial Inclusion. Various implementing partners support the GPFI, including the Consultative Group to Assist the Poor (CGAP),[62] the Alliance for Financial Inclusion (AFI),[63] the World Bank[64] and International Finance Corporation and the OECD. A summary of the evolving FIAP is given in Box 8.

[61] *http://www.gpfi.org/sites/default/files/documents/2014 g20_financial_inclusion_action_plan*

[62] *CGAP provides practical support across a range of inclusion initiatives, from good practice in micro-finance to the role of mobile payments in extending financial services.*

[63] *AFI is an organisation that offers a platform for financial inclusion policymakers to address issues of common interest and to share the experiences of financial inclusion policies and interventions. Organisations from more than 100 developing countries are members of AFI.*

[64] *The World Bank as part of this focus gives technical assistance to many countries including South Africa, with funding from the Swiss government through its agency the State Secretariat for Economic Affairs (SECO).*

Box 8: Financial inclusion action plan (FIAP)

The G20's FIAP intends to improve the level of financial inclusion among G20 member and non-member countries. The FIAP plan provides the main areas of focus, with objectives and outcomes and the specific activities required by the G20 to support and promote financial inclusion. The plan is revised every three-to-five year(s), as such an approach allows for the incorporation of new financial inclusion developments. The GPFI, as the coordination mechanism for the implementation of the FIAP, monitors progress in each signatory country. It also mobilises funding for financial inclusion by leveraging existing funding mechanisms or setting up new ones.

The key actions in the original FIAP included:

- Commitment to implement G20 Principles for Innovative Financial Inclusion
- Further encourage standard-setting bodies (SSBs) to support financial inclusion
- Work with the private sector to harness public and private sector cooperation
- Improve data to contribute to, and strengthen, the global dialogue to measure progress
- Support capacity building and training to enhance the skills and knowledge of policymakers and financial sector institutions
- Improve national, regional, and international coordination for financial inclusion
- Advance progress towards universal financial inclusion by implementing the G20 Principles for Innovative Financial Inclusion
- Integrate financial inclusion into all types of financial system assessments

In 2014 a review of the FIAP resulted in revised key actions in the following areas:

- SMME finance
- Regulations and standard-setting bodies
- Financial consumer protection and financial literacy
- Markets and payment systems

In 2017 another review reaffirmed the G20 leaders' commitment to financial inclusion, focusing on the under-served groups (such as the poor, women, youth, and people living in remote rural areas) and vulnerable groups (which include elderly people, migrants, and forcibly displaced people). The following four trends were also identified to set the stage for continued progress in financial inclusion:

- Align the work of the GPFI with the 2030 Agenda for Sustainable Development
- Digitisation of financial products and services and identity systems to accelerate financial inclusion
- Increased attention to the importance of responsible access to, and usage of, financial products and services
- Mainstream financial inclusion goals alongside the other financial sector goals of stability, integrity, and consumer protection. In addition, reinforce the notion that financial inclusion and other financial sector goals are mutually supportive.

At the country level on financial inclusion has had varying degrees of success. The GPFI and implementing partners have been key in monitoring experiences and distilling lessons into overarching principles, revisions to the FIAP, and country-case studies. It is worthwhile to note that the starting point for more successful countries like Brazil, Malaysia, India, and Kenya was the development of a multi-stakeholder financial inclusion strategy, with high-level political buy-in, and strong monitoring and evaluation strategies to track implementation effects.

No single model or blueprint will satisfy the needs of all countries. The reality of different stages of development and infrastructure, differing economic and political priorities, and the relative maturity and strength of the financial sectors, demand that each country decides on its own financial inclusion strategy and means of implementation. We, therefore, reflect on relevant country experiences and case studies in this document to propose a Policy that is uniquely designed for the South African context.

Box 9: G20 Principles for Innovative Financial Inclusion

- **Leadership:** Broad-based Government commitment to financial inclusion
- **Diversity:** Promote competition and provide market-based incentives for sustainable financial access and use
- **Innovation:** Promote technological and institutional innovation including to address infrastructure weaknesses
- **Protection:** Comprehensive approach to consumer protection that recognises the roles of Government, providers, and consumers
- **Empowerment:** Develop financial literacy and financial capability.
- **Cooperation:** Create an institutional environment with clear lines of accountability and coordination within Government, businesses and other stakeholders
- **Knowledge:** Utilise improved data to make evidence-based policy, measure progress and consider an incremental "test and learn" approach
- **Proportionality:** Build a policy and regulatory framework that is proportionate to the risks-and -benefits involved in innovative products and services
- **Framework:** Consider the following in the regulatory framework, international standards, national circumstances and support for a competitive landscape: an appropriate, flexible, risk-based anti-money laundering regime that also combats the financing of terrorism (AML/CFT); conditions for the use of agents as a customer interface; a clear regulatory regime that reflects electronically stored value; and market-based incentives to achieve the long-term goal of broad interoperability and interconnection.

3.3 INTERNATIONAL PRINCIPLES LOCALISED AND MADE RELEVANT FOR SOUTH AFRICA

Through this Policy, Government is making an explicit commitment to improve financial inclusion by promoting greater access to, and sustainable use of, appropriate financial products and services to all who need and will benefit from them. Considering the South African context, the evolving G20 FIAP (Box 8) and the G20 Principles for Innovative Financial Inclusion (Box 9), National Treasury has identified eight principles to guide implementation of this Policy.

3.3.1 PRINCIPLE 1: ACCESS FOR ALL, AND RESPONSIBLE USE OF FINANCIAL PRODUCTS AND SERVICES ACCORDING TO THE USER'S NEED

Financial inclusion requires that unreasonable or unfair barriers to access are removed, so that a variety of financial services are available to all. However, it is equally important that financial services are used in responsible, appropriate, and beneficial ways, based on the actual needs of the users. This should be achieved through a strong market conduct regulatory framework and improved consumer financial literacy and improved product and service design and delivery.

3.3.2 PRINCIPLE 2: PROMOTE COMPETITION AND MARKET-BASED SOLUTIONS, ENCOURAGING DIVERSITY IN SERVICE PROVIDERS

In South Africa, the range and quality of products offered to low-income households and SMMEs, and the reach of the distribution network have increased over the years. However, there is scope for improvement, especially in underdeveloped urban centres ("townships") and rural areas where financial products and services are not adequately provided, and the distribution infrastructure is limited.

A transformed financial sector with a diversity of providers and products is important to promote competition and encourage market-based solutions to financial inclusion. A provider who understands a local community is likely to be better positioned to respond to that communities financial services' needs. The more black industrialists and SMMEs who participate in the supply of financial products and services, the more financial sector gains are retained in black communities.

Regulations in the financial sector should embrace both institutional and product diversity, enabling large universal financial institutions and small-scale community institutions to co-exist. The licensing and regulatory requirements imposed on these providers should be proportionate to the risks they individually bring to consumers and the system, and they should not pose unreasonable and prohibitive barriers to entry.

3.3.3 PRINCIPLE 3: THE DRIVE FOR FINANCIAL INCLUSION IS BALANCED WITH AND SUPPORTED BY THE OBJECTIVES OF FINANCIAL STABILITY, INTEGRITY AND MARKET CONDUCT

The approach to financial inclusion should consider the complementarity of inclusion goals with other financial sector policy objectives promoting financial stability, consumer protection and financial integrity. For example, expanding access to formal credit to South Africans has increased inclusion, but exposed customers to poor business practices. As a result, half of borrowers show signs of financial distress.[65]

The market conduct framework for the sector must therefore ensure that users of financial services are provided with the information they need to assess the services on offer. It should also identify and sanction poor business conduct such as collusive or other abusive behaviour by financial institutions. Furthermore, improved financial literacy and capabilities through financial education is essential to broadening awareness among consumers and SMMEs of the need for financial services and improve their financial decisions. Market conduct regulation and consumer financial education are core functions of the new FSCA. Regulatory requirements should protect consumers while not unduly excluding or impacting service providers .

Similarly, the prudential and integrity frameworks should not be compromised by recklessly bringing customers into the system in ways that threaten financial institutions' balance sheets or prevent them from performing effective due diligence under AML/CFT obligations. On the other hand, these frameworks should at the same time support financial inclusion. For prudential regulation, this means that licensing and regulatory requirements should accommodate a wider range of providers than has traditionally been the case. For integrity, the application of AML/CFT requirements by financial institutions should not lead to overly onerous requirements placed on the un- and under-served, which prevents them from accessing a bank account and related services.

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[65] *The NCR's Q3, 2017 Credit Bureau Monitor reported that only 49,2 per cent of credit-active consumers had a current credit standing, the remainder were either 1-3 months in arrears, had adverse listings or judgements on the bureau.*

The pursuit of these objectives and any resulting trade-offs must be balanced and proportionate, an approach referred to as I-SIP.[66] The I-SIP approach highlights that financial inclusion efforts should not be to the detriment of the other financial sector goals, and vice versa.

3.3.4 PRINCIPLE 4: THE INFORMAL SECTOR[67] IS AN IMPORTANT TRANSFORMATION AND EMPOWERMENT TOOL IN FACILITATING THE TRANSITION TO FORMALITY

The informal financial sector, for example burial societies and stokvels provide financial services to many South Africans in townships[68] and rural areas, especially low-income earners and the formally excluded. While it is important to ensure that financial services providers are all appropriately licensed and regulated, but Government also recognises the important role played by the informal sector in the lives of financially excluded South Africans.

Stokvels have over the years provided crucial savings mechanisms for millions of households (there are an estimated 850,000 stokvels in South Africa supporting 11 million members), while burial societies and funeral parlours have also played an important role in those households by securing a dignified burial for their loved ones.

National Treasury acknowledges the transformation and empowerment potential in financial sector SMMEs (i.e., SMMEs operating as financial services providers) and informal community-based financial service groups and will approach the informal sector with a view to growing and supporting financial sector SMMEs to enable them to become formal service providers. Such intervention requires proportionate regulatory frameworks to ensure that consumers are protected against any illegal activities and abusive market practices by such providers.

3.3.5 PRINCIPLE 5: PROMOTE TECHNOLOGICAL AND INSTITUTIONAL INNOVATION IN SUPPORT OF FINANCIAL SYSTEM ACCESS AND USAGE, ADDRESSING INFRASTRUCTURE WEAKNESS

The use of digital platforms to deliver financial services to consumers has the potential to provide them with greater universality, speed, accountability, and efficiency, and is a powerful driver of financial inclusion. Technology and innovation in competitive financial sectors have the potential to increase the quality of financial products and services and make them more accessible. While technology creates many benefits and opportunities, it also brings challenges to the way in which individuals engage with the financial sector. Financial education will thus play a critical role in improving awareness and understanding of digital financial services and strengthening overall consumer trust and confidence.

Regulation will need to balance the risks and benefits of innovation. Regulators responsible for prudential management, financial stability, and market conduct should take a collaborative approach to develop a balanced framework consistent with I-SIP.

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[66] *I-SIP stands for inclusion, stability, integrity and protection. It refers to a proportionate approach to any financial inclusion measure (and specifically to its regulatory and supervisory design and implementation) that optimises the I-SIP linkages, maximising synergies and minimising trade-offs and other negative outcomes. Inclusion, Stability, Integrity and Protection: Observations and lessons for the I-SIP methodology from Pakistan, CGAP, 2014.*

[67] *The informal sector, informal economy, or grey economy is the part of an economy that is neither taxed nor monitored by any form of government. Unlike the formal economy, activities of the informal economy are not included in the gross national product (GNP) and gross domestic product (GDP) of a country, https://en.m.wikipedia.org/wiki/Informal_sector.*

[68] *Townships in the South African context refer to the often underdeveloped segregated urban areas, https://en.m.wikipedia.org/wiki/Township.*

3.3.6 PRINCIPLE 6: PROMOTE PROPORTIONALITY IN REGULATION AND SUPERVISION

Regulation and supervision should be proportionate to the risks posed by a financial institution. The Twin Peaks reforms recognise that the traditional 'one-size-fits–all' approach to regulation can create an unnecessary regulatory burden, while still not achieving intended outcomes. The reforms aim to provide legislation that can be proportionately applied.

Large and complex financial institutions with a commensurately large customer base can pose a high risk because their conduct or prudential failings could impact many people as they are likely to be more connected to the rest of the financial sector and the economy at large. Their failure could thus cause a domino effect of poor outcomes. More stringent regulatory requirements should be placed on institutions

Smaller and simpler financial institutions inherently pose less risk than the larger, complex business and therefore will pose a low risk to the financial system. While their conduct and prudential failings may have less impact on the financial system, their customer base may include more vulnerable customers. Small institutions are also especially sensitive to compliance costs.

Hence regulation and supervision should be proportionately designed and applied based on the risks posed. This includes the risk to the development of the financial sector, which would suffer if firms exited due to overly burdensome regulatory requirements that made their operation unprofitable and onerous.

3.3.7 PRINCIPLE 7: ENCOURAGE COORDINATION ACROSS STAKEHOLDERS WITH CLEAR LINES OF RESPONSIBILITY AND ACCOUNTABILITY

An inclusive financial sector cannot be achieved without the collaborative participation of all relevant stakeholders. A multi-stakeholder approach should be adopted to ensure that financial inclusion does not only increase access, but also creates economic opportunities and improves the quality of life for the poor and low-income earners and supports growth and resilience of SMMEs. The cooperation of Government departments and agencies, regulators, financial institutions, representative bodies, and relevant development partners is necessary to achieve South Africa's financial inclusion objectives.

3.3.8 PRINCIPLE 8: IMPROVE DATA TO MAKE EVIDENCE-BASED POLICY AND MEASURE IMPACT, APPLYING A "TEST AND LEARN" APPROACH

Policy implementation requires that appropriate and reliable data be available to support proper monitoring and measurement of the Policy's impact over time. The availability and quality of data on financial inclusion cannot be the sole responsibility of policymakers. Regulators and service providers play a pivotal role in the collection, analysis, and dissemination of the data.

Any current lack of data should not delay or deter interventions aimed at improving financial inclusion. Rather, an incremental "test and learn" approach by both regulators and financial service providers can be adopted to mitigate any risks posed by the introduction of a new service or business model. It can also ensure that the financial service providers make early data available to regulators and policymakers to monitor, assess, and refine regulatory policy.

4. POLICY PILLARS OF FINANCIAL INCLUSION

South Africa compares well with similar developing countries in its overall rate of financial inclusion. However, the high concentration of banks in the financial sector combined with the legacy of apartheid may go some way to explaining the inadequate attention low-income individuals and SMMEs have received, particularly in what concerns the design and delivery of products and services that would adequately meet their needs. Low levels of financial literacy and capabilities in the country exacerbate these effects, often leading to poor financial decisions, greater vulnerability to misconduct, and worsening economic conditions for those who can least afford it.

The high rate of financial inclusion driven by high bank account ownership tends to obscure significant issues that need to be dealt with. **For individuals**, the level and composition of take-up and usage of financial products and services are suboptimal, and have not led to a sustainable impact for users and financial services providers. Examples include: ownership of a bank account not sufficiently translating into higher levels of digital transactions, greater savings or insurance coverage, and the negative impact of the overuse of credit, resulting in over-indebtedness. These factors point to a need to review the current financial services landscape in South Africa, with a particular focus on increasing the accessibility and quality of products and services including suitability, convenience, and affordability.

Evidence shows that **SMMEs** are even more constrained, in their access to and usage of appropriate payments, financing, and insurance products and services. This constrains SMME development, growth, and resilience. The NDP emphasises the role of SMMEs in achieving South Africa's future economic growth and employment targets. The NDP foresees that as much as 90 per cent of new employment will be created in small and expanding firms by 2030. However, indications are that we are falling short of these targets and that, if anything, the percentage of employed adults in South Africa has decreased in recent years. According to the Stats SA Labour Force Surveys, SMMEs are maintaining employment levels far better than corporates do, although there is no real growth. It is therefore critical to develop appropriate financial products and services to support the SMME sector.

The major challenges for effective financial inclusion in South Africa are the lack of available, appropriate, and affordable financial products and services and the lack of, or limited knowledge about, financial services and products for a significant portion of the South African population. The challenges identified will need to be addressed through a carefully designed holistic response which will need to consider the dynamics explained in this chapter. In addition, steps must be taken to address the structural deficiencies noted, especially as they relate to the highly concentrated financial sector, within which black South Africans are under-represented. Government intends to address these issues via two strategic core policy pillars and a supporting pillar:

- ***Policy Pillar One – Deepen financial inclusion for individuals.*** Improve the beneficial use of financial products and services for the newly-included and underserved segments, and foster inclusion of those who are completely excluded.
- ***Policy Pillar Two – Extend access to financial services for SMMEs***. Improve access to and use of quality financial products and services by SMMEs.
- ***Policy Pillar Three – Improving the enabling foundations – leveraging a more diversified provider and distribution base***. Support competition and diversification of the supply base to strengthen the enabling foundation to support tangible progress in Pillar One and Pillar Two.

This will be complemented by government processes such as:

- The evolving financial sector codes;
- Reform of the national payment system spearheaded by the South African Reserve Bank;
- The implementation of the Insurance Act of 2018 (this accommodates microinsurance as a licence category) alongside a market development roadmap for the insurance sector;
- The implementation of recommendations made by the retail banking diagnostic conducted by the World Bank on behalf of the National Treasury in 2018; and
- The development of a national financial education policy and corresponding strategy to provide a consistent framework for financial literacy in South Africa.

The sections that follow highlight the main barriers for financially including individuals and SMMEs. These barriers vary across the two client segments but can be broadly divided into the three elements contained in the financial inclusion definition: access (including physical access, and eligibility), usage, and quality (including fairness, trust, product suitability, and transparency). The sections below also identify priorities to address the identified barriers. These priorities will be further detailed through the identification and prioritisation of specific actions and projects, which will be organised in an Action Plan, as part of the process to develop the Implementation Strategy.

Policy Pillar One – Deepen financial inclusion for individuals

Section 2.3 shows that most individuals in South Africa already have a bank account. Many also have a funeral, credit, or legal insurance policy but this does not necessarily reflect the appropriateness of those products and services and the extent to which they are actively used. For instance, 23 percent of bank account holders withdraw all their money as soon as it is deposited[69], illustrating that many people, especially those in the low-income threshold (47 percent) make suboptimal use of ***bank accounts.*** This is a concerning trend since the store-of-value aspect of transaction accounts is removed along with the holders' ability to make and receive payments electronically. Users falling into this category, if they have no other products from financial services providers, cannot be considered to be financially included. The root causes of this situation could include the lack of a convenient service network that would allow digitization of routine cash-based payments, such as purchases at spaza shops and payment for groceries, lack of knowledge of the benefits of a transaction accounts, the high costs associated with ATM withdrawals (which incentivises a single withdrawal) trust, confidence, and literacy.

The take-up of both ***savings and insurance products and services,*** except for funeral insurance, is significantly low. While informal savings are widespread in South Africa, the level of formal savings via savings accounts at regulated institutions continues to be very low. The root causes could include the use of traditional distribution models by financial services providers high eligibility requirements, unaffordability, and the unavailability of appropriately designed products and services that meet client needs.

Retail ***credit*** advanced to low-income customers, although high, is primarily for consumption, rather than productive purposes or wealth-accumulation, such as buying a house or starting a business.[70] Credit bureau data indicates that most retail credit for low-income earners is unsecured loans, credit cards, and retail accounts. More concerning is that 47 per cent of low-income earners have at least one line of credit that is three months or more in arrears, in comparison to only

[69] *FinScope SA Consumer Survey, 2019*

[70] *It is estimated that over half (56 per cent) of credit active consumers earn less than R7,500.*

20 per cent of those earning more than R15,000.[71] The root causes for this could include inability to meet requirements set by financial services providers and unavailability of appropriate products and service that meet consumer needs.

The current most prominent underlying problems for financial inclusion for individuals can be summed up as follows:

- Inadequate usage of bank accounts;
- Underdeveloped payment options;
- Low levels of use of formal or regulated remittances (as opposed to informal remittance services);
- Low savings rates in the traditional formal sector;
- Low take-up of insurance products, with the exception of funeral, credit and legal products;
- Over-indebtedness relating to excessive take-up of unsecured credit and, on the other hand, frustrated access to housing finance;
- Inadequate leveraging of opportunities for inclusion arising from social grants; and
- Low levels of client on-boarding due to perceived onerous regulatory requirements.

These underlying problems inform the seven policy priorities under this pillar.

Priority 1: Promote the beneficial use of transaction accounts

Seen as the "gateway" to financial inclusion, transaction accounts are the starting point to accessing and using a wider range of financial products and services. However, as previously highlighted, many South African bank account holders use their account solely as a tool for cash distribution. Shifting away from the currently limited use of transaction accounts is a key priority for financially including individuals, particularly low-income earners. Apart from the obvious need for improved financial education improving the value proposition of all transaction accounts and related payment services will be fundamental. Although efforts are underway to promote a cash-light society (Priority 2 explains the associated benefits), South Africa's substantial informal sector and the underdeveloped payment ecosystem means cash remains prevalent. With retail and other network participation in the payment system, payment services and withdrawal options have improved considerably, but too often they are operated on a closed-loop system outside of the national payment system, with many innovations favouring middle- and high-income clients (for example, relying on smart phone apps). Getting cash into your account remains expensive, while high and opaque penalty charges foster mistrust.

To address this, key measures include improving the reach and diversification of the payments distribution network, and allowing for greater competition by non-bank financial services providers that could offer convenient store-of-value accounts and points of access. These could lead to improving customer benefits and cutting frictional problems that impede usage, and thereby improve the value proposition of transaction accounts.

Priority 2: Position remittances as springboard for further financial inclusion

In today's global society, it is common for people to migrate to other countries or areas in search of a better life. This phenomenon can often have a positive effect on the economy of the destination country or area, while also benefitting the place of origin through the transfer of surplus income to family members residing there. This transfer of money to migrants' countries of origin is referred to as "cross-border remittance", while transfers to areas in the same country are termed "domestic remittance". Globally, remittances are an important and stable source of income for low-income households, particularly in developing countries. The World Bank estimates that remittances totalled $613 billion in 2017, $466 billion of which went to developing countries, involving some 258 million migrants (including refugees). In some

[71] *Understanding heavily indebted consumers in South Africa, Eighty20 on behalf of National Treasury, 2018.*

countries, the value of remittances is often on par with, or even exceeds, foreign direct investment and overseas development assistance. Studies from CGAP and other development agencies have shown that remittances can be a springboard for financial inclusion and contribute to poverty reduction in home countries, hence the increasing international focus on this issue.

Both domestic and cross-border remittances are widely used in South Africa. However, many of the current remittance flows, especially cross-border remittances, go through the informal sector. This may be a result of the high costs associated with this service driven by the dual and related effects of stifled competition because of regulatory barriers to entry, on the one hand, and the way in which financial institutions give effect to these regulatory requirements, on the other. This is concerning from the perspective of consumer protection as well as the integrity of the financial system, while it also does not provide the desired financial inclusion on-ramp.

Government and the private sector will need to develop this market with a view to achieving both greater formalisation and efficiency. Key areas of action include expanding low-cost, accessible cross-remittances options by enabling greater competition and increasing interoperability. In addition, it will be important to improve the collection of data on remittance flows for monitoring purposes, to include estimates of transfers through regulated and unregulated channels. These could be widely disseminated to raise service providers' awareness of the potential of the market.

Priority 3: Supporting increased formal savings for low-income earners

The 16 per cent savings rate among South Africans is undesirably low. The reasons for the low savings rate in the country are manifold, including the high level of poverty, the low incentive to save, and the insufficient engagement by regulated financial service providers in the low-income market which leads to inappropriate products and services. Initiatives to improve the quality of savings products offered will require that the savings environment be changed to make it easy and worthwhile to save, particularly for people with low incomes.

Over the years, the South African Government has introduced various products to improve the low rate of savings while in some instances also helping to maximise tax relief, but these have not translated to increased savings, particularly amongst the low-income earners. For instance, the retail savings bond[72], although the product has an attractive rate of return, it requires a significant initial investment of R1,000 which cannot be met by most low-income savers. The tax-free savings accounts offered by designated service providers [73],also make savings attractive by allowing for all proceeds on the annual limit of R36,000 or lifetime limit of R500,000 to be tax-free, reducing a person's tax burden and thereby increasing their returns. Both these products require a fixed long-term commitment which may be inappropriate for low-income earners with variable and unstable incomes.

Although formal savings via instruments such as savings accounts, policies, and investments are not common among low-income earners like Thato (Box 10), informal means remain popular in South Africa.

[72] *An RSA Retail Saving Bond is an investment with the government that earns fixed interest for the term of the investment. It offers guaranteed returns, and carries no commission, agency or service fees.*

[73] *Currently the following are designated to provide tax-free savings accounts: licenced bank, long-term insurers, a manager of registered collective schemes (with certain exceptions), the National Government, a mutual bank and a co-operative bank.*

Box 10: Understanding savings

Thato (40) is a single mom of two children aged nine and seven. She started working at the age of 25 in the Pretoria CBD but continued to stay with her parents in Mamelodi so that she could try and save up for her own house. However, due to unreliable transport services, Thato reverted to buying herself a small car to get around. This eroded the little money she had intended to save. Ten years ago, after paying off her car, Thato moved out of her parent's home and eventually purchased her own house.

Thato is still not saving, as most of her income goes towards her monthly living expenses. Anything that is left over from Thato's monthly budget is transferred to her mortgage account. Thato's main financial goal is to be debt free by the time her first-born child goes to university.

The high prevalence of informal saving in South Africa through stokvels points to the potential in building on and expanding savings patterns. The National Stokvel Association of South Africa estimates that R49 billion is held in savings by stokvels. These funds, with the potential to create wealth, are mainly held in bank accounts earning low interest, highlighting the need for more innovative products to service stokvels. The introduction of a stock exchange for stokvels in recent times, affording them the opportunity to invest in the stock market, is one such initiative towards better servicing this market. It is, however, not without risk and appropriate financial education and market conduct regulation and supervision are needed. To instil a wider formal savings culture and mobilise savings additional products and other initiatives which leverage the strong informal savings culture will need to be developed. India provides a few examples (Box 11).

Box 11: Savings products in India

The **Indian Government** offers a multitude of savings schemes that are easy to enrol in through both the public and private banking systems. These range from high-value to low-value schemes and include:

- The **Public Provident Fund (PPF)** - a savings-cum-tax-saving instrument introduced by the National Savings Institute of the Ministry of Finance in 1968. The aim of the scheme is to mobilise small savings by offering an investment with reasonable returns combined with income tax benefits. The scheme is fully guaranteed by the Government. The balance in a PPF account is not subject to attachment under any order or decree by a court.
- **Kisan Vikas Patra (KVP)** - a savings certificate scheme that was first launched in 1988 by India Post. KVP certificates are available in denominations of Rs1,000, Rs5,000, Rs10,000 and Rs50,000. The minimum amount that can be invested is Rs1,000 but, there is no upper limit.
- **Sukanya Samriddhi Account** (literally Girl Child Prosperity Account) is a Government-backed saving scheme encourages parents to build a fund for the future education and marriage expenses of their female offspring. The account can be opened at any post office with a minimum opening balance of Rs1,000.

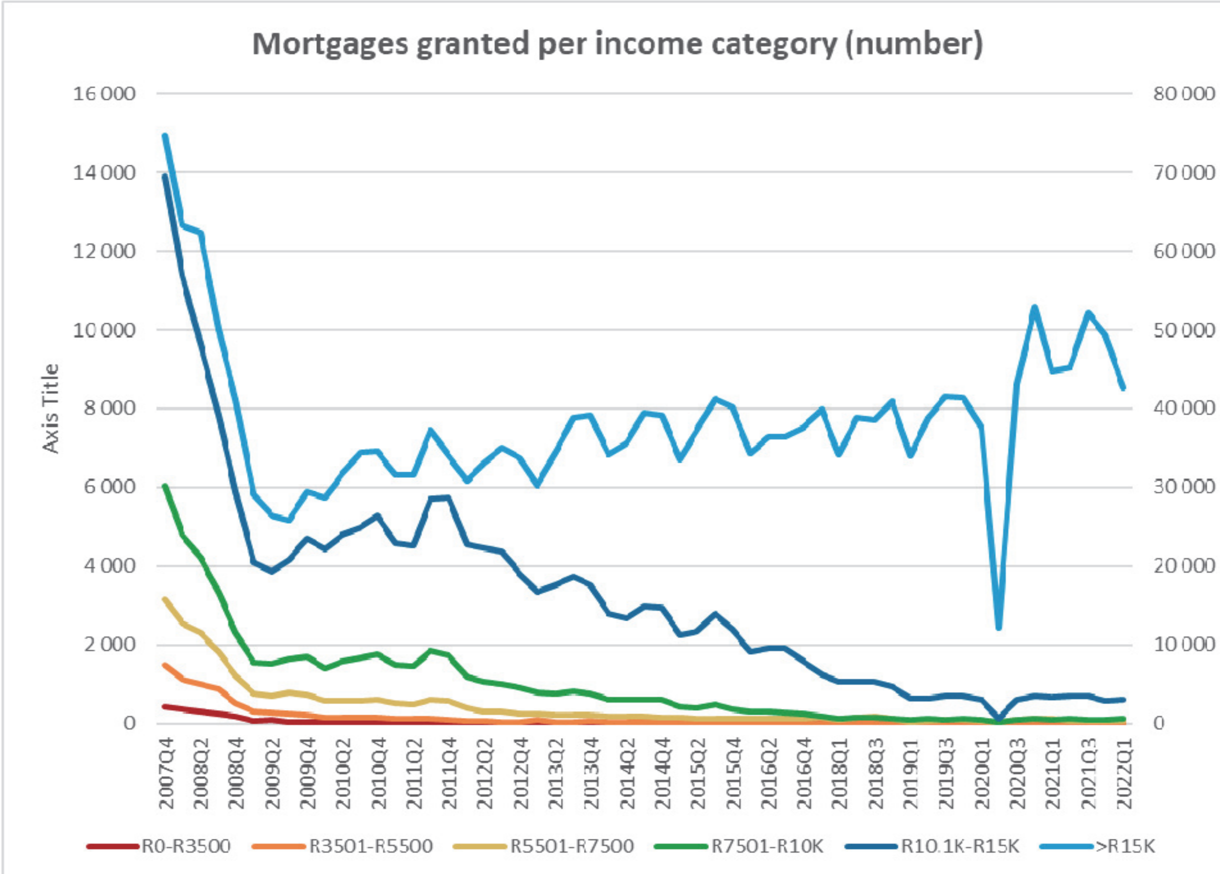
Priority 4: Promote appropriate credit for assets and investment over consumption

Many South Africans have access to some form of formal credit, but underlying problems in its access and usage persist. For low-income earners the excessive use of unsecured credit, mainly for consumption purposes has led to credit dependency and over-indebtedness. In the period up to mid-2014, the growth in unsecured credit was mainly driven by extending more credit to the same market, rather than extending credit to new markets. To relieve over-indebtedness pressures on households, the Ministers of Trade and Industry and Finance, acting under the direction of cabinet, took measures to reduce reckless lending and egregious debt collection practices, improve the functioning of the credit insurance market and limit debit order abuse.

In response to the partly worsening economic conditions and a tightening regulatory environment, credit extension has slowed. The ratio of household debt to disposable income declined to 65 per cent in 2022, down from an all-time high of 86 per cent in 2008. Despite this, the number of registered credit providers continues to increase year-on-year, and there are now more access points at which a South African can borrow money than deposit it (see Table 3). This reflects the underlying structural challenge; South Africans are net borrowers and prefer to spend on consumption rather than investment. In line with South Africa's developmental agenda, poverty relief and reduced inequality requires ordinary South Africans to shift from consumption to investment spending, meaning a shift from credit to savings, and consumption credit to productive credit. A wider range of appropriately designed and delivered credit products is needed. Of these, credit for housing and education is critical.

The social imperative of providing safe and secure housing for South Africans warrants focus on the availability of home loans, i.e., mortgages. Middle-income earners, with or without Government subsidy, remain under-served because their earnings are above the qualification threshold of R3,500, but generally insufficient to qualify for a mortgage loan at a financial institution. There are two main challenges to the extension of mortgage credit: a lack of suitable housing stock and mortgage lenders' appetite for risk. While the former lies outside the scope of this study, the issues are difficult to separate. As a result, certain South African banks have indicated that they are looking to partner with property developers in support of this objective. Figure 9 below shows the significant decline in mortgage lending to lower income segments. Of concern is the dramatic decline of lending to the R10,100–R15,000 income category, which had tracked the higher income categories until 2011.

Figure 9: Mortgages granted per income category (number), 2007-2022



Source: NCR

Funding tertiary education continues to be under considerable scrutiny. While options are being considered to make education free for those in need, not all students will be accommodated, and there will likely remain a funding gap. Box 12 explores some of the realities and challenges faced by students and the knock-on effect on society.

Box 12: #FeesMustFall – Funding failures spark protests

In October 2015 disgruntled students protested university fee hikes that were above the inflation rate. The protests started at the University of Witwatersrand and spread rapidly to other universities across the country. The announcement by Government that there would be no tuition fee increases for 2016 saw the end of the 2015 protests, but this was short lived as protests were reactivated when the Minister of Higher Education announced there would be fee increases for 2017. Although the focus of the protests was on a rise in fees, other factors may be contributing towards the discontentment of students.

High cost of tuition

South African universities are unaffordable to many. In 2015 BusinessTech looked at tuition fees for the first year of study at those universities featured in the top 100 universities in the BRICS nations and emerging countries. On average a first-year student will pay R72,172 per annum for tuition and accommodation. In contrast, Bankserv Africa's Disposable Salary Index shows monthly "take home" salary for South Africans in the formal sector average well under R15,000.

Funding through the National Student Financial Aid Scheme (NSFAS)

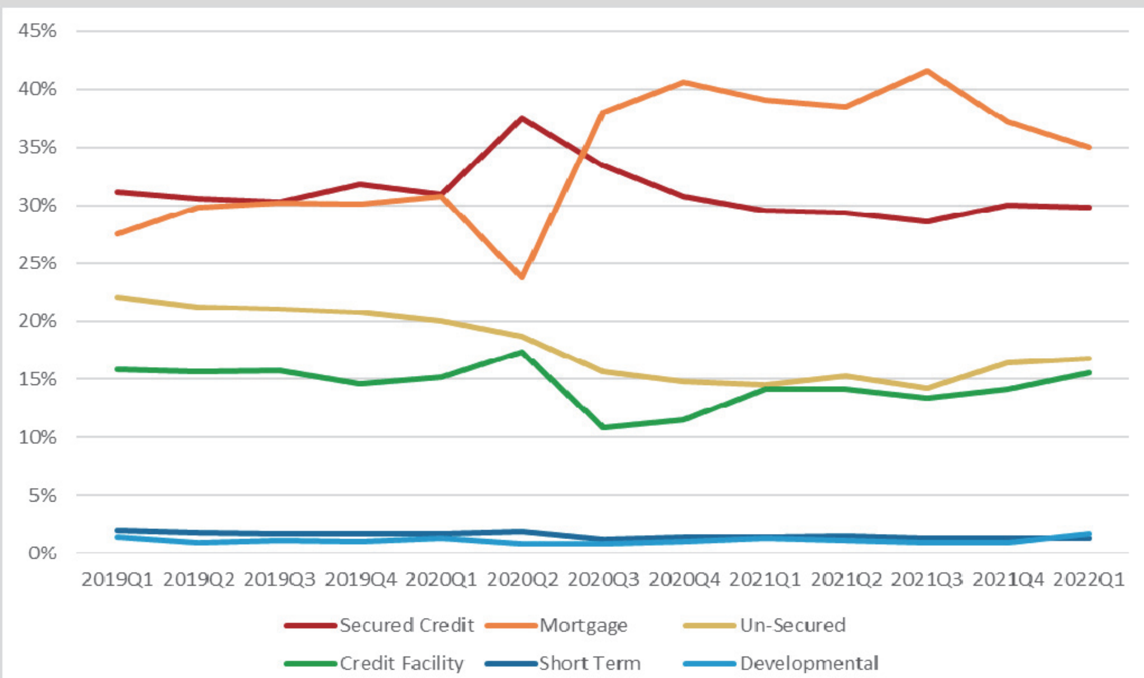
The funding of tuition and accommodation fees can take place through various means, such as full bursaries (students are fully funded by the bursar and do not need to co-pay), partial bursaries (students need to co-pay some of the expenses), financial aid by Government's NSFAS or self-funded (includes cash payments or study loan).

The NSFAS facilitates loans to students in financial need. The loans are paid back by the recipient student upon completion of studies and attainment of employment, provided that their salary is R30,000 or more per year. To qualify for the loan a student is subject to a "means test" to rank how financially needy they are. Usually, students with an annual household income of up to R160,000 are eligible to apply.

For households earning above R160,000 that do not qualify for financial aid or need to co-pay, the cost for university translates to approximately 45 per cent of household income.

Developmental credit (educational loan, development of a small business and the acquisition, rehabilitation, building or expansion of low-income housing) is underdeveloped in South Africa, making up the lowest share of the gross debtors' book (see Figure 10). While Government continues to develop solutions to fully fund tertiary education for students from low-income households, the remaining gap in developmental credit will also need to be addressed.

Figure 10: Credit granted per credit category



Source: NCR, 20198-2022

Priority 5: Promote appropriate, affordable and quality insurance

The low-level use of formal insurance products by the low-income market (see section 2.3.2) is concerning, as it reflects the reality that the most vulnerable people in society are not adequately protected against day-to-day financial risks. In times of a sudden life event such as death of a family member, illness or injury, and loss of income or property these households struggle to recuperate, thus perpetuating their unfavourable living conditions.

Although South Africa has a well-developed and large formal insurance sector, for the low-income market insurance uptake and use is only attributable to funeral insurance. There is little uptake and use of other insurance products such as asset insurance, life insurance, income protector, etc. This is due to:

- The strong correlation between disposable income and insurance uptake;
- Lack of affordable and suitable products in the market;
- The distribution (or delivery) model used for the market which historically in South Africa was aimed at supporting the middle and upper market segments;
- Inadequate financial education on insurance and
- Poor business conduct, including the Inappropriate sales practices as is the case in Karabo's situation in Box 13.

Box 13: Funeral cover vs life insurance

Karabo is a 25-year-old male, employed at a small law firm in Kempton Park, earning R5,000. Karabo's parents passed on when he was still young, and he and his sister were left in the care of their grandmother. Karabo recently started working and took out funeral cover for his family (himself, his grandmother and sister). He covered his sister and grandmother for R20,000 each, as he believes that is how much it will cost to have a decent funeral.

Karabo explained to the sales consultant assisting him with the cover that he wanted to safeguard his sister's future thus needed a cover that will pay-out a substantial amount of money to cater for his sister's needs should he die. With little knowledge on the type of insurance products at his disposal to meet his needs, Karabo was informed he could take the maximum funeral cover which would pay-out R100,000 upon his death. Karabo took out the maximum cover for which he pays R195 per month as he wanted to safeguard his sister's future should he die.

Although Karabo decided to take the R195 funeral cover, he could have opted for a life cover with the same pay-out value and pay just over R100 per month or a bundled life and funeral product with pay-outs of R100,000 and R20,000 respectively and paid R15 more than what he is paying.

According to a study conducted on micro-insurance by CGAP titled "Making insurance markets work for the poor: micro insurance policy, regulation and supervision" uptake and use of insurance by low-income households is influenced by the following factors:

- Demand side factors:
  - Perceived cost determined not only by the level of the premium, but also by what the person needs to sacrifice to buy insurance.
  - Perceived value, impacted by disposable income, level of trust in the institution to successfully deliver on claims, and the probability of the risk event occurring (with high frequency and/or probability risks such as health and life likely to receive priority in the minds of consumers).
- Supply side factors:
  - Business models and distribution channels which facilitate positive market discovery, where consumers are introduced to products in a way that allows them to understand its potential value and the ability to institute a claim successfully when required.

In countries such as India and Kenya, Governments, NGOs and private companies have partnered with self-help groups to reach a wider customer base and provide appropriate products to meet customer needs but as shown in Box 13 above, South African distribution model for insurance products still lags behind and provides an opportunity for the sector to relook their distribution model with the objective of meeting customer needs through appropriate and affordable products.

To sustainably improve the accessibility and usage of insurance products requires that:

- Products offered should address the needs of the targeted customer segment (i.e., the products need to deal with risk management effectively and affordably in the low-income market);
- Consumer perceptions be addressed through appropriate consumer financial education;
- Accessible and appropriate delivery channels for the low-income market be developed; and
- Claims process be efficient and easy to administer.

This will require an adaptable and nimble insurance market. New business and distribution models are needed. An example is the cell captive arrangement (see Box 14).

Box 14: Cell captives and financial inclusion

Cell captives, created by an agreement (a participation agreement or shareholder's participation agreement or SPA) between a cell owner (s) and a licensed cell captive insurer (known as the "promoter") are a uniquely South African construct that emerged in the early 1990s as a way for entrepreneurs or organisations with an insurance business concept to participate in the insurance market without obtaining an insurance licence of their own.

Under this arrangement, a cell captive account is created on the books of the "promoter" and a cell owner buys a special class of shares in the cell captive insurer to capitalise that cell. This ownership allows the cell owner rights that will be stipulated in the SPA, such as: drawing dividends on the proceeds of the cell, obtaining underwriting from the cell captive insurer, and benefiting from other services provided by the "promoter".

The cell structure, as opposed to a pure distribution relationship, allows the cell owner the independence to tailor its product offering to suit their vision and customer-base needs, as well as the ability to innovate in an agile structure that sits outside of the corporate culture and legacy systems of "traditional" corporate insurers.

A cell captive can be arranged in terms of four different models, namely:

- ***Model A: The cell owner as underwriting manager.*** Under this model, the cell owner also acts as the "promoter's" binder holder and an underwriting manager.
- ***Model B: The cell as affinity.*** Under this model, the cell owner has an existing relationship with an identifiable customer base which is regarded as an "affinity group" and provides products for this market.
- ***Model C: The cell owner as a non-mandated intermediary.*** Under this model, the cell owner has a specific distribution platform or IT solution and a value proposition and distribution model to market products to an identified market.
- ***Model D: The silent partner cell owner.*** Under this model, the cell owner does not perform any services directly related to insurance provided under the cell structure, but rather just capitalises the cell and is responsible for ensuring its continued solvency.

The independence of the cell owner to tailor its product offering, the agility of a cell structure as well as the lean regulatory and capital requirements relative to traditional insurers mean that cell captives provide a good base to implement product and process innovations. These create value for clients and have the potential to serve the un-served, particularly in the low-income segment. For instance, those with pre-existing affinities can tailor-make products to better serve their customers because of the relationship they have already established. Those with specific distribution platforms or IT solutions can use these technology-based platforms to reduce distribution costs to the un- or under-served market.

The cell captive model as well as Fintech disruptors can provide opportunities for both individuals and SMMEs in need of insurance coverage. Consider the example of Lemonade in Box 15.

Box 15: Lemonade

Lemonade is an insurance company offering homeowners, renters, and home sharers property and liability or cautery insurance in New York, USA. It uses artificial intelligence in the form of chatbots and machine learning to underwrite and handle claims. Lemonade also uses behavioural research to reduce fraud and conflicts of interest.

Product uptake and claims process

A client or potential policyholder accesses Lemonade services through a mobile app or web interface. The potential policyholder will answer a few questions on the chatbot, e.g., location for insurance and personal details. An artificial intelligence programme will respond by drafting an individually risk-based policy document that can be accepted or amended via the app or web interface. The process is on demand, paperless, available anytime, and quick. Claims are handled similarly via the app or web interface.

Twenty per cent of premiums received are retained by Lemonade as a fixed fee, utilised for all running expenditure. The remaining 80 per cent is utilised for paying claims. Lemonade does not benefit from the underwriting profits. If the full 80 per cent is not used to pay claims, the remaining premium is used for social good by means of "Giveback". Giveback is a charity that also attempts to mitigate fraudulent claims. Upon signing up for Lemonade, policyholders select a non-profit organisation or charity that will receive a payout on an annual basis from the unclaimed premiums or underwriting profit.

Priority 6: Increase the financial inclusion impact of social grant distribution

About 30 per cent of adults in South Africa receive a social grant, as compared to an average of less than 5 per cent globally. This high percentage and the resultant role that social grants play in society's economic life must be leveraged. While it is paramount that the social grants improve the lives of the recipients, it is also crucial that they are managed in such a way that the beneficial effect to society is optimised, both in terms of the grants made and used, and the way in which they are paid (i.e., the distribution channels and instruments). The restricted use of bank accounts previously used, required that funds be withdrawn within three months of their receipt. For those that are transferred out to other accounts, the funds are nonetheless usually withdrawn in full immediately.

As at December 2020, the scheme distributed over R17 billion via more than 18 million grants to more than 12 million people. The *Banking the Poor via G2P Payments* report from CGAP estimates that 170 million people receive regular G2P[74] payments globally. This makes the South African grant distribution scheme one of the largest in the world. Its size makes it imperative that maximum and lasting benefit is derived from it. The use of a bank account in the current scheme does not constitute meaningful financial inclusion as it has not led to high levels of usage, limiting the benefits to the recipient.

The social grants network provides an opportunity for Government to optimally use both the payment and national identification infrastructure, thereby advancing financial inclusion. Optimal use will allow for responsible provision of other appropriate financial services to this market. Improving the payments infrastructure in this process will be essential to the benefit both grant recipients and other users of the payment services. Moreover, Box 16 highlights principles for the distribution of social grants, which can inform projects in this area.

[74] *Government-to-person (G2P) payments include social transfers as well as wage and pension payments. With appropriateexperimentation, these payments have the potential to become a vehicle for extending financial inclusion and improving the welfare of poor people.*

Box 16: Principles for the distribution of social grants[75]

- A recipient should receive the grant in a dignified and convenient manner.
- A recipient should be able to use the grant for their benefit or that of their family.
- A recipient should receive appropriate financial consumer protection.
- Full use should be made of the existing national infrastructure, both from an informational and payment perspective:
  - The Department of Home Affairs (DoH) has the mandate for identity management in the country, including the life status of all South African residents. Information of this kind can be used to assess applications and oversee grant distributions. Physical verification should therefore align with existing capabilities.
  - The South African National Payment System has enabled a nationwide set of interoperable payment capabilities that can be leveraged to drive down per-transaction costs (resulting from high volumes).
- Cost of distribution and the potential incidence of fraud must be minimised. In particular:
  - Life stage identification should be linked to the DoH repository for each distribution.
  - There should be no duplicate identity payment created.

Priority 7: Improve efficiencies in the on-boarding of financial services clients

The effect of the FICA has been touted by financial services providers as a major hindrance to efficiently on-boarding clients, particularly in the low-income segments where the required documentation may not be easily available. Similarly, potential clients viewed the requirements of FICA as onerous and a reason for not acquiring formal financial services. In many financial institutions, a client may be subjected to multiple FICA processes for different products. This is not a regulatory requirement, but rather the result of customer-unfriendly internal processes.

National Treasury challenges "accountable" institutions to ensure that any new systems they put in place should not expose the customer to higher costs, because of inefficiencies. Opportunities to address these issues include the potential creation of utilities that can provide centralised access to customer information across multiple institutions, and the adoption of a "single view" of each customer across different product lines within the same institution.

Policy Pillar Two – Extending access to financial services for SMMEs

Of the estimated 2.6 million SMMEs in South Africa, about 37 percent are considered formal. Of the total, 54 percent are micro-enterprises and 15 percent are in rural areas. The owners include individuals who have identified a business opportunity as well as those conducting some sort of business because of necessity, and for whom no alternative sources of income are available. Two out of three SMME owners run their enterprises and do not have any employees, while 32 per cent provide between one and 10 jobs. While growth in the number of SMMEs over the last ten years has been lower than economic growth, the contribution by these SMMEs towards South Africa's gross value-added (which is equal to GDP before taxes and subsidies) increased from 18 percent in 2010 to 40 per cent in 2020.[76]

But South African entrepreneurs are struggling. An estimated 40 per cent of new business ventures fail in their first year, 60 per cent by the second year, and 90 per cent within the first 10 years of existence.[77] In recent research, entrepreneurial

[75] *Social protection payment delivery mechanisms, inter-agency social assessment protection, https://ispatools.org/*

[76] *Figures from this paragraph are derived from the FinScope MSME Survey South Africa, 2020.*

[77] *The DTI's annual review of small business in South Africa 2005-2007, which cites Radipere & Van Scheers, 2005.*

intentions have dropped by one-third since 2013 and halved since 2010.[78] The regional average is four times higher than South Africa's. The rate of established SMME ownership among adult South Africans is low at only 2.6 per cent, a decline of 26 per cent since 2015 and the lowest rate recorded since 2011.[79] South Africa performed especially poorly in this indicator across all participating economies, ranking 61st of 65 economies. The regional average for SMME ownership is almost five times higher. Global Competitive Report rankings for 2016/17 show South Africa is slowly improving overall (it climbed two places to 47th position out 138 countries).[80]

SMMEs are not homogenous and thus do not all have the same financial service needs. Entry-level enterprises typically consist of informal sole proprietor operations where there is no distinction between business and personal financial needs (the so-called "survivalist" enterprises). These micro enterprises usually lack formality in terms of registration and include "spaza" shops, minibus taxis and household industries. They typically employ no more than five people and the business turnover is less than the VAT registration limit. The predominant financial services need for these micro enterprises is for short-term access to working capital and access to payment services. An SMME that is not formalised is not bankable. As a result, informal enterprises must rely on the business owner's bankability and finance worthiness rather than the businesses. Formal SMMEs are more structured and better resourced, with more sophisticated financial needs that are determined by their scope of operations. Across the spectrum of SMMEs exist different permutations of arrangements relating to institutional form, tax status, size as relates to income and number of employees and ownership. In developing a work programme for the priorities identified, it will be necessary to take these differences and the heterogeneity of SMMEs into account – different solutions will be required for different types of SMMEs. This reveals an inherent challenge in developing financial products and services for the SMME market, which is to cater for unique business needs on the one hand while still obtaining sufficient economies of scale for the product providers on the other.

The core financial services needed by SMMEs are:

- Access to funding and credit;
- A transaction account as a store-of-value;
- Appropriate payment services, both to receive and make payments; and
- Appropriate insurance products to mitigate risks pertaining to the enterprise.

Of these, increasing access to funding and credit is the highest priority. Credit is critical to establish and grow a business. Currently common practice for SMMEs is to rely on personal credit lines (linked to a personal transaction account) but this commingles consumer and commercial credit, making one type of credit indistinguishable from the other; risks violations of company law and accounting standards; reduces the owners' ability to borrow in support of their personal life; affects the owners credit profile and history; leads to the take-up of unsuitable products designed for a different purpose and ; makes it is more challenging for the owner to maintain appropriate financial records and build up a credit history; and increases the risk of excessive personal indebtedness, especially given South Africa's weak insolvency framework.[81]

The IMF recommended the following activities to improve financial inclusion of SMMEs:

- Exploit credit information technology; and

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[78] These statistics relating to the state of entrepreneurship in South Africa are by Global Entrepreneurship Monitor (GEM) South Africa Report for 2015/16.

[79] The GEM determines the established business ownership rate as a percentage of the adult population between the ages of 18 and 64 who are currently an owner-manager of an established business. The latter means owning and managing a functional business that has paid salaries, wages, or any other payments to the owners for more than 42 months.

[80] Indicators here include Public trust in politicians (88 in 2013/2014 to 109 in 2016/17), irregular payments and bribes (47 to 53), and favouritism in the decisions of government officials (110 to 115).

[81] The Insolvency Act of 1936 requires significant modernisation, a process being led by the Department of Justice and Constitutional Development.

- Develop a separate framework for "Tier II" banks that service SMMEs.

In addition, the Global Entrepreneurship Monitor (GEM) South Africa report for 2015/2016 makes the following recommendations to improve SMME access to funding:

- Strengthen seed funding for market research, product development and proof of concept, especially through increased state support for research and coordination. For example, this can be done through collaborative funding models between commercial financial institutions and DFIs.
- Micro-funding models combined with training and mentoring especially in the first year of operation.
- Consider expanding subsidies and other grants to all SMME owners not just black entrepreneurs, given the social benefits that result from the growth of the SMME sector.
- Improve transparency and good governance practices in DFIs supporting SMMEs.
- Improve the turnaround time for loan approvals for SMME lending.
- Strengthen incentives for lending to SMMEs below a certain threshold, e.g., tax benefits to "angel investors".
- Simplify the legal and regulatory framework for SMMEs, including rationalising BEE and labour law requirements.
- Explore alternative support mechanisms like establishing a database of funders and replicating initiatives like the Western Cape Funding Fair.[82]
- Encourage the private sector to develop credit products for SMMEs, which are profitable and sustainable on their own, without the need for external subsidies or guarantees.

It is unlikely that the level of funding for SMMEs will improve without considering other factors crucial to ensuring their success and sustainability, including market access, business and management skills, and financial education. A broader developmental support should be considered, especially to support the formalisation of informal SMMEs.

Looking past an SMME's funding and credit needs, improved payment services facilitate the ready transaction capability of "sales" and are therefore also a high priority. A final challenge relates to transactional accounts as a store of value. While start-ups tend to rely on the owner's bank account when setting up, combining personal and business accounts has many risks, especially for budget and cash-flow management. Moreover, the payment services suitable for SMMEs are likely different from those for personal use. Although insurance is a secondary need that can follow once the business is operational, the anticipated review of the FSC in support of transformation presents an opportunity to bring SMME insurance to the agenda.

These dynamics require foremost an effort to improve the credit infrastructure in South Africa, a topic that is addressed under the Pillar 3 and informs the three policy priorities under this pillar.

- Priority 8: Broaden the range of financing instruments that are available for SMMEs.
- Priority 9: Improve the use of transaction accounts and payment services by SMMEs.
- Priority 10: Develop suitable insurance for SMMEs.

[82] *This is a partnership between Deloitte and the Western Cape Department of Economic Development and Tourism (DEDAT). It facilitates face-to-face contact between project promoters, entrepreneurs, and other funding institutions within the region, seeking to educate and empower the former two to turn ideas into bankable business plans and provide funders with single-point access to projects seeking finance. Expert workshops, presentations and an exhibition support knowledge-sharing and the transfer of skills.*

Interventions should consider SMMEs of different sizes, geographical footprint and stages of business development and growth, as these have differing financial service needs. They also should uphold the consumer protection and market conduct framework provided by the Financial Sector Regulation Act (FSR Act), existing financial sector laws and the impending Conduct of Financial Institutions Act.

An SMME development policy, based on current realities and objectives, is crucial for the sector. It should not be a financial inclusion matter *per se*, but should in its development take into cognisance the role that the financial sector can play in the sustainability, resilience, and growth of the sector. National Treasury should thus play a role in the development of such a policy and assist the Department of Small Business Development on issues pertaining to financial inclusion. Not only will such a policy give purpose to inter-governmental cooperation in the SMME space, it will also inform Government and private sector engagement on the matter. From a financial sector perspective, it is essential that the role of the state and the private sector is addressed in the policy and that the approach to the informal-formal "divide" is dealt with, to the extent that the provision of financial services can be undertaken with greater certainty. In the South African context, it is unrealistic to expect that enterprises will simply move from informal to formal. At the same time, financial service provisioning requires that the entity being served is clearly identifiable. However, this can be achieved in different ways along a "path to formality", not only through a single step.

Priority 8: Broaden the range of financing instruments available to SMMEs

Bank lending remains the most common source of financing for SMMEs and entrepreneurs, but it is not sufficient to meet the large untapped demand. Also, capital gaps will likely remain for transitioning enterprises, like those undergoing ownership and control changes, and those looking to deleverage and improve their capital structures.[83] Indeed, the high degree of leverage observed in SMMEs may be a contributing factor to their weak success rates. The "*New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments*" study conducted by the OECD in 2015 considers a wider range of financing instruments for SMMEs and entrepreneurs, to bring in a much stronger role for the capital markets, including:

- Alternative forms of debt like corporate bonds, debt securitisation, and covered bonds;
- Equity finance for companies looking for long-term corporate investment, which is relevant for companies that have a high risk-return profile, such as new, innovative, and high-growth firms; and
- Hybrid instruments, which combine debt and equity features into a single financing vehicle, are suitable for firms that are already highly geared but do not want to necessarily dilute their ownership.

Private equity investments are also considered to include venture capital funds and business angels, as well as crowdfunding. They differ from the other instruments insofar as they finance a specific project rather than the enterprise as a whole. Of these, to date, only venture capital placements have been promoted by Government, through a tax incentive scheme.

These interventions will be particularly sensitive to the stage of an SMME's development, as well as its size and degree of business capability.

[83] *New approaches to SME and entrepreneurship financing: Broadening the range of instruments, OECD, 2015.*

Priority 9: Promote the use of transaction accounts and payment services by SMMEs

Most formal medium SMMEs have a bank account, but micro and other informal businesses often rely on the personal account of their owner or trade in cash. Among other factors, this is due to:

- SMMEs preferring to remain informal, driven by the lack of knowledge about formalisation, a distrust of the tax implications, and the cost of compliance once formalised;
- A lack of focus from regulated financial services providers on developing appropriate products and services for SMMEs influenced by the lack of information about the SMME sector and the enforceability of commercial agreements with enterprises in the sector, e.g., collateral agreements; and
- The retail payment system which caters to formal and larger enterprises is largely inappropriate and too costly for small-value transactions due to the lack of interoperability of payments channels and providers.

As payments are typically the entry-point to the beneficial use of transaction accounts and other financial services products and services, it is important that these constraints be addressed. SMME formalisation should be made easier and come with discernible benefits to the enterprise, e.g., access to finance, as well as support for financial capability. Developing the payment system to cater to the needs of SMMEs is critical, with ease of use, low cost and full interoperability being key objectives. Most of these issues are further covered under the priorities described in Pillar 3.

The digitalization of supply- and value chains is a critical element in extending digital payment capability to SMMEs. This requires working with all state entities acquiring goods and services from SMMEs to ensure that digital payment capability is embedded in their processes. Similarly, corporates should be engaged to support the digitization of their value. At the same time, the relative lack of digital capability and access by informal enterprises should be addressed through outreach programs and working with MNOs and communications service providers.

The take-up and use of transaction accounts by SMMEs will be enhanced if appropriately priced and easy-to-use payment services are designed and made available via convenient distribution channels. These services need to include the ability of the SMME to both make and receive payments. Receiving payments for low-value traders should get special attention if South Africa is to reduce its reliance on cash in the informal markets and help SMMEs build financial history through transaction data, which could help them access credit and funding.

The utilisation of enhanced mobile payment by SMMEs should assist their efficiency, as illustrated by the example in Box 17.

Box 17: A new point of sale device and app in South Africa[84]

A new device that offers a secure cloud-based solution that backs up continuously and syncs automatically across all devices, enabling off-site store management, has recently been launched in South Africa. It is designed to enable payments to be made and received more easily, including by working offline, and using shortcuts to speed up check-out. It provides a user-friendly payment experience for customers by enabling easy refunding and discount options and interfacing with other payment apps. The support team is said to be available 11 hours of the day and support is proactive, i.e., support contacts you when a possible problem is detected.

This app has been designed to support small and emerging enterprises with tools to enhance their business. In addition to its standard POS offering, an extended package allows businesses to also organise stock, ring up sales, do cash-ups, recons and monitor their sales performance in real-time.

[84] *Business Report article by Zeenat Vallie, OCTOBER 5th, 2017, https://www.iol.co.za/business-report/meet-yoco-point-of-sale-sas-first-free-solution-for-MSMEs-11493944*

The example of Anzole farming in Box 18 highlights the benefit of related value-added services to payments, and the potential benefit of aggregating businesses to leverage economies of scale.

Box 18: Payment solutions make payments easier for SMMEs[85]

Anzole Farming, a group of small businesses run from Tzaneen in Limpopo, South Africa, has streamlined its payments, accounting, and payroll processes by replacing its old business system with an innovative payment solution. The tight integration between this solution's payment portal, accounting services, and its payroll services has enabled Anzole Farming to reduce its costs while improving efficiency.

Before the implementation of the solution for the group, paying creditors meant printing out the creditors list from the bank, searching for each account in the banking app, and then re-entering each amount to be paid. Not only was this time consuming, but it also left room for error. Now, they can export payments from the solution's accounting module and its payroll service to pay creditors and employees.

Priority 10: Suitable insurance for SMMEs

The recent FinScope South Africa MSME survey, 2020 indicates that only 33 percent of SMME have insurance products. These though are covers taken in the owner personal capacity with the risk covered geared toward personal risk as opposed to business risk. Like individuals, businesses in South Africa are inadequately protected from risk making them vulnerable as many of them do not have high liquidity which means in times of unfortunate incidents these entities would not be able to absorb the shock brought about by those incidents.

In trying to unearth the reasons for not using insurance, businesses cited affordability and uncertainty over the value of having an insurance cover key reasons for not taking up insurance for their businesses.

Lack of knowledge about the type of covers available for business risk risks is directly related to the perception of lack of value in having insurance. This points to poor or lack of appropriate education on the subject and highlights poor product design, ineffective disclosures and marketing and sales practices that are not customised to SMMEs. For instance, if SMMEs feel that insurance offers little value, an investment or savings component added to the insurance's core offering might change their perceptions and increase penetration rates. Given the importance of land ownership and food security in South Africa, National Treasury together with the Landbank have been working with the World Bank Group and the insurance industry, to explore the case for weather index insurance for smallholder farmers in South Africa. Box 19 reflects on the rationale for, and potential benefits of weather index insurance applied across Africa.

From a supplier perspective, lack of understanding on the needs of SMMEs combined with heterogeneity of the SMME sector makes selling a generic low-cost product using the traditional sales challenging distribution network unviable.

[85] *https://www.sagepay.co.za*

Box 19: Evidence of weather index insurance in Africa[86]

Weather index insurance refers to a contract between an insurer and a farmer where compensation is paid if an observable and public index falls below a predetermined threshold, which could for example be linked to rainfall or regional production. It can help rural households mitigate the risk that they will lose income from a poor crop due to extreme weather events – like drought, flood, tidal waves and hurricanes. This type of insurance is particularly important in areas affected by global climatic changes. For example, in a household survey conducted by Giné, Menand and Townsend in Andhra Pradesh, India, 89 per cent of surveyed rural landowners cite drought as the most important single risk faced by the household. Closer to home, Malawi is a very rural country, with over 80 per cent of its people engaged in farming, and primarily smallholders cultivating areas of 1 ha or less. The main crops are maize, tobacco and groundnut, with over 90 per cent of crop production rain-fed, taking place during a single rainy season lasting from December to April.[87]

Weather shocks tend to affect all households in a local region, meaning that seeking help from nearby family, friends and neighbours may be ineffective. Also, the risk of drought is a major productivity constraint, since even in good years farmers are wary of using inputs such as improved seeds and fertilisers for fear of losing their investment. Weather index insurance is being implemented worldwide for low-income farmers.

Recent drought in parts of Africa has triggered the largest insurance pay-out to date for vulnerable farmers, under an innovative climate risk management scheme known as the R4 Rural Resilience Initiative (R4). Farmers participating in R4, launched by the United Nations World Food Programme and Oxfam America in 2011, will receive insurance payments totalling $1.5 million to compensate for weather-related crop losses in Ethiopia, Kenya, Malawi, Senegal and Zambia.

The pay-out enables nearly 30,000 farming households to cover immediate needs including the purchase of food and payment of children's school fees. Many smallholders also invest a portion of the pay-out in seeds or fertilisers, or in starting small-scale family businesses. Since 2011, more than $2.4 million has been distributed in pay-outs to R4 participants in Ethiopia, Senegal, Kenya, Zambia and Malawi as compensation for weather-related losses. The programme will be expanding to Zimbabwe this year. The initiative reaches over 57,000 farmers in Africa who are vulnerable to climate risk

Insurance payments in the R4 programme are based on an index of rainfall, vegetation or yield estimates determining the extent of the loss incurred by participating farmers.

R4 combines four inter-linked risk strategies: improved natural resource management (risk reduction), insurance (risk transfer), the promotion of investment including better access to micro-credit (prudent risk-taking) and savings (risk reserves).

However, demand for this insurance remains a challenge and take-up will not necessarily stimulate greater input usage and yields. A study of Ethiopian farmers in this regard found that improving access to credit alongside the insurance offering can assist.[88]

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86 *Sarris, Karfakis and Christiaensen, 2006 FAO Commodity And Trade Policy Research Working Paper No. 18, "Producer demand and welfare benefits of rainfall insurance in Tanzania"; World Food Programme http://www1.wfp.org/r4-rural-resilience-initiative; Giné (World Bank), Menand (Federal Reserve Bank of New York), Townsend (MIT Economics Department) and Vickery (Federal Reserve Bank of New York), "Microinsurance: A Case Study of the Indian Rainfall Index Insurance Market."*

87 *Case Study, Drought Insurance in Malawi, https://www.fanrpan.org/archive/documents/d00255/3-Climate-risk_Africa_2007e.pdf;*

88 *2017, Ahmed (Food and Agriculture Organization of the United Nations, Italy), McIntosh (University of California, USA), Sarris (National and Kapodistrian University of Athens, Greece) "The impact of commercial rainfall index insurance: experimental evidence from Ethiopia"*

Policy Pillar Three – Improving the enabling foundations – leveraging a more diversified provider and distribution base

The high level of concentration in the provision of financial services is concerning not only from a market structure perspective but also from a financial inclusion one. A competitive and market-focused financial services landscape has the potential to develop more appropriate products and services, lower costs-to-users, and increase market penetration, thereby improving the levels and sustainability of financial inclusion.

A diverse, competitive, and market-focused financial services sector has greater potential to develop quality products and services, lower costs to users and increase market penetration, thereby improving the levels and sustainability of financial inclusion. Transforming, diversifying and strengthening the provider and distribution base for financial services, including payment services, are priorities. For instance, retail and other nonbank networks already participate in the payment system but too often these nonbank payment service providers offer only closed-loop systems[89] that are not linked to the national payment system and do not offer a wide range of interoperable services such as allowing digital purchases in any store or establishment equipped with a POS device or a mobile phone. Also, many of the recent innovations in digital retail payments have targeted middle- and high-income clients. One success story however is the introduction of the ADLA licences for Low Value Cross Border Remittances. The ADLA's provide cross border remittance products and services to migrants and dominates this market resulting in a 50 per cent decrease in the price of cross border remittances over a 10-year period, to an average of just over 10 per cent. Opaque fee structures and penalty charges leads to mistrust of both nonbanks and banks. Finally, although efforts are underway to promote a cash-light society, cash will remain prevalent for quite some time, particularly among low-income earners, so an extensive and reliable cash-in/out network is still crucial but remains underdeveloped.

In many developing countries, the SMME market is served by specialised financial service providers, in particular deposit-takers and credit providers with otherwise limited-service offerings. These actors usually have the ability to structure their operational and risk management models to serve SMMEs. Several international "franchise" organisations have emerged in this niche SMME finance market. This enables lessons from other countries to be deployed as well as the sharing of technology investments. In many instances, these organisations have adapted to serve the low-income individuals too.

Incumbent large financial institutions have struggled to meet the financial needs of lower-income individuals and SMMEs in South Africa, while other types of business models seem to be more effective. Many smaller or alternative financial services providers have emerged, with the potential to improve quality through more suitable products and services, improve awareness about and increase trust in formal financial services, when they follow fair and ethical business conduct and abide to consumer protection principles. In addition, co-operatives, provide direct ownership and generate gains for members in the communities in which they operate.

These institutions currently fall into five broad categories:

- Financial co-operatives,[90] in which members, besides obtaining the financial services on offer, share in its ownership, management and, potentially, profits if services are offered to non-members, and provided that the main motive of the arrangement remains the benefit of members;
- Non-bank lenders i.e., Micro-finance institutions, or micro-lenders;
- Funeral parlours offering funeral insurance and services;

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89 A closed-loop system is a system where the issuer of a payment service is the only one that can process the payment to the recipient, no other provider can process the payment.

90 A co-operative is a farm, business, or other organisation which is owned and run jointly by its members, who share the profits or benefits.

- Alternative financial institutions, being non-traditional providers of financial products and services that can operate in competition to traditional financial institutions like banks, insurers and asset managers. Often, the financial sector activity is not its core business, but rather has been deployed in support of it. Currently in South Africa the main alternative financial institutions are ADLAS, telecommunications companies and food retailers (for payment services), clothing retailers (for credit and insurance) and motor dealers (for asset insurance). This could include many other types of fintech companies; and
- Informal or semi-formal, member-based arrangements like stokvels,[91] friendly societies[92] and burial societies.[93]

Steps should be taken to support the growth and development of these entities in a way that improves access to and take-up of quality financial products and services by individuals and SMMEs, improves consumer protection and supports wealth creation. Recognition is also given to the role of these and other entities acting as intermediaries of traditional banks and insurance companies, therefore significantly broadening the potential access points for South Africans to meet their financial service needs. Lastly, the rapid pace of technological developments in the provision of financial products and services – loosely termed "fintech" – is expected to increasingly bring in new players, business models and distribution channels in competition with traditional models.

The following therefore constitute the priorities for this pillar:

- Priority 11: Build appropriate payment options to drive usage
- Priority 12: Building a credit infrastructure that will improve access to credit for SMMEs
- Priority 13: Enable and strengthen the capability of new and small financial institutions, with increased focus on strengthening the financial co-operatives and developmental microfinance sector;
- Priority 14: Explore the role of the state in supporting sustainable financial inclusion;
- Priority 15: Enable a broad base of agents in the provision of financial services; and
- Priority 16: Leverage fintech disruptors to promote and support financial inclusion.

Priority 11: Build appropriate payment options to drive usage

Payment systems play a crucial role in providing financial products and services by facilitating the flow of funds between parties. The interoperable[94] capability of retail payment system has the potential to increase access to quality financial products and services offered by a wider range of providers, by increasing shared access points, convenience, and reducing the transaction costs for the user.

To operationalise the convenience and increased access, local points of payment, particularly in township and rural retailers, must be enabled. It is generally recognised[95] that the acceptance of digital payments – and hence the active use of transactional accounts – requires a functional digital payments ecosystem. It serves little purpose to ensure that most people have a transaction account but there are few practical places where it can be used for day-to-day purchases. This is one of the reasons behind the very low levels of usage of bank accounts owned by low-income earners. Creating local ecosystems holds immediate benefits for the small retailer as well, in that the enterprise can make and receive convenient and safe digital payments, over and above the benefits of reducing cash handling and holding. The digital

91 *Stokvel is a savings or investment society to which members regularly contribute an agreed amount and from which they receive a lump sum payment. South Africa has large numbers of stokvels.*

92 *Friendly societies are non-profit organisations or associations of persons established to provide relief or maintenance during minority, old age, widowhood or illness for members or persons related to members.*

93 *Burial societies consist of informal groups of people who contribute a regular sum of money into a communal "pot" to cover the costs of a burial within the group.*

94 *Interoperability is the ability of a payment system to conclude transactions across multiple payment service providers.*

95 *See for example the GPFI Guidance Note on Building Inclusive Digital Payment Systems 2017. https://www.gpfi.org/publications/gpfi-guidance-note-building-inclusive-digital-payments-ecosystems*

transaction trail can then be used as input in credit and risk assessments. The same benefits can be felt by individuals using digital payments.

In a global context, the World Bank – CPMI *Payment Aspects of Financial Inclusion* (PAFI) report – lists guiding principles to develop an inclusive digital payment ecosystem, anchored on transaction accounts. The World Bank has undertaken an assessment of the South African payment system. The resulting report *Achieving effective financial inclusion in South Africa: A Payments Perspective* was published in August 2018 and informs this Policy.

Advancing mobile payments.[96] The vast majority of South Africans (more than 90 per cent of adults) use a mobile cellphone, which has spurred banks and nonbanks to offer an array of mobile-based financial products and services over the last 15 years. In some other African countries, notably in East Africa, mobile money offered by nonbanks, mainly Mobile Network Operators (MNOs) led to the wide-spread adoption of mobile payments. This in turn has led to the introduction and growth of other mobile financial services, offered by MNOs, banks and FinTech companies, increasing the level of financial inclusion. A well-known case is that of M-Pesa -. In South Africa, the efforts by major MNOs to offer mobile money-type products have not been successful. There are several potential reasons for this:

- The regulatory restrictions in South Africa require that 'mobile money accounts' are backed on a one-to-one basis by a bank account, thereby reducing the potential cost advantages and convenience of a stand-alone mobile money offering.
- The high penetration of bank accounts in South Africa is such that the demand for mobile money may be less compelling than it is in countries with a lower level of bank account ownership (in Kenya, less than 20 percent of adults had a bank account when M-Pesa was first introduced).The low level of financial and digital literacy requires significant market interaction to gain public of knowledge and trust in new services.
- The mobile money providers may have not been able to develop compelling use cases, particularly in domestic remittances, which anchored the success of mobile money in other countries.
- The underlying infrastructure was not adequately developed. This included the lack of interoperability across different payment schemes and the lack of focus on developing an extensive agents' network with a sustainable business model. At least initially, the ability to cash-in and cash-out is required to build trust and convenience in mobile money.

Interoperability and institutional diversity. A major barrier to massive adoption of digital payments by low-income earners and SMMEs is when payments are not interoperable, i.e., when the payment recipient must be part of the same platform of the sender. Lack of interoperability has many negative consequences, such as for the efficiency and convenience of retail payment systems. Together with unfriendly customer interfaces, non-standardised means in which payments are initiated and executed, and the limited level of competition that nonbanks are allowed, by regulation, to offer in the payments space, have led to low levels of adoption of digital payments. Without the ability to facilitate fund exchange among all users of all regulated financial service providers and across all mobile networks, the potential of digital payment schemes will always be limited. Without allowing competition by nonbank innovators and their participation in the national payment system in equal terms as banks, product innovation anchored on interoperability principles may not happen. Similarly, without adequate digital and financial literacy, new initiatives are unlikely to achieve their full potential. Still, fully interoperable digital payments will have a relative greater impact on low-income individuals and SMMEs.

Nonbanks and institutional diversity. It is in South Africa's best interest to create quality options for small-value digital

[96] *Mobile payment (also referred to as mobile money, mobile money transfer, and mobile wallet) refers to payment services operated under financial regulation and performed from or via a mobile device.*

payments that could be provided by banks and regulated nonbanks. The participation of nonbanks in the payment system could also include intermediaries, or "facilitators", which do not provide transaction accounts, such as companies providing payment initiation services and account information services, within an open finance scheme (see Priority 16 below). Improving the regulatory framework and adjusting the governance structure of retail payments to ensure nonbanks can provide quality products in a level playing field will be key for South Africa to foster beneficial use of transaction accounts.

Promoting a cash-light society. The Government is promoting cashless payment methods for low-value payments, particularly in the mass-transit industry such as the taxi industry. The payment industry has responded positively to this by introducing low-value payment cards. These payment cards allow the customers to "tap and go". A distinguishing attribute of low-value instant payment systems is that such payments can be similar to cash in terms of convenience (when appropriately designed). Moreover, additional authentication is not required at the point of payment: the card is simply presented and authenticated. This increases convenience but also increases risk. Risk is mitigated by restricting either the maximum balance stored on the cards or the transaction amount or both. Mass-transit systems are promising entry points for the acceptance of digital payments. However, currently, there is limited interoperability for these systems and clients must maintain multiple payment cards for different transportation methods.

Unlocking the potential of e-money.[97] E-money is defined as an electronic store of monetary value on a technical device in the consumer's possession or a centralized system. It is generally used for making small value payments to entities or persons other than the e-money issuer (i.e., it is not a closed-looped payment scheme). The device acts as a prepaid bearer instrument which does not necessarily involve bank accounts to store funds or channel fund transfers. Unlike in some other countries, in South Africa e-money activities may be considered a deposit-taking activity, which is reserved for banks. Hence, e-money providers, specifically mobile money providers, have only been able to operate in partnership with banks. This has constrained the e-money business by limiting entry into the market by nonbanks, reducing the value that nonbanks could provide to customers, and reducing the economic viability for e-money businesses, since a partnership with banks may involve sharing revenues.

Creating an interoperable domestic remittance system. Numerous remittance services are offered by financial services providers in South Africa in the domestic remittance market. These include the use of networks of non-financial services providers, e.g., retailers and retail mobile resellers, which has extended the reach of formal remittance service providers. These services are typically closed-loop, in the sense that the recipient must find a point-of-representation associated with the originating service provider. This is true even where the pay-out can occur at an ATM, as the recipient must find an ATM operated by the original service provider. This may prove to be a logistical problem and precludes the effect of competition on services being provided to recipients. An additional issue is that remittance senders are typically treated as having a once-off interaction with the service provider so that the remitter must undergo the full AML/CTF process or elements of it every time the service is requested.

Priority 12: Building a credit infrastructure[98] to improve access to credit for SMMEs

A lack of access to appropriate credit products is a major inhibitor of SMME development. A recent study by FinMark Trust confirmed that access to formal credit by SMMEs constituted as sole proprietorships have a positive relationship with firm size as measured by the number of employees.[99] Yet GEM has found that for the past 15 years almost 60 per cent of experts surveyed identified access to finance as a constraint,[100] especially for those wanting to start a business or a business that is in its early stages of existence. Financial institutions generally require property or securities as collateral

97 *E-money, or electronic money is defined as monetary value represented by a claim on the issuer. This money is stored electronically and issued on receipt of funds, is generally accepted as a means of payment by persons other than the issuer and is redeemable for physical cash or a deposit into a bank account on demand.*

99 *Financial Access and SME Size in South Africa, FinMark Trust, 2016.*

100 *Access to finance is identified as a constraint alongside government policies on education and training – see Pillar Three to follow.*

in addition to formal business records, which many SMMEs do not have. Entrepreneurs tend to raise start-up capital from their own or family savings rather than approaching formal institutions or agencies. This means that young South Africans, women, and people in rural areas are likely to be particularly disadvantaged in their attempts to start small businesses.

The main reasons for the lack of formal financial products that are available to SMMEs include the absence of readily available credit information, the perceived riskiness of SMME finance, high costs of administration, inadequate record-keeping by SMMEs, and a lack of appropriate assets available to SMMEs to serve as collateral.[101] These issues reduce the availability and increase the cost of credit for SMMEs. These inefficiencies in the SMME credit market have a direct bearing on the sustainability and growth of SMMEs.

In trying to address SMME access to responsible financing and assist in the development of this market, Government has created development financial institutions (DFIs[102]) at the national and provincial levels as well as other support agencies, such as the Small Enterprises Finance Agency (SEFA), the Small Enterprise Development Agency (SEDA), the National Empowerment Fund (NEF), the National Youth Development Agency and the Gauteng Enterprise Propeller. These DFIs and agencies offer products and services that include wholesale and retail financing, credit guarantees, and other ancillary services, such as business development services and the implementation of special sector schemes for specific industries, for, example small agricultural development. The funding agencies have seen some success. Over the five-year period from 2013 to 2017 SEFA financed 241,537 businesses through disbursements valued at R4.3 billion.[103] Nearly 56,000 jobs were facilitated in 2017. The NEF in 2016 dispersed R819 million to support 4,938 job opportunities.[104] However, the problem of inadequate infrastructure, the lack of appropriate skills, governance challenges, and operational inefficiencies have to date limited the impact of these DFIs and agencies on the development of SMMEs.

For the formal credit market to be made more accessible to SMMEs, it is necessary to address the structural issues in the market. Viable SMMEs must be able to access credit priced according to their specific risk profile. By further developing financial infrastructure to support the provision of credit to SMMEs, credit providers will be in a better position to advance credit to viable enterprises at risk-appropriate prices if there is improved credit information, structured risk-sharing, and risk-reduction mechanisms. Acknowledging that many SMMEs and especially informal providers blur the line between the business and the individual, alternative lending models should be developed to support personal lending for business purposes. Over time these businesses can become more "business" focused.

Improving access to appropriate finance products is not a silver bullet to maximise the growth in this sector in general, but it is a key enabler for many SMMEs to realise their potential growth.

Credit information sharing. Credit information services for retail clients are well-established and highly developed in South Africa. The corporate sector, including larger micro, small and medium-sized manufacturing enterprises, is also well-served through a range of credit and risk assessment tools. In both cases, albeit on very different scales and levels of complexity, credit assessment is a well-informed and efficient process, generally leading to rational credit decisions and appropriately priced credit. This is not the case for SMMEs, as there is a dearth of readily available information on which to base credit decisions. This requires potential credit providers to obtain information from enterprises seeking access to credit in each instance, leading to significant costs to simply gather information on which to base credit decisions. This leads to a reluctance to engage in this market and an increase in the cost of credit where such engagements do happen. A sound, efficient, and easily accessible credit information infrastructure will assist in responsible credit provisioning.

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101 *South Africa Country Report No. 17/189, ARTICLE IV, IMF, 2017*

102 *A development finance institution is an alternative financial institution aimed at capacitating the market and includes microfinance institutions and community development financial institutions.*

103 *SEFA annual report, 2017.*

104 *NEF annual report, 2016.*

Government will focus on expanding and strengthening this infrastructure, with a specific focus on improving SMME access to finance.

PCG schemes. In South Africa, as is the case globally, SMMEs have a high rate of business mortality in their infancy. Over and above the lack of credit information discussed above, this high failure rate, coupled with the prudential burden placed on the main credit providers through adherence to the international banking regulatory accord Basel III, results in the main credit providers being very cautious in extending credit to the SMME market. While this has a positive impact on the stability and international reputation of South Africa's financial sector, it has severe negative implications for the state's ability to support and grow the SMME sector. This situation is a very good example of where a balanced I-SIP approach, rather than a focus on stability only, is the preferred option.

To start addressing the issue of reducing the risk of enterprise failure, particularly but not exclusively related to start-ups, many countries have introduced the concept of risk-sharing through PCG schemes. In such a scheme the risk of default is shared between the credit provider and the provider of the credit guarantee, typically the state. This does not take the form of a guarantee for the full default amount, but rather an agreed portion of the default amount.[105] If the scheme works well, it has the effect of reducing the expected cost of default on a loan for the lender, thereby changing the credit provider's overall credit assessment. This in turn reduces the cost of credit for viable SMMEs and increases the amount of funding that is made available to those enterprises. Such schemes played a significantly beneficial role in south-east Asian countries after the global financial crises. Evidence suggests that the overall outcome of the schemes played a role in maintaining the healthy GDP growth rates in that region, despite the global slow-down (see Box 20).

Box 20: Loan guarantee schemes for SMMEs – Malaysia

The Credit Guarantee Corporation (CGC) in Malaysia was established in 1972 because of the unavailability of funding for SMMEs by formal institutions. Many small firms had to resort to non-institutional sources of finance whose cost of funding was exorbitant. This situation still prevailed in the 1980s, despite the efforts of the CGC and other government bodies to promote SMME financing. The CGC was subsequently restructured and strengthened. The CGC primarily facilitates SMME access to financing through its guarantee schemes. Initially, it provided guarantee cover for credit facilities extended to SMMEs in three broad sectors: general business (including, wholesale and retail outlets, small-scale construction firms and hawkers and petty traders), agriculture and manufacturing. As the Malaysian economy expanded and diversified over the years, the demand for CGC's guarantee services also grew and this led CGC to expand its range of products and services to cater for larger credit facilities required by medium-sized SMMEs.

Today, the CGC's support for SMMEs is not only confined to the provision of loan guarantee and financing facilities but also advisory services such as financial and business development, credit information and credit rating services in collaboration with SMME Corp and Credit Bureau Malaysia.

In recent years, CGC has forged strategic alliances with fellow banking partners to offer innovative financing options and delivery channels that are cost-effective and efficient to enhance SMME access to financing.

- The current shareholders of CGC are Bank Negara Malaysia (the Central Bank of Malaysia) and commercial banks licensed in Malaysia.
- CGC has assisted SMMEs by providing guarantees to over 445,217 financing facilities to SMMEs valued over RM63.7 billion since its establishment.

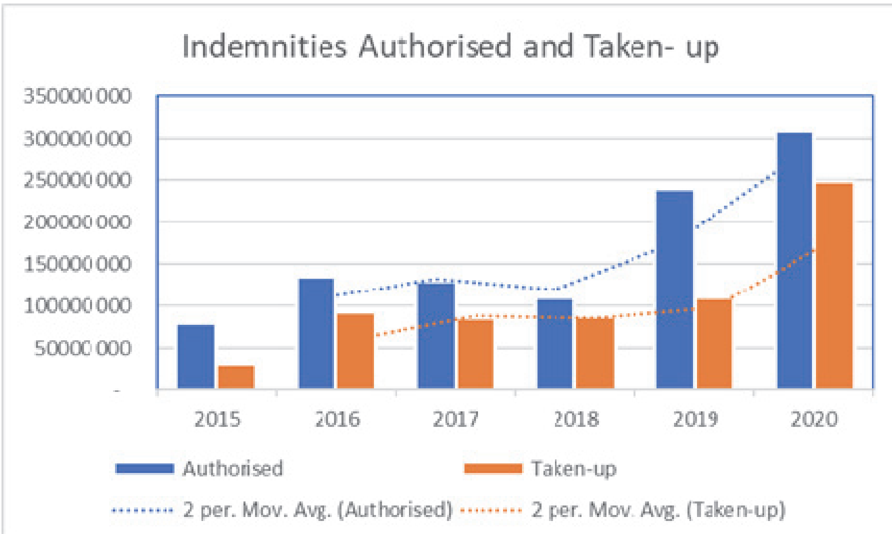
The uptake of SEFA's Khula Credit Guarantee product by commercial lenders has been increasing steadily, as is evidenced in Figure 11. Currently the scheme supports loans totalling about R250 million. Some of the reasons cited for this improved performance includes a diagnostic assessment of the scheme that was undertaken by The World Bank in

[105] *To further decrease the risk of irresponsible lending practices due to the reduction in risk to the credit provider, further conditions could be imposed on the scheme.*

2015, where it recommended a major re-engineering of Khula's institutional structure, regulatory status, business model, product offering, guarantee approval process, claim pay-out, and monitoring and reporting. Since then, SEFA has managed to implement some of the recommendations from the assessment.

The high failure rate of SMMEs has a significant adverse effect on the ability of viable enterprises in this category to access start-up funding. It may be worthwhile to explore mechanisms by which viable start-ups can be distinguished from riskier ones. This has been explored in a few countries, notably Italy. If such a distinction is possible, it will reduce the risk of moral hazard.[106]

Figure 11: Usage of SEFA Credit Guarantee Scheme



Source: SEFA, 2020

Asset-based finance. SMMEs often encounter difficulties in securing credit from formal credit providers due to not having adequate assets to offer as surety. These difficulties arise partially from most formal credit providers accepting only fixed assets as appropriate collateral for loans. However, SMME capital in South Africa is mostly in the form of movable assets such as livestock, inventory, raw material, and equipment. It is often necessary for the owner of the business to raise the required loan capital in their private capacity, which is undesirable. By way of an alternative, asset-based funding is obtained by an SMME based on the value of its available assets, including accounts receivables, inventory, machinery, equipment, and real estate, rather than on its own credit standing. These are known as "movable assets". Accepting movable assets as collateral gives much more flexibility to SMMEs, serving the needs of young and small firms that have difficulties in accessing traditional lending. Many SMMEs in OECD countries, and increasingly in emerging economies, use asset-based finance for working capital, supporting domestic and international trade and investment purposes. (Despite the global financial crisis, in Europe asset-based lending is approximately equal to that delivered by traditional banks.)

Secured transactions [107] laws and registries support asset-based finance by providing:

- Greater flexibility in the loan transaction and the property that can be used as collateral;

[106] ***Moral hazard*** *occurs when one person takes more risks because someone else bears the cost of those risks.*

[107] *A diagnostic on secured transactions that was undertaken by the World Bank on behalf of National Treasury is published as a supporting document to this policy. It should be seen as an input supporting the policy debate, and unless specified as such, the recommendations of the report (which go wider than financial inclusion), should not be assumed to be the recommendations of this policy.*

- Greater uniformity in the registry system and notice provided to third parties;
- More certainty and transparency about the priority of creditors (including insolvency proceedings) and rights of third parties; and
- Greater agility in the enforcement of a security interest in the case of default.

By operating electronically, a modern collateral registry system is accessible to all users, including lenders, borrowers and third parties.

Modernised secured transactions systems have been shown to increase the credit capital available in a local economy, creating a virtuous legal and economic environment through the existence of increased legal certainty and reducing the risk of a loan and the cost of credit. This in turn facilitates greater access to finance and increased competitiveness among local financial institutions. Countries with positive experiences in this regard include China, Mexico, Ghana, and Columbia.108

However, credit providers in South Africa generally do not accept movable assets as collateral as these cannot easily be attached should the debtor default. It is problematic for the lenders to ascertain whether the same asset has already been used as collateral by the applicant with another credit provider, which makes it difficult to execute a legal claim on such assets. A diagnostic conducted by the World Bank on behalf of National Treasury into secured transactions collateral registries found that existing security options – including pledges, notarial bonds, cessions, hire purchase agreements and retentions of title – do not provide sufficient legal certainty or an economic or operational framework for lending against movable assets. This can cause disagreements and uncertainty with respect to the way notice is provided to third parties and the way creditor priorities are determined. Registry and enforcement frameworks are reported as being complex and outdated in various respects, adding time and costs to operations.

The diagnostic makes the following recommendations:

- Reform the law related to secured transactions, to introduce a modern, simplified legal framework governing security interests in movable property[109];
- Create a registry for security interests in movable assets;
- Raise awareness amongst lenders and borrowers of the opportunities created and how to take advantage of reform; and
- Monitor and evaluate the results and impact of the reform project over time, especially to identify those SMME segments that the movable asset register supports best versus those that are not as well supported.

The law reform and establishment of a movable asset register may facilitate SMMEs to put up these assets as traceable and legitimate forms of collateral, without having to rely on any fixed private assets of the business owner. This could in turn lower the risk of lending to these SMMEs, increasing access and reducing the cost of credit. However, the wide reach of the recommendations is recognised to go considerably beyond the scope of financial inclusion for SMMEs, and reform may need to be narrowed to focus on this aspect, at least as a first step.

Technical support for SMME entrepreneurs, including building business knowledge and financial literacy. While not part of the credit infrastructure *per se*, the level of business and financial knowledge of business owners is fundamental to ensuring sustainable SMMEs, thereby increasing the likelihood that an SMME borrower can pay back its loan, in turn substantively reducing its credit risk. Conversely, improvements to the credit infrastructure in isolation will assist credit providers in more accurate risk assessments on the one hand and provide opportunities to better share the risk of default

[108] *The World Bank diagnostic of STC registries describes case studies of Columbia, Mexico, Ghana and China.*

[109] *The diagnostic advises further that the law be tailored to the local legal system taking into account international best practices and standards developed by UNCITRAL.*

on the other (through risk-sharing schemes or extending asset classes that can be used as collateral). However, it does not actually bring down the risk of default. To reduce the risk of business failure, and therefore better leverage the credit infrastructure available, there is a need to focus on building technical expertise within SMMEs. In recognition of this, Government established the SEDA, which provides a range of business support services to SMMEs. Some financial institutions are creating support platforms for prospective SMME business owners that look to build skills and financial literacy, and may even explore how to support market access challenges.

Priority 13: Enable and strengthen the capability of new and small financial institutions, with an increased focus on strengthening the financial co-operatives and developmental microfinance sector.

Financial co-operatives provide a platform for communities to participate in the ownership and management of their own financial institutions. These institutions can be geared to their members' specific financial service needs. In the process, they can support empowerment and development through offering a range of products like low-cost, safe savings channel; the ability to make and receive payments in competition to banks; and the provision of productive credit for home improvements, education and SMME financing. Although provisions in the Co-operatives Banks Act allow for these institutions to function as either savings only institutions, savings, and loans institutions, secondary or tertiary institutions and authorised as either a co-operative bank or co-operative financial institution (CFI)[110] the sector has not yet made a meaningful impact in serving the financially excluded. As of 2019, there were only 4 co-operative banks and 23 co-operative financial institutions registered in the country, collectively serving just under 30,000 members.

The most prominent areas of weaknesses in the sector includes: inadequate credit management practices; weak governance structures; weak operational capability, especially the lack of accounting expertise and poor management information systems, e.g., using manual accounting and management information systems; and a shortage of skills at all levels, including the board of directors, senior management, and staff.

A 2014 assessment by FinMark Trust[111] found that while the regulatory environment in South Africa is enabling, additional support may be required, noting:

- Past grant-based programmes did not operate long enough to ensure that managers and communities were sufficiently upskilled to run CFIs, and the resulting poor performance of these institutions compromised trust in the sector.
- Inadequate development programmes for CFI start-ups that do not achieve the thresholds for registration.
- Inadequate Government resources dedicated to support CFIs.
- Low levels of financial literacy among CFI members, which means society does not fully understand the benefits of being a member of a CFI.
- Public sector payroll deductions were disallowed.
- No deposit insurance scheme exists in South Africa now. Such a scheme would cover members' deposits should a CFI fail.

The Co-operative Banks Act provides a developmental framework for CFIs, including through the establishment of the Co-operative Banks Development Agency (CBDA). At the core of the CBDA's objectives is the promotion of sustainable co-operative banking that will contribute towards providing South Africans with access to affordable financial services. Yet, as noted, the impact of the co-operative financial sector has been limited and many financial co-operatives are non-

[110] *A co-operative financial institution CFI) is a member-based deposit-taking financial co-operative with a common bond among its members. A co-operative bank is any CFI registered as a bank, but the term applies automatically to any CFI that has 200 members or more and holds deposits of such members in excess of R1 million.*

[111] *"Understanding financial cooperatives in South Africa, Malawi and Swaziland," FinMark Trust, April 2014.*

viable. The

CBDA has conducted a series of stakeholder engagements to understand the regulatory, developmental and other support needs of financial co-operatives to support its strategy development process. The envisaged strategy will guide the role of co-operative banking in the transformation of the financial sector and the economy broadly. This will allow the CBDA to provide the most appropriate support thereby bolstering the sustainability and growth of the sector.

The development of an inclusive financial sector also needs to look at informal mutual and co-operative arrangements, especially stokvels and burial societies. Government acknowledges the role that these institutions play and will ensure they receive the necessary support to maximize their value to low-income individuals and SMMEs.

Stokvels. In pursuit of formalising the stokvel industry, a national umbrella body, the National Stokvel Association of South Africa (NASASA), was established in 1988. NASASA is a self-regulatory organisation authorised by the South African Reserve Bank. Its members do not have to be registered unless such a stokvel has more than 20 members who operate on a commercial basis.

Friendly societies. These are not-for-profit organisations or associations of people established to provide relief or maintenance in case of a variety of events for members or people related to members. The relief could take any form or nature, such as payment of a sum of money upon the birth of a child or the death of a member, for the insurance of tools used in a trade, for unemployment benefits, or the education or training of members or their children. Hence friendly societies play a risk-mitigating role in communities. As of the end of 2017 there were approximately 196 registered friendly societies in South Africa with R908 million worth of assets[112].

Microfinance institutions. The developmental microfinance sector in South Africa is immature, with only two institutions having achieved scale by servicing more than 2,000 clients. Successful development microfinancing has the advantage that its business model incorporates a business development focus, directly or through a group. In South Africa, this speaks directly to the major needs in the market as discussed in this Policy. By their nature microfinance institutions take a considerable time to reach sustainability, so they require direct support Also, global development microfinance institutions are absent in South Africa, primarily due to the cost and licensing requirements, since the only practical way in which they could maintain their business model which includes taking deposits and providing payment and credit is by obtaining a full banking licence, even though they do not usually engage in the full range of activities allowed to licensed banks. It is envisaged that a tiered licensing framework will assist in allowing development microfinance institutions as well as state banks, innovative banks (including fintech banks) and others to be licensed, regulated, and supervised in line with the FSR Act and Twin Peaks implementation.

[112] Out of the 196 registered friendly societies, 10 were in the process of liquidation, 158 were excluded in the data reported due to either exemptions or failure to submit financial returns on time. The size of the assets is based on the value held by 28 friendly societies that submitted financial statements. Registrar of Friendly Societies Annual Report, 2017.

Priority 14: Explore the role of the state in supporting sustainable financial inclusion

In certain instances, the state may be well placed to bring competitive products and services to the market, especially where there are market gaps or failures as in the case of lending to SMMEs.

South Africa already has some niche or specialist state-owned financial institutions, such as the Land Bank. Consistent with the parliamentary recommendations on transformation, Postbank also has a role to play given its branch network. Less than 2 per cent of the banked population hold an account with Postbank, and it holds less than 1 per cent of deposits, presenting an opportunity for growth. However, the issuing of its licence – as with any other prospective bank – should be subject to it satisfying any licensing conditions set by the Banks Act as overseen by the Prudential Authority.

The main purpose of the DFI model is to provide finance or capital in areas of the private sector that would otherwise not have access to it, as well as ensuring that the catalytic impact is high and sustainable. Internationally, DFIs do not only focus on providing access to capital but are premised on the notion that financial and developmental success go hand in hand, therefore viewing the growth of the private sector as one of the keys to sustainable development. South Africa has witnessed the establishment of several DFIs to address different developmental challenges, including private sector growth and job creation, poverty reduction, improved health, education and environmental sustainability and social change. These DFIs include the IDC and SEFA. The role, scope and funding of all DFIs should be examined and optimised in terms of what is the desired impact and investment requirement to develop the SMME sector. This sector provides funding for SMMEs through grants and financing. The outstanding direct Government loans to SMMEs at the end of 2016 was R8.7 billion, which accounts for 1.4 per cent of extended SMME loans.

Priority 15: Enable a broad base of agents in the provision of financial services

Success in improving access to financial products and services depends to a large extent on the penetration of financial service providers' physical and digital presence and the availability of the underlying technological infrastructure to ensure safety and reliability. The South African financial services sector, particularly the banking sector, has established a well-developed distribution network, including digital channels. According to the Banking Association of South Africa (2010), more than 90 per cent of all households have access to a physical point of presence within a 10 km radius. Physical points of presence comprise bank branches, ATMs and point-of-sale payment devices. The number of branches has been stagnant over the last few years, presumably due to the high cost of setting up a traditional bank branch.

To complement the branch distribution model, banks offer a variety of electronic channels including on-line services (typically internet enabled) and mobile-enabled services. Particularly relevant for low-income earners is the increase in the number and transactional capabilities of merchant payment devices in stores, enabled by both banks and nonbanks. These in-store payment options (e.g., POS, mobile phones and QR codes) enable card-owning consumers to purchase goods, make payments and get cash, without having to go to a branch or ATM.

Although the physical reach and the use of technology have improved financial access in South Africa, there is still much scope for improvement, particularly in rural areas where the presence of financial services infrastructure is limited. For example, according to the FinScope survey 2015, the median time for adults in South Africa who live in rural areas to get to a bank branch is 54 minutes and 48 minutes to get to an ATM, as opposed to 26 minutes and 20 minutes respectively in urban areas.

To support financial inclusion, especially to enable the beneficial use of transaction accounts, greater use of alternative, low-cost distribution models is needed. Leveraging third party infrastructure through agency relationships reduces operational costs, allowing further expansion of the distribution network. The use of agents allows banks and non-banks to deliver services in local grocery stores, retail outlets, post offices and pharmacies, significantly increasing convenience to customers.

The agent model is also attractive to agents (most of which are SMMEs), who may be paid a commission per transaction or per new account opened, diversifying their revenues sources, and making them more resilient. Also, when a financial consumer makes a withdrawal, for instance, they may decide to spend part of their income at the retail store, increasing sales. Moreover, agents usually have longer trading hours than bank branches for instance, reducing the need for customers to take time off work to use financial services.

Brazil and Kenya have both successfully adopted the agent model in support of financial inclusion, as described in Box 21. Consumers use the retail outlets to acquire a basic product, such as a transaction account, deposit and withdraw funds, pay their bills, transact, and make basic information enquiries. Countries in Latin America that have followed Brazil include Mexico, Peru, Colombia, Ecuador, Venezuela, Argentina, and Bolivia. Other countries around the world include Pakistan, Philippines, Uganda, and India.

Box 21: Leveraging agents in Brazil and Kenya

Brazil

Brazil's economy is the largest in Latin America. With 200 million people living across an area of 8.515 million square kilometres, Brazil has a very uneven population distribution, ranging from two people per kilometre in areas around the Amazon to more than 400 people in cities. In 1999, 29.8 per cent of Brazilian municipalities lacked access to bank branches. The poorest states in the northeast and north of the country were worse, with the proportion of unassisted municipalities reaching 45.6 per cent and 60.3 per cent, respectively. These states contain a larger proportion of the poor.

Customers had to travel long distances to reach a branch and spend time traveling and queuing up. A customer survey carried out by the Brazilian bank Caixa Econômica Federal (CEF) found that prior to the opening of its Caixa Aqui agent outlets, 51 per cent of respondent clients had to travel more than an hour to get to a bank branch, and 55 per cent had to spend from R$5-R$15 in travel expenses.

In response the Banco Central do Brasil in 2000 introduced regulatory changes that supported an agent model. This enabled banks like CEF to expand their existing partnership with the national chain of lottery shops to broaden the range of services offered in those locations. The number of agents in Brazil is currently around 467,000 covering almost all municipalities.

Bank agents in Brazil are permitted to perform extensive services on behalf of banks, including receiving deposits, payments as well as loan and credit card applications.

Kenya

Kenya's banking sector experienced a slowdown in bank expansion from the 1990s, and it had a limited reach. Low-income Kenyans were not inclined to access banking services, as they perceived them to be too "elitist. The Central Bank of Kenya (CBK) thus sought to develop customer-friendly, convenient and lower-cost delivery channels.

In October 2009, CBK, together with the Kenya Bankers Association (KBA) and the National Treasury, conducted a knowledge exchange tour of Brazil and Colombia to gain in-depth and hands-on learning experience of the agent model. This led to the development of Agent Banking Guidelines for commercial and microfinance banks in 2010 and 2012, respectively. The model enables banks to leverage cost-effective channels to offer financial services.

For this model to be introduced, the Banking Act was amended to permit banks to contract third parties to provide specified banking services on their behalf. The guidelines to facilitate rolling out the agent model was issued by CBK and took effect in May 2010.

The agent model has enabled commercial and microfinance banks to expand into areas they would otherwise not have reached, due to such limitations as the viability of establishing a branch and lack of infrastructure. Agents also tailor services to the convenience of consumers who can save on transport costs and time taken to avail services.

Since the rollout of this model in May 2010, 18 commercial banks and five microfinance banks (MFBs) have contracted 53,833 and 2,068 agents respectively. These agents have managed over 322 million transactions cumulatively from 2010 to December 2016, which was worth over Ksh1.9 trillion (USD 18.65 billion) over that period.[113]

Equity Bank is one of the banks in Kenya that adopted the model, and it offers its clients the following range of banking services through an agent: cash deposit and withdrawal, payments including remittances, airtime top-up, account opening, origination and balance enquiries.

[113] *Level of impact of financial inclusion in Kenya with a particular focus on poverty eradication and employment creation, Central Bank of Kenya, 2017*

Currently a few banks in South Africa have entered into partnerships with retailers and mobile network providers so they can use that infrastructure to extend financial services to their customers, as well as deepening the use of already acquired products. However, the current use of the agent model is very limited overall. Its contribution to financial inclusion through increased access is therefore limited.

In a study undertaken by FinMark Trust,[114] a main reason cited for the limited use of the agents in South Africa was the perceived (or real) regulatory implications. There is a perceived lack of clear guidance from the regulatory authorities on the use of agents, leading to a cautious interpretation of the regulations. While there is nothing in the Banks Act that stops banks from making use of agents, FICA and the FAIS Act were perceived to be restrictive. The study recommended, among other things, an inclusive banking licence to foster agency banking, use of agents, leading to improved coordination across regulators including the FIC.

Priority 16: Leveraging fintech disruptors to promote and support financial inclusion

The G20 Financial Stability Board has defined fintech as technologically enabled financial innovation that can result in new business models, applications, processes, and (financial) products or services with an associated material effect on financial markets and institutions. Fintech can be applied to a wide range of areas, including electronic payments, automated advice, delivery channels, data-sharing, cyber security, and peer-to-peer lending.

These innovations present a challenge to policymakers and regulators, who need to adopt balanced policies and regulations that do not create an un-level playing field or negatively affect competition and consumer protection. Importantly, consideration needs to be given to how customers– particularly the vulnerable groups – understand and interact with innovative financial products and services. Consumer protection principles need to be upheld regardless of the type of companies involved in the design, delivery, sales, and servicing of products and services.

The G20 recognises digital financial inclusion as an important feature of economic growth. Leveraging the opportunities that technology offers to reduce costs, expand access to financial products and services and extend their reach is vital to the success of achieving universal financial inclusion. The GPFI High-Level Principles for Digital Financial Inclusion[115] included in Box 22 provide guidance on country-level actions needed to harness digital financial services and delivery mechanisms to safely expand access and the usage of financial services for under-served market segments.

114 *https://econrsa.org/system/files/workshops/papers/2012/hawkins-agency-banking.pdf*

115 *The 2016 High-Level Principles for Digital Financial Inclusion build on the success of the 2010 G20 Principles for Innovative Financial Inclusion which spurred initial efforts by providing a basis for country action plans reflecting country context and national circumstances to leverage the potential offered by digital technologies (https://www.gpfi.org/publications/g20-high-level-principles-digital-financial-inclusion)*

Box 22: GPFI High-Level Principles for Digital Financial Inclusion

Principle 1: Promote digital financial services as a priority to drive the development of inclusive financial systems, including through coordinated, monitored, and evaluated national strategies and action plans.

Principle 2: Balance promoting innovation to achieve digital financial inclusion with identifying, assessing, monitoring, and managing new risks.

Principle 3: Provide an enabling and proportionate legal and regulatory framework for digital financial inclusion, taking into account relevant G20 and international standards and guidance.

Principle 4: Expand the digital financial services ecosystem, including financial and information and communications technology infrastructure, for the safe, reliable, and low-cost provision of digital financial services to all relevant geographical areas, especially under-served rural areas.

Principle 5: Establish a comprehensive approach to consumer and data protection that focuses on issues of specific relevance to digital financial services.

Principle 6: Strengthen digital and financial literacy and awareness support and evaluate programmes that enhance digital and financial literacy, considering the unique characteristics, advantages, and risks of digital financial services and channels.

Principle 7: Facilitate access to digital financial services by developing or encouraging the development of customer identity systems, products, and services that are accessible, affordable, and verifiable, and accommodate multiple needs and risk levels for a risk-based approach to customer due diligence.

Principle 8: Track progress on digital financial inclusion through a comprehensive and robust data measurement and evaluation system. This system should leverage new sources of digital data and enable stakeholders to analyse and monitor the supply of, and demand for, digital financial services, as well as assess the impact of key programmes and reforms.

The South African authorities have established a fintech working group to coordinate efforts in developing the country's approach to fintech. The working group represents a collaborative approach among the National Treasury, South African Reserve Bank, Financial Sector Conduct Authority, South African Revenue Service, National Credit Regulator, and the Financial Intelligence Centre. Through the intergovernmental fintech working group (IFWG), financial sector regulators work together to demystify the regulatory landscape, provide a space for safe experimentation and actively advance innovation. The IFWG has recently published the Fintech Vision Document, which outlines the following vision statements for fintech: (i) Addressing the needs of underserved and marginalised segments, (ii) encouraging expanded investment in South African fintech's, (iii) enhancing the legal and regulatory environment to promote innovation and competition, and (iv) building South Africa's talent base.[116]

The following areas, which are expected to evolve over time, were identified:

- peer-to-peer lending, online marketplace lending, or "loan-based crowdfunding";
- non-bank payment services including digital wallets;
- regulatory technology, including the use of big data;
- robo-advice; and
- data management, including offshoring and cloud computing.

[116] *Fintech Vision Document, 2020, https://www.ifwg.co.za/reports/*

Malaysia has been at the forefront of fostering fintech for financial inclusion; Box 23 shows how sandboxes are being used to drive technological enhancements in support of reaching the final inclusion "frontier" and supporting take-up and effective usage.

Box 23: An approach to sandboxes – Malaysia[117]

Malaysia is a middle-income country where 92 per cent of the adult population had an active deposit account at a financial institution by 2016, and an estimated 70 per cent of working Malaysians invested in unit trusts. Households have access to a wide range of conventional and Islamic financial products and services.

An identified challenge is to reach the remaining segments of the population, which have limited or no access to financial services. These are generally people with low levels of formal education, living in low-income households and rural areas. An additional challenge is usability. Many Malaysians are not fully deriving the developmental benefits from the financial services currently available. These people are, however, rapidly gaining access to financial services through innovative financial products, such as mobile phone applications and agent banking, which can leverage technology and enable financial institutions to reach out to customers in remote areas in a secure and cost-effective manner.

Recognising the potential of technology to transform the financial sector, Malaysia has taken proactive steps to facilitate innovation and the growth of its fintech industry. In September 2016, Bank Negara Malaysia, the Central Bank of Malaysia, issued the Regulatory Sandbox for new companies to test their products in a safe regulatory environment. The "sandbox" enables new companies in the financial sector to develop and test their products under a more flexible regulatory regime, for a period of up to six months. It is intended to protect consumers and contain risks, as some products and fintech companies will not be able to survive in the marketplace. In particular, the sandbox framework:

- Adopts an open application programme interface to enable data-sharing with third parties without compromising data privacy and security.
- Creates a common know-your-customer (KYC) utility for financial institutions to facilitate a more effective and efficient approach to managing compliance obligations, while also aiming to reduce fraud and improve the delivery of personalised financial services.
- Develops guidelines for cloud computing to harness operational efficiencies while protecting data integrity.
- Examines applications of distributed ledger technology to evolve new infrastructure, arrangements, and processes that will transform the way financial services are delivered.
- Takes steps to enhance cybersecurity resilience within the financial sector.

[117] *Financial Inclusion in Malaysia: Distilling Lessons for Other Countries, World Bank Group, May 2017*

5. FROM POLICY TO ACTION: A COORDINATED APPROACH

Government acknowledges that the successful implementation of this Policy requires strong coordination among its departments and agencies, regulators, the financial sector transformation council, financial institutions and their representative bodies, the private sector (i.e., mobile network operators, technology companies, and SMME associations), relevant civil society organisations as well as the informal sector. To achieve this, two bodies are proposed:

- An intra-government Financial Inclusion Sub-Working Group (FISWG) established under the Council of Financial Regulators (as provided for in the FSR Act); and
- A Financial Inclusion Forum (FI forum) for industry and other non-governmental stakeholders to engage policymakers and regulators on strategic priorities.

Chaired by the National Treasury, the purpose of the FISWG is to: [118]

- Act as a platform for intra-governmental coordination on matters of financial inclusion.[119]
- Develop the financial inclusion Implementation Strategy derived from this Policy and, in doing so, determine an Action Plan that prioritizes the needed interventions, with an indication of the leading implementing agency/party and the timeline for implementation.
- Provide the basis for stringent and in-depth analysis to inform the implementation phase, including potential changes to the Action Plan.
- Oversee the implementation of the Action Plan.
- Monitor the progress in terms of access, usage, and quality of financial products and services, and propose how the assessment of the socio-economic impact of financial inclusion will be conducted.

Additionally, the FISWG will coordinate interactions with regional and international bodies engaged in the promotion of financial inclusion and deliberate on key regulatory and supervisory reforms required to balance stability, market conduct, integrity, and competition policy objectives while expanding financial inclusion.[120]

The FISWG will be supported by the FI forum whose purpose is to encourage greater openness and collaboration and to transcend entrenched interests. It will also provide a platform for regulators and financial service providers to deal with compliance matters that impact financial inclusion. At times the industry and other stakeholders may be best placed to lead or actively participate in technical work, so working groups will be set up to facilitate this as required.

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[118] *A few leading practices are emerging in the international financial inclusion world; with the establishment of a national, broad-based financial inclusion focus or task group one of the most promising. Mexico, during its presidency of the G20 in 2012, was a firm proponent of this approach and embedded it in its contribution to the development work of the G20. Several other countries have established such a national platform as well, notably Brazil, Malaysia, the Philippines and Nigeria.*

[119] *The FIT will map the financial inclusion landscape not only in terms of the demand-side needs, but also in terms of governmental bodies contributing to the agenda with different focus areas. Particularly in terms of the SMME sector, priorities and projects supported by development agencies and DFIs (e.g., mandates, value add, synergies) should be considered.*

[120] *The forum will seek to foster consistency in regulatory and enforcement approaches, with regard to conduct issues impacting on financial inclusion – from both a consumer and an industry perspective – particularly between the Financial Services Conduct Authority and the National Credit Regulator. This may additionally be addressed by the abovementioned MoUs. While input from other stakeholders is important and the policy objectives are paramount, the actual regulatory changes are the responsibility of the regulators.*

The FI sub-working group should have as permanent members:

- National Treasury (as the proposed executive lead and secretariat);
- The Prudential Authority, the Financial Services Conduct Authority, the National Credit Regulator and the Co-operative Banks Development Agency, and the National Payment System Department of the Reserve Bank as regulators;
- The Department of Small Business Development, the Economic Development Department, the Department of Trade and Industry, the Department of Social Development, and other critical Government role players; and
- The Financial Sector Transformation Council as the coordinating body for the Financial Sector Code.

The consultative FI forum should have as permanent members all financial inclusion sub-working group members as well as:

- Financial service industry representatives (BASA, SAIA, ASISA, ABSIP, FIA, BIOA, BIAC, MFSA, DMA, Fintech representatives and others);
- Mobile money network operators and technology companies;
- The Payments Association of South Africa;
- Agencies representing civil society and other relevant interests as invited by the National Treasury; and
- Independent financial inclusion experts as may be determined by the financial inclusion sub-working group.

Consumer representative organisations, SMME representative organisations, state-owned enterprises involved in the provision of financial services (Post Office/Postbank, SEFA and others), Statistics South Africa, the National Consumer Commission, Nedlac, human rights advocacy groups and specific industry players, as relevant on a topic-by-topic basis, could be co-opted on an *ad hoc* basis over time.

Furthermore, to rationalise its effort towards an inclusive financial sector, Government will leverage the financial sector codes through the (i) enterprise supplier development, (ii) consumer education, (iii) empowerment financing and (iv) access to financial services elements to ensure a coordinated approach in the implementation of this policy and the subsequent strategy. The financial sector transformation council, as the entity responsible for the enforcement of the financial sector codes, will thus play a critical role in advancing the work of the FISWG and more broadly financial inclusion in South Africa.

6. MEASURING PROGRESS AND IMPACT

Monitoring and evaluation play a critical role in the financial inclusion policymaking and adaptation process, and in ensuring that the design, prioritisation, and implementation of initiatives are based on evidence. Many international organisations and agencies have developed robust financial inclusion indicators to help countries assess their state of financial inclusion.

The collection of relevant supply-side and demand-side data for a comprehensive assessment of the state of financial inclusion should thus be prioritised. Measurement and monitoring should cover the three dimensions of financial inclusion (access, usage, and quality). A wide set of specific indicators for each dimension can be used on a dynamic basis. This is a necessary feedback loop to learn what interventions are effective and to serve as a catalyst for the future design of new financial products and services.

It is also necessary to assess the ultimate impact of financial inclusion on the quality of life and well-being of low-income households and SMMEs. To this end, efforts will be made to develop appropriate indicators for impact assessments.

It is important to utilise data from all relevant sources to arrive at informed policy decisions and interventions. This requires:

- Standardised definitions to be used for data collection, especially in the SMME space and regarding data reported by financial service providers to their respective regulators. For SMMEs, agreed definitions for the different sizes of SMMEs, definitions for women-led SMMEs and agreement on what constitutes informal businesses, are some of the aspects that require standardization.
- The determination and agreement on the indicators to be used. The data required for the indicators of access, usage, and quality should inform what specific data points are to be gathered, and what the best source of such data should be.
- Coordination to ensure regular and reliable data collection, analysis, and dissemination. National Treasury will play a leading coordination role.

To understand the dynamics of the low-income and SMME market and the landscape of financial service access, usage, and quality it is necessary to collect demand-side and supply-side data.

- Supply-side data provides an exact quantification of, for instance, the number of products offered, the number of account holders, and policyholders, by client segments. The commitment of financial service providers to report data to their respective regulators at a greater level of disaggregation as required by the agreed financial inclusion indicators is of the essence. Gender-disaggregated data points are always relevant, but other disaggregation attributes should also be incorporated. In addition, data that can be used to assess the level of use of the various products and services, by client segment and potentially by geographic location should be included.
- Demand-side data provides, from the perspective of users, a view of the level of penetration of services (users vs. non-users), the use of informal financial services, the depth of use, the constraints faced in taking up services, and the reasons for not taking up services. It can also provide a wealth of different attributes for disaggregation and understanding the market dynamics of different groups and allows the assessment of the extent of meeting the financial needs and the financial health of users.

If available, data from outside the financial sector should be utilised as well, to further deepen the understanding of the market dynamics. Data types that are in use in some countries include the use of mobile and fixed-line communications and (for SMMEs) the use of value-chain and supply-chain information.

Bringing these disparate data sets together requires active coordination and agreement as to the structure of the data sets and a commitment to share data between the different actors.

7. NEXT STEPS

This document presents South Africa's Financial Inclusion Policy and proposes an approach to the implementation of the policy objectives.

A FISWG and FI forum will be established in 2024 and together with the National Treasury will lead the development of the National Implementation Strategy and Action Plan.

To measure, monitor, and assess the impact of the implementation strategy, a Financial Inclusion Monitoring and Evaluation framework will also be developed in the year 2024.

ANNEXURE A

The Impact of COVID-19 and Financial Inclusion Initiatives

The COVID-19 pandemic resulted in the South African Government declaring a state of national disaster and this led to the introduction of regulations aimed at curbing the spread of the virus.

During the lockdown, many businesses, including SMMEs were prohibited from operating and only a few essential businesses remained operational, albeit under strict health and safety protocols. This reduced consumer demand for goods and forced businesses around the country to lay off employees, cut salaries, restructure their debt, downsize their businesses or shut down.

To support the President's economic recovery plans to mitigate the impact of COVID-19, this annexure complements and proposes additional considerations, and proposals for further development in support of the financial inclusion agenda in South Africa. Each of the considerations below supports the Policy Pillars and priorities that are covered in this Policy.

POLICY PILLAR ONE: DEEPENING FINANCIAL INCLUSION FOR INDIVIDUALS

Additional Priority: Build an appropriate digital and payments ecosystem to drive the use of digital financial services

To support Priority 1, promote the beneficial use of transaction accounts. For Priority 11, build appropriate payment options to drive usage. For Priority 6, increase the financial inclusion impact of social grant distribution.

Government administers one of the most extensive social security grant systems in the world which assists more than 11 million people and benefits more than 40 per cent of South African households. Very few recipients use their bank accounts as a store of value from which they can store their funds and make payments as needed. About 200,000 recipients receive their funds at cash distribution points provided by the South African Post Office, while most of the other recipients withdraw all their funds from ATMs or POSs once they are available. The consequence of this reality is that the benefits of the grants, both to the recipient and to the communities in which they reside, are limited to the use of cash[121].

The pandemic impacted the way consumers interacted with financial products and services, particularly with the closure of some post office branches. This heightened the importance of digital transactions, including online, mobile, and contactless payments in the country.

In light of the above, the importance of a robust digital payments infrastructure that quickly gets money to those in need, as well as the development of an ecosystem to enable digital financial services that aid merchants - particularly in the informal sector - to accept electronic and contactless payments, emerged as a key financial inclusion priority for government after COVID.

121 *Deepening the social protection of SASSA grant recipients: Raising returns form social protection, FinMark Trust, 2020*

The South African government's COVID-19 unemployment grant of R350 also demonstrated the importance of digital payments for crisis response and addressing the prompt distribution of funds to the eligible recipients.

South Africa has not yet introduced convenient and affordable digital payment mechanisms for low-income and rural markets, as seen in countries like Kenya and Rwanda. Most transactions are still conducted in cash (i.e., 52 per cent), which is perpetuated by its convenience and the absence of appropriate digital payment channels. The perceived lack of fees on cash transactions also makes transacting in this manner attractive for many low-income individuals. In recent years, the rise of fintechs has played a role in addressing the gaps in digital financial service innovations, but the country still has a long way to go in ensuring that its citizens have access to and are comfortable with using digital financial services. Moreover, traditional financial service providers have closed some of their branches and pushed clients to use digital platforms (i.e., online apps) to access and use of financial products and services.

While digital payments played a significant role in ensuring social distancing and facilitated consumers' ability to make payments without the need for physical contact during COVID, the risk of scams and cybersecurity issues also increased. Scammers targeted consumers, particularly senior citizens who were not comfortable with digital transactions. To this end, it is important that the promotion of digital payments be complemented with improving consumer digital capability and literacy to ensure that digitisation does not unintentionally become an access barrier for consumers who are not technologically savvy.

Key considerations and proposals for project development

Digital payment mechanisms for low-income and rural markets

- Design a pilot study to incubate the development of a transformational digital financial services ecosystem in South Africa. This should consider: beneficiary identification and registration? Digitising payments and creating an enabling financial sector ecosystem? Financial management systems? Interoperability? Cashing out? There could be an opportunity to support the distribution of the social assistance grants effectively, and specifically the interoperability of Government databases through a master social security register which could support the targeting and registration of beneficiaries. This pilot project could target clients of development microfinance institutions, spaza shops and or SASSA grant recipients. Any move towards digitisation should take into context the reality of South Africa's rural communities: i.e. many rural villages and townships have weak foundations to support robust digital finance. This includes the availability of enabling conditions i.e. telecommunications infrastructure, cell phone data, and the digital capability (i.e., literacy) of individuals. [122] Banks may have little incentive to serve these communities, but other types of companies such as telecommunications or cable companies that utilise agent networks may be a better channel to deliver digital finance services.
- Engaging the extensive network of spaza shops and other informal vendors in the digital payments' ecosystem is an enormous opportunity to overcome the last mile challenges while supporting commerce in poor neighbourhoods. There is a resounding gap in SASSA's vendor model and in South Africa's ecosystem for digital payments more broadly. Spaza shops and informal vendors in townships and rural zones are largely outside the digital payment's ecosystem. An opportunity also exists to engage these players.
- Given the increasingly digital environment for financial products and services and the potential for digitisation to support greater financial inclusion and inclusive growth, the need for effective financial consumer protection is more important than ever. Digitisation has the potential to increase customer vulnerability to criminal activity, including fraud and scams like phishing schemes and data theft.

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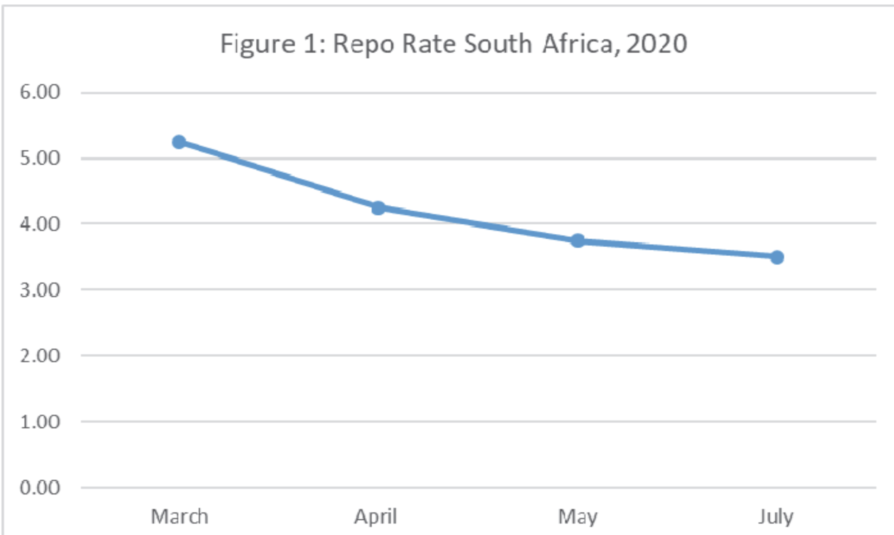
[122] *Rizzi A. (2020) A Covid-19 digitization stampede mustn't trample consumer protection, Center for Financial Inclusion* https://www.centerforfinancialinclusion.org/a-covid-digitization-stampede-mustnt-trample-consumer-protection

Additional Priority: Consumer financial vulnerability

To support Priority 4, promote appropriate credit for assets and investments over consumption.

From as early as 2012, the debt servicing costs, as a percentage of disposable income was increasing in South Africa, showing that consumers were struggling financially and becoming more indebted in an economy that was not showing signs of growing. In the fourth quarter of 2020 i.e. a few months before the pandemic, the estimated household debt-to-disposable-income ratio was 75.4 per cent, indicating that almost 70 per cent of households' available funds were spent on debt.

Households' ability to continue meeting their financial obligations was further put under immense pressure by the COVID-19 crisis resulting in many consumers being unable to service their debt.



Source: South African Reserve Bank

In the year ending December 2019, many banks had already noted an increase in bad debts on their books.[123] NPLs continued to increase for all banks, reaching 4.59 per cent in May 2020 versus 3.83 per cent in May 2019 amid weak economic growth.

Although the SARB had provided some relief through repurchase rate (repo rate) reductions since the start of 2020 to support the debt repayment capacity of borrowers, non-performing loans (NPLs) continued to increase during the pandemic. The absence of adequate safety nets, including savings and insurance, further added to consumer financial vulnerability.

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[123] *Cranston, S. Are SA's Bank facing a bad debt crisis?, Financial Mail,12 March 2020* https://www.businesslive.co.za/fm/money-and-investing/2020-03-12-banks-bad-debt-blues/

Standard Bank's credit loss ratio rose from 0.56% to 0.68%, Nedbank's climbed from 0.53% to 0.82%. FirstRand, reporting results for the six months to December, said its credit loss ratio went from 0.86% to 0.95%.

Key considerations proposals for project development

Alternative credit scoring models

- While financial institutions rely on traditional credit scores from credit bureaus to assess the risks of loans, these methods exclude a major portion of individuals and SMMEs. Many people have had drastic salary cuts and challenges in paying loans resulting in the impairment of many consumers' credit profiles.
- Policymakers should explore policies aimed at enabling and regulating the use of alternative credit scoring in the long term. This will enable lenders who are flexible to collect more information and gain a larger picture of a borrower's financial history, and thus extend credit to these individuals.

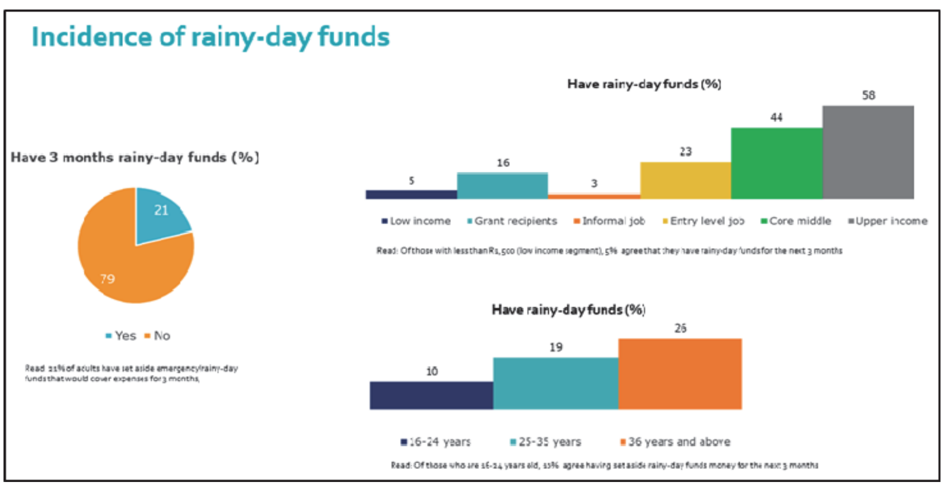
Disclosure and transparency

- Consumers must be provided with key information relating to the fundamental benefits, risks, and terms and conditions of financial products and services.
- The disclosure standards should also address the potential lack of consumer awareness, which may give rise to poor consumer outcomes.
- It is important to strike a balance when considering initiatives to assist consumers to ensure they are not unintentionally over-indebted, which increases their vulnerability.
- **Building consumer financial capabilities** Limited financial and digital literacy impede the effective adoption of digital financial services. Targeted financial education programmes play a major role in empowering consumers to take responsibility for their debt/financial management, this improve consumers' ability to make sound and informed financial decisions related to their unique needs.

Additional Priority: Short-term and long-term savings

To support Priority 3, supporting increased formal saving for low-income earners

Figure 2: Incidence of "rainy day" funds



FinScope, 2019

According to FinScope 2019, only 21 per cent of individuals have three months' savings set aside as an emergency fund. With the pandemic, many employers found themselves unable to pay workers while others were only able to make partial payment of salaries and wages. Some businesses closed whilst others reduced the number of workers. The retirement fund industry and the insurance sector were affected as workers who lost their jobs withdrew their retirement savings or surrendered their long-term insurance savings policies early. While withdrawals from retirement savings and surrendering long-term savings policies before the maturity date may not be advisable, for some, these savings are the only source of funds available to them.

Legislative amendments to enables early access to pension funds is being explored.

South Africa's worryingly low formal savings rate and people's current dependence on retirement savings necessitates that an awareness drive be put in place to ensure South Africans save more in the future.

Key considerations and proposals for project development

Restructure the retirement system – long-term measure

- Create a savings vehicle for fund members that will be accessible for tuition, housing, medical emergencies by taking advantage of the effectiveness of savings through the retirement system.
- Restructure the retirement system to cater for and withstand another potential state of disaster in the future.

Consumer awareness and education

Customers should receive clear information about the consequences and implications of withdrawing long-term savings. This is particularly important for those whose actions may be driven more by market uncertainty than the need to access funds.

Additional Priority: Consumer investments

Prior to the pandemic, the ratings agency Moody's downgraded South Africa's credit rating to sub investment grade, which culminated in the country's exclusion from the FTSE World Government Bond Index.[124] Barclays and Citigroup estimated that Moody's downgrade could lead to $6 billion and $6.6 billion of outflows respectively due to their forced bond selling.

R2.2 trillion (ASISA: 2020) in assets held in collective investment schemes (CISs) are predominantly invested in equities, fixed-income instruments (e.g., bonds) and real estate vehicles in South Africa. The majority of low-to-middle income South Africans are investors in CISs in the form of unit trusts, given their affordability and easy accessibility. According to media company Moneyweb (March 2021), 23 of South Africa's top 40 companies lost more than 30 per cent of their value as result of the impact of COVID-19, and these loses were transmitted to the investment savings of millions of South Africans.

[124] *The FTSE World Government Bond Index (WGBI) measures the performance of fixed-rate, local currency, investment-grade sovereign bonds. The WGBI is a widely used benchmark that currently includes sovereign debt from over 20 countries, denominated in a variety of currencies. The WGBI provides a broad benchmark for the global sovereign fixed income market. Sub-indexes are available in any combination of currency, maturity, or rating.*

Key considerations

- The COVID lockdown forced selloffs, significantly of depressed bond portfolio values, and inevitably the overall assets under the management of the industry.

Proposal for project development

Going forward, Government and the investment management industry should work together to rebuild investment values and discourage panic withdrawals through consumer education.

Additional Priority: Increase access to Insurance

To support Priority 5, promote appropriate, affordable, and quality insurance

In South Africa, credit life insurance[125] (CLI) regulations came into effect on August 10th, 2017. CLI provides for loss of income and most credit providers require that consumers take this cover. Despite many consumers having CLI as part of their loan agreements, a lot of them are unaware that they have this insurance in place, and or or the circumstances under which they could file claims against the insurers because were not aware that were covered for loss of income and or retrenchments.Of the customers who were offered payment relief during the pandemic, 60 per cent had credit life, and this boosted claim numbers.

Key considerations

Inclusive insurance should form a part of the financial inclusion strategy, focusing on well-designed insurance products that provide households with the means to protect themselves against the consequences of different kinds of shocks.

PILLAR TWO: EXTENDING ACCESS TO FINANCIAL SERVICES FOR SMMES

Additional Priority: Enable the transition of SMMEs from the informal to formal businesses

To support Pillar 2 extending access to financial services for SMMEs

According to the FinScope MSME South Africa Survey, 2020 there are an estimated 2,6 million SMMEs in South Africa that account for 40 per cent of GDP and 50 per cent of the employment. Protecting this sector during a crisis is particularly important given that South Africa already has one of the highest unemployment rates in the world, sitting at 32 per cent at the end of the fourth quarter of 2020. Although SMMEs are a core part of the economy, they were particularly vulnerable to a host of adverse effects from the COVID-19 pandemic.

[125] *Credit life insurance is insurance that provides security should you be unable to repay your debt due to retrenchment, disability or death.*

COVID19 led to the implementation of measures to support SMMEs. For SMMEs to access debt relief from the Department of Small Business, some qualifying criteria were put in place. These conditions included that a business must have been registered with the Companies and Intellectual Property Commission (CIPC) in addition to being registered and compliant with SARS and UIF. This situation resulted in the re-emergence of the issue of formality vs informality in the South African context.[126] According to the World Bank (2019) only 14 per cent of SMMEs are formalised in South Africa.

In mid-May the SARB/NT launched the SMME loan guarantee scheme of R200 billion in partnership with all South African commercial banks.

The Department of Small Business Development (DSBD) also launched a debt relief fund for SMMEs directly, or indirectly, negatively impacted by the COVID-19 pandemic. The debt relief finance provided preferential financing (at interest rates of prime less 5 per cent) for salaries, rent and municipal accounts. SMMEs could access the resources after registering on the national SMME database and they needed to be registered with the CIPC to qualify. Companies had to be 100 per cent South African-owned and registered and complainant with SARS and UIF

The DSBD further launched the Township and Rural Entrepreneurship Programme (TREP) offering R740 million in loans and grants targeted at informal businesses and formal microenterprises operating in townships and villages in the following sectors: (a) bakeries and confectionaries, (b) clothing and textiles, (c) automotive afterparts support, (d) fruit and vegetable traders, and (e) spaza shops.

Key Considerations and proposals for project development

- Policymakers must work in close collaboration with banks and actively support entities like the Small Enterprise Development Agency to encourage informal businesses that display formality characteristics to formalise.
- Reduce regulatory red tape to improve the operating environment for SMMEs.
- Rollout one-stop shops and technology-enabled business registration to grow the bankable SMME market segment.[127]
- Minimize onerous tax administration processes.
- Develop projects to improve the COVID-19 response. i.e., improve the uptake of the COVID-19 loan guarantees and improve loan and grant disbursements through DSBD.

Additional Priority: Promote appropriate affordable and quality insurance for SMME

To support Priority 10, suitable insurance for SMMEs

Pandemics are generally excluded from insurance policy coverage. This has led to coverage disputes particularly business interruption cover. The tourism and hospitality sector, particularly its smaller SMMEs, were severely impacted by this. Coverage, relative to various policy wordings against potential COVID-19-related losses and liabilities, is restrictive and there is still uncertainty in this area of insurance on coverage disputes.

[126] *SMME Debt Relief Finance Scheme, Department of Small Business Development (https://www.gov.za/sites/default/files/gcis_documents/SMME%20Debt%20Relief%20Scheme.pdf*

[127] *The Unseen Sector Report, 2019, IFC, https://www.ifc.org/wps/wcm/connect/2dddbf2b-bd44-4965-a7bf-b71475602649/2019-01-MSME-Opportunity-South-Africa.pdf?MOD=AJPERES&CVID=mxxxHod*

The full or partial closing of businesses led to a decreased demand for insurance, as fewer people were buying houses, cars, and other insurable products.

Key considerations

- Understand SMME needs and use the findings to develop minimum product standards.
- Explore the need and mechanics for having "business interruption" insurance to cover SMMEs whose businesses are disrupted during extraordinary events like pandemics.

Priorities in the future world of promoting and enhancing financial inclusion

Enhanced focus on consumer protection

Depressed economic conditions make more customers susceptible to engaging in risky investments, and more likely to fall prey to fraudulent schemes such as Ponzi or pyramid schemes, as they seek to make returns on limited capital.

Key considerations

- Finalise the COFI Bill and fast-track its full implementation.
- Strengthen the financial sector ombuds system to protect poor and vulnerable financial customers.

Enhanced focus on consumer financial education

As consumers continue to grapple with the after effects of COVID-19, it is important that they are provided with information on how to manage their personal finances. They must be helped to adapt to their evolving circumstances.

Apart from South Africans failing to save, taking on debt, and making poor spending decisions, consumers who are not financially savvy are also highly vulnerable to scams. Any move to digitisation will require a 'bottom-up' approach where the digital capability (literacy) of individuals is considered. Considering this, the National Consumer Financial Education Committee (NCFEC)[128] facilitated coordination and collaboration on the communication of topical COVID-19-related financial information to the public to ensure the effective reach and use of available resources.

[128] *The NCFEC is a multi-stakeholder which was established in 2012 to secure the active involvement, collaboration, and coordination of a range of stakeholders in consumer financial education. The committee comprises of representatives of the financial sector industry associations, government agencies, academia, and other civil society organisations and under normal circumstances, meets quarterly.*

Key considerations and proposals for project development

- The high cost of communication data makes digital financial education material inaccessible to low-income consumers. Explore zero-rated websites[129] for financial literacy content.
- Inclusive consumer awareness campaigns are crucial to ensure consumers can make informed financial decisions that are suitable for their personal circumstances. If people have relatively low levels of financial education, they will not be able to meaningfully participate in the financial sector.
- As a complement to financial inclusion and financial consumer protection, financial education is also important to foster confidence and trust in financial markets, and it can also support financial stability[130].

Proposed Research Agenda

The pandemic has exposed the plight of low-income households and SMMEs, but it remains unclear how the future will unfold. Human behavioural research might be required to fully understand the impact of COVID-19 on financial inclusion as it relates to households and SMMEs.

Key considerations

Research survey (preliminary questions)

- How was life (financial status) before the pandemic regarding access and usage of financial services? How is it now?
- Which firms (especially SMMEs) have or are exiting the financial services market i.e., the basic characteristics of those SMMEs?
- Those firms that survived how are they keeping their doors open and how long can they survive?
- Are communities comfortable with going digital? if not, what would make it easier for them to adopt technology?
- Are households making ends meet? Are they food secure? If not, how can they be further assisted?

CONCLUSION

We do not yet know the long-term implications of the coronavirus pandemic on financial inclusion. What we know is that "our new economy must be founded on fairness, empowerment, justice, and equality. It must use every resource, capability and innovation we have in the service of the people of this country. Our new economy must open new horizons and offer new opportunities." [131]

One thing the pandemic has taught the Government of South Africa is to be agile and has forced consumers to tighten their budgets and adjust household spending and priorities as their incomes were reduced.

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[129] *Zero-rated websites provide internet access without financial cost under certain conditions, such as by permitting access to only certain websites, by subsidizing the service or by exempting certain websites from the data allowance. In the context of Covid-19 it means that financial education/ awareness material could be posted to these websites to enable all citizens to improve their financial literacy levels.*

[130] *Advancing National Strategies for Financial Education: A joint publication by Russia's G20 Presidency and the OECD (2013); and Seminar on Financial Education, Financial Stability Board, 2016.*

[131] *President CM Ramaphosa Statement, 21 April 2020, https://sacoronavirus.co.za/2020/04/21/extraordinary-budget-for-coronavirus-response/*

Policymakers had to move quickly to implement policies in support of hard-hit consumers; financial services providers were forced to be innovative and agile, to quickly design and deliver products that offer relief and support to their customers; and regulators had to come to the party and ease the regulatory compliance burden on the providers of financial services. With financial literacy and consumer financial education as long-standing issues in South Africa, COVID-19 has placed the finalisation of work around the review of the National Consumer Financial Education Strategy high on Government's agenda.

Access to finance for SMMEs also needs to be tackled at a hastened pace and more creatively than it was in the past. Initiatives like the formalisation of SMMEs, the development of a credit information system for SMMEs as well as the development of an immovable collateral registry for SMMEs, remain pressing matters for South Africa.

The pandemic has also further emphasised the digital divide and the need for Government to develop and roll out short-, medium- and long-term strategies in collaboration with the private sector to mitigate and narrow it. The crisis has also revealed the need for the efficient management of market conduct risks, especially during a pandemic. In addition, incidences of market abuse have further highlighted the need for the finalisation of the COFI Bill and the strengthening of the Ombud System.

The lessons from the crisis has afforded policymakers an opportunity to build a "new economy" and set a new agenda for financial inclusion for the whole country.

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