SOUTH AFRICA / **DISCUSSION PAPER:**

POTENTIAL VISIONS AND IMPLEMENTATION STRATEGIES FOR GROWING FINANCIAL COOPERATIVES IN SOUTH AFRICA

South Africa FSDRP II

February 2021 | Report No: AUS0002080

WORLD BANK GROUP
Finance, Competitiveness & Innovation

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I — PURPOSE OF THE PAPER

1. **The purpose of this paper is to provide viable options to the financial cooperative sector in South Africa on how it can grow the number of members it serves.**

   Over the past decade the number of members in the financial cooperative sector, inclusive of cooperative banks (CB), cooperative financial institutions (CFIs) and saving and credit cooperatives, has stagnated despite evidence of improvements that are needed in the financial sector.[1] In order to grow membership in financial cooperatives a June 2020 study by Rabo Partnerships, titled Development of the South African CFI Sector: Input for the ongoing discussions on the future of the CFIs in South Africa looked at one strategy on how to drive membership growth, specifically through technology and/or establishment of a national cooperative bank. In this exercise we take a step back to present three potential visions, as opposed to focusing on just one vision, for consideration among the sector and options for implementing these visions.

2. **The potential visions described here are intended for the financial cooperative sector, not the Cooperative Banks Development Agency (CBDA) itself.**

   The pathway chosen by the sector, with input from policy makers in South Africa, towards a clear vision could have implications for how CBDA is structured and conducts is work in the future.

3. **This paper was prepared at the request of the National Treasury under the SECO-funded Financial Sector Development Reform Program (FSDRP) II managed by the World Bank.**[2]

   The views expressed in this paper do not reflect the views of the World Bank, the Executive Directors of the World Bank or the governments they represent. This is not a World Bank strategy nor an endorsement by World Bank of a path for the financial cooperative sector in South Africa. Rather, the World Bank is facilitating a discussion and is bringing international expertise for consideration, decision, and implementation by the cooperative sector and authorities in South Africa.

4. **This diagnostic report was prepared by Dave Grace**

   (Cooperative Banking Consultant) with support and guidance from Juan Buchenau (Senior Financial Sector Specialist, (Julian Casal (Senior Financial Sector Economist), Claudia Meek (Financial Services Consultant) and Mogorosi Mashilo (Consumer Insights Consultant).

5. **These options for growing the CFI sector recognize the broader environment in which financial services are occurring in 2021.**

   The most pressing and immediate challenge for financial services is the COVID-19 pandemic which has put pressure on consumer's ability to repay loans and financial service providers' operational and financial capabilities. These pressures on communities as a result of the national lockdown have also renewed the need for local community economic development, small and medium enterprise support and deeper financial inclusion. The options in this paper for growing the CFI sector have been developed within the context of the draft National Financial Inclusion Policy, which was published for public consultation in November 2020.

6. **A survey of what members and potential members are looking for in their financial cooperatives was conducted to feed into the process of forming a direction for the sector.**

   The Cooperative Financial Institution/Co-operative Bank Members Survey (hereafter referred to as the Members Survey) was conducted online between July and October 2020 and it involved 63 quantitative entries.[3] In addition, 25 respondents were engaged on telephone and online video calls (20 minutes each) to expand on their qualitative insights obtained from the online survey. The survey was conducted in seven of South Africa's nine provinces, namely: Gauteng, KwaZulu Natal, Limpopo, Eastern Cape, Northern Cape, North West, and Western Cape. While 84% of members have a positive impression of their CFI/co-op bank, most members use their institution because of its structure and less because of its services.

[1] The term financial cooperatives is used generically in the paper as these institutions are often called savings and credit cooperatives (SACCOs) or credit unions in other countries. However, there is a distinction between cooperative financial institutions (CFI) which must have at least 200 members and R100,000 in shares to be registered. A CFI can apply to become a cooperative bank when it has R5 million in deposits but must do so once it has R50 million in deposits. The term financial co-operative is used here to refer to CFIs, SACCOs and co-operative banks.

[2] The FSDRP II also supported the recent Rabo Partnerships paper on the financial cooperative sector.

[3] Although this survey was not intended to be statistically rigorous but rather inputs for the qualitative discussions, at the 95% confidence level the answers can be considered statistically valid, albeit with a 12% margin of error. Reading the full version of the Cooperative Financial Institution/Co-operative Bank Members Survey 2020 is strongly recommended in preparation for Indaba in March 2021.

7. The objective of this paper is to contribute to reaching a consensus on the best vision for the sector.

Similar to South Africa, financial cooperatives in most countries are represented by a variety of organizations and interests and it's common that there can be different visions for a financial cooperative sector within the sector itself. This paper first provides a brief overview of the broader financial sector environment and history of financial cooperatives in South Africa, followed by a review of what has and has not worked well, before presenting three potential visions and their respective strategies and structures for achieving the chosen vision to increase membership and usage of financial cooperatives. The visions presented are distinct and very different so that by choosing what not to include in the vision, the sector is choosing a focus.

II — ENVIRONMENT AND RECENT HISTORY OF FINANCIAL COOPERATIVES IN SOUTH AFRICA

8. In recent years the South African economy has been challenged by high unemployment, slow growth and a high cost of government borrowing.

While the gross national income per capita has grown from $7,500 in 2000 to $12,670 in 2019,[4] these gains have not been broadly shared and income inequality remains a persistent problem. The World Bank's human capital index, which measures education, health and childhood survival, places South Africa in the bottom 20% globally. The issues of inequality and low human capital have been some of the key drivers of the economic malaise in South Africa and are areas in which financial inclusion, financial education and local economic development could help.

9. In the decade following the end of apartheid, development partners provided assistance to grow the financial cooperative system.[5]

These early efforts focused on developing a strong, independent association of financial cooperatives that could aid with a "train the trainer" approach. By 2004 there were 40 financial cooperatives (then called savings and credit cooperatives or SACCOs) with 14,000 members. They operated under Exemption Notice No. 2173 from the Banks Act, which required membership in the Savings and Credit Co-operative League of South Africa (SACCOL) as a self-regulatory organization. With only moderate success, many international development partners scaled back support as their expectations were unmet.[6]

10. Despite being active in the last 25 years financial cooperatives serve only 29,500 members out of 40 million adults in South Africa – a number that has remained relatively flat (0.7% annual growth) over the past decade.

The sector had R433 million in deposits as of November 2019 and 70% of the deposits are concentrated in just three institutions. While some of the decrease in membership in 2014-16 is attributed to cleaning up dormant accounts, the overall number of members in CFIs is still well below their smaller neighbours in Eswatini (50,000 members) and Lesotho (76,000 members) and far below peer countries such as Kenya (7.7 million financial cooperative members) and Brazil (10 million financial cooperative members). Notwithstanding having the largest economy and second-largest population in the Southern African Development Community (SADC) South Africa has the second smallest financial cooperative system in terms of members ranking just above the small island nation of Seychelles. In terms of the percentage of the adult population served by financial cooperatives, South Africa is at 0.08% (ranks last out of 118 countries) and had $22 million in assets in 2018.[7] In comparison, Colombia has a similar size economy and population, yet their financial cooperatives serve 9.4% of the adult population and had $6.7 billion in assets in 2018 (Figure 1). In comparison, financial cooperatives in South Africa are still relatively new (except for mutual banks) and have had to try to make headway in a market dominated by sophisticated commercial banks which have strong outreach strategies.

Country	% of Adults with Account – 2018 Findex	Assets of Financial Cooperatives in USD - 2018	% of Adults with Accounts at Financial Coops - 2018
South Africa	69%	$22 million	0.08%
Kenya	82%	$8.3 billion	28.4%
Brazil	70%	$54 billion	6.9%
Colombia	46%	$6.7 billion	9.4%
Lesotho	46%	$7.3 million	6%

Figure 1: Cross Country Comparison of Financial Cooperatives in Peer Countries

Sources: *World Bank's Global Findex 2018 and World Council of Credit Union Statistical Report 2018.*

11. Sensing that part of the problem was the lack of enabling legislation, lack of awareness, confidence in the term SACCO, and the need for consistent development support from government, South Africa passed in 2008 the first stand-alone Co-operative Banking Act in Southern and Eastern Africa.

[4] See the World Bank's Data Bank at https://data.worldbank.org/indicator/NY.GNP.PCAP.PP.CD?locations=ZA.

[5] The first Cooperative Societies Act in South Africa was passed in 1908 with a focus on agricultural cooperatives but mutual banks have a history dating back to the 1880s in South Africa.

[6] In hindsight, these expectations lacked an acknowledgement and understanding of the uniqueness of South Africa's well-developed and technically advanced banking system and the cultural issues.

[7] 2018 Credit Union Statistical Report, World Council of Credit Unions.

The Act also created the Cooperative Bank's Development Agency (CBDA). In addition, the term "bank" has been allowed to be used by the cooperative banks to help lend credibility to the businesses. This is in-line with how members' when surveyed described their financial cooperative, be it a CFI or co-operative bank, as a community bank for the people by people.

12. Over the past decade CBDA has played a dual role as both a development arm and supervisor of financial cooperatives that had up to R20 million and later up to R30 million in deposits per CFI.

This period has been characterized by consolidation in the number of institutions, a focus on meeting prudential financial standards and the concentration of assets in just a few large institutions. Discerning a conflict between the development and supervisory roles and the movement towards a twin peak model of separate prudential and market conduction supervision, the supervisory function in CBDA was migrated to the Prudential Authority at the South African Reserve Bank in 2018.

13. Despite the support and oversight by the South African authorities, the CFI sector is making a limited contribution in terms of supporting the financial inclusion agenda and offering diverse products and services.

The World Bank's Global Findex survey indicates South Africa lags other upper-middle income countries with only 69% account ownership in South Africa compared to 73% upper-middle income countries as of 2018. In addition, Findex indicates that account ownership differences persist between the poorest 40% of the population which is 63% financially included and the richest 60% which is 74% financially included. The 2018 FinScope Fact Sheet indicates an even higher level of financial inclusion than Findex – 80% but with only 60% actively using their accounts as its common to withdraw cash immediately to avoid fees. There is a disproportionately high concentration of CFIs more recently in the Gauteng province, where most members are already using a variety of products and services at a commercial bank. This aspect of parallel usage of CFIs and commercial banks in not unique to South Africa, as usage of CFIs exclusively often happens at either the very low end of the market, deeply rural areas, or with CFIs that are highly advanced.

14. The commercial banking and informal (stokvel) financial sectors are highly advanced and are in competition with financial cooperatives.

While regional and global comparisons of financial cooperative systems can be useful, most other financial cooperatives did not face the level of banking sector sophistication and reach during their early periods of growth. For example, in former Soviet bloc countries financial cooperatives started with significant donor support and were in competition with banks that were not service-oriented. In the SADC region and East Africa financial cooperatives have had a much longer history and the banks there have generally been less stable than in South Africa. The FinScope 2018 data for South Africa shows that 30% of adults use informal savings clubs and 37% borrow from family and friends. As such, scope exists for improving the service offerings lessening the reliance on cash.

15. The National Stokvel Association of South Africa (NASASA) which provides technical support to stokvels estimates there are 810,000 stokvels serving 11 million people.[8]

The FinScope 2018 for South Africa estimates that only 14% of adults (or 5.6 million people) use stokvels. These rotating savings and credit associations are common in many countries around the world and operate in a similar framework whereby 5-20 people that know each other agree to save a fixed amount weekly, bi-weekly or monthly. Traditionally the monies saved are held by one of the members in a locked box, with multiple locks, and other members hold the keys to the locks. Many groups are now holding the funds in mobile money accounts or in group bank accounts held by the stokvel which may have multiple passcodes held by different members. Members take turns each month borrowing from the group and repaying, generally but not always with interest. At the end of the cycle, which is often 6, 10 or 12 months, all of the savings and interest received is paid back at a "share-out" meeting where the stokvel is liquidated. Some stokvels are designed to help with school fees or Christmas gifts such that the share-out meetings occur right before the money is needed for the occasions. The forced savings, community nature, and periodic liquidation of the groups at the end of cycle payout meeting (which ensures that the accounting has been correct and no fraud has occurred) make rotating savings groups very popular and transparent. The apartheid history of South Africa meant that many individuals used stokvels as their only or primary source of financial services.

[8] See National Stokvel Association of South Africa website and data is repeated in academic literature, however, the informal and fluid nature of stokvels makes precise numbers difficult to verify.

III — WHAT HAS AND HAS NOT WORKED IN SOUTH AFRICAN FINANCIAL COOPERATIVES

A. What Has Worked

16. To date the financial cooperatives have been successful at serving a small number of niche communities, being financially strong as a sector, and building support from the government.

Unlike many regional and even global peers where only 29% of financial cooperatives are supervised by their central bank,[9] in South Africa the sector has its own legislation, its own development agency within National Treasury and strong prudential supervision from the Prudential Authority. Most financial cooperative systems in SADC don't have this infrastructure and it's an indication of the level of government support for the sector in South Africa.

17. The largest cooperative banks in South Africa have served very well-defined and insular communities.

Financial cooperatives have shown the ability to offer financial services to small, defined communities. While there have been many CFIs that have entered and exited the market over the past 25 years, many of the financial cooperatives today are on a strong financial footing. With guidance over the years from associations and government most, not all, CFIs that have remained standing, have an adequate financial position, and value proposition that relies on ease of use, proximity, convenience and local ownership/pride.[10] A small group of CFIs volunteers and professionals have been able to acquire the skills needed to assess risk and adequately manage their financial institutions based on their sustainability.

18. The Member's Survey reveals that 84% of members had a positive perception of their CFI or co-operative bank.

Members also perceive their financial co-operative as a good place to obtain financial assistance for personal and business loans, if the financial co-operative is actively lending. Getting a business loan for a small business is perceived to be easier as the CFI does not require the applicant to submit a business plan and projection, which would usually be required from a commercial bank before releasing money for a business loan. The sense of ownership of the institution was cited as a unique aspect that is only available at their financial co-operative.

B. What Challenges Continue in Financial Cooperatives

19. There are several formidable challenges that financial cooperatives face regarding trust, managerial capacity and financial infrastructure.

Although there has been commendable average annual growth in assets (18%) and deposits (15%) over the past 9 years (Figure 2), the number of members has grown annually at only 0.7%. Given that 11 million working-aged South Africans are unbanked there is lots of untapped opportunity for growth and mobilization of their deposits.[11]

Description	Avg. Annual Growth	Nov-19	2018	2017	2016	2015	2014	2013	2012	2011
Number of CFIs	2.8%	22	26	30	30	26	26	35	21	18*
Members	0.7%	29,547	27,831	29,818	29,752	24,722	33,391	38,084	31,481	28,034
Assets	18.3%	433.5	317.6	282.2	279.6	236.6	231.4	220.8	201.8	175.9
Deposits	15.3%	358	244.8	123.2	233.8	201.1	198.6	200.8	187.9	161
Loans	19.5%	274.9	NA	227.6	NA	152.1	140.5	142.3	128.7	107.3

Figure 2: CFI Sector Metrics, 2011 to Nov. 2019 - Assets, Deposits and Loans are in millions of Rand

Sources: *International Credit Union Regulators' Network (ICURN) Peer Review Report 2018 & Prudential Regulatory Authority.*

[9] International Credit Union Regulators' Network Members Survey 2020.

[10] The value proposition could align well with the opportunity in the market as the World Bank's Findex 2018 survey indicates that the top reason South Africans remain unbanked are the costs of banking (38%), a financial institution is too far away (28%) or the financial institution is not trusted (27%).

[11] Author's calculations based on Findex data of 69% inclusion and 36.9 million working-aged adults in South Africa.

20. The lack of public awareness and broader confidence in CFIs hinders their ability to attract deposits, grow loans and generate the resources needed for growth.

Based on World Bank consultant's initial discussions with CFIs in focus groups and the Members Survey from July - October 2020, there is no single reason for the slow member growth. Some CFIs don't want to grow beyond their small familiar group because it will require greater trust and risk taking. Members and potential members lack awareness and confidence in CFIs which are key constraints that inhibit deposit mobilization. Because stokvels are historically well-known and utilized, especially among the unbanked and underbanked, CFIs have struggled to clearly define their difference and advantages compared to stokvels where savings can be entrusted among close friends and colleagues. The financial cooperatives have also failed to offer debit and ATM cards to facilitate easier access to funds – a service widely available from banks.

21. Most members use their institution because of its structure and less because of its services.

Figure 3 from the Members Survey reveals that the value proposition of CFIs/CBs is less about their ability to offer efficient financial services and more about the local ownership aspect.

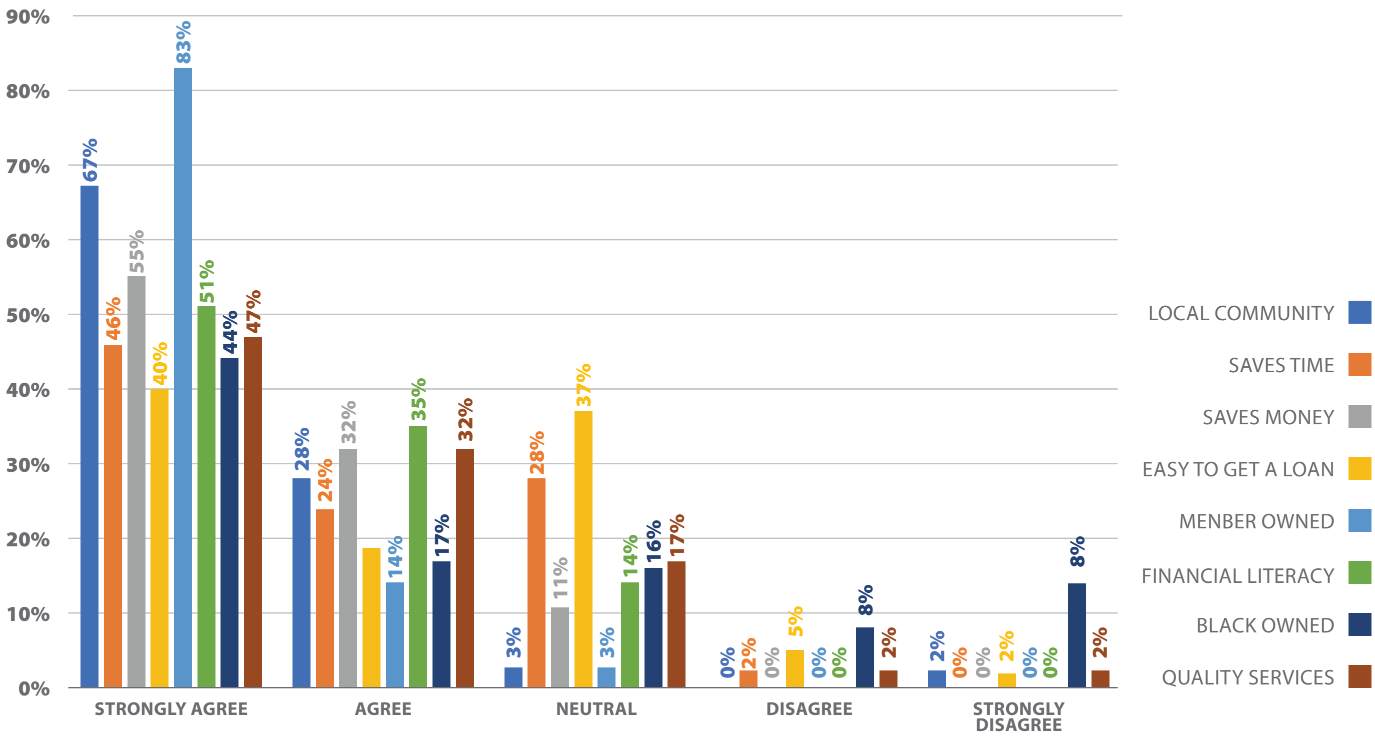

Figure 3: Value Proposition of CFIs/CBs

Sources: *Cooperative Financial Institution/Co-operative Bank Members Survey 2020, World Bank/CBDA*

22. Given the small size of CFIs and niche communities they serve, many have struggled to attract and retain quality staff and board members.

CFI boards have struggled to attract people who have financial skills and are willing or able to put in the time commitment needed as unpaid volunteers. Initially restrictive common bonds have limited the outreach to potential members and volunteers. Even if CFIs did pay board members a reasonable amount it still would be a challenge to attract individuals with the required skills in the rural areas where CFIs could prosper. The same has been true at managerial levels and is exacerbated by the small size and lack of resources within CFIs.

As such, some CFIs have had to build the skills internally, only to see some of the best people leave for more lucrative opportunities. At times, support from the national or local governments which have tried to bolster the CFIs have created some dependency in CFIs on the skills of the people employed in these agencies.

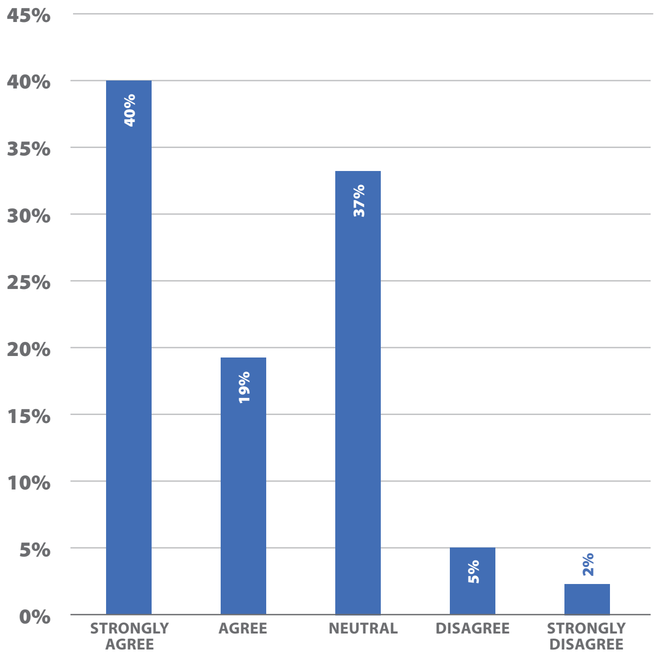

Figure 4: Ease of Getting a Loan at a Financial Co-operative

Sources: *Cooperative Financial Institution/Co-operative Bank Members Survey 2020, World Bank/CBDA*

23. The largest area of potential improvement identified in the Members Survey was around the granting of loans.

Both the quantitative and qualitative aspects of the survey revealed that members are experiencing frustrations with either their cooperatives not yet being granted authority to give loans from the National Credit Regulator or their financial cooperative not being all that easy to deal with for a loan. The long process for these institutions to obtain a loan license from the National Credit Regulator[12] means that some of the recently founded CFIs have not yet been issued a license to lend. Members, in particular board members, believe that their CFI applications for a loan licence were time consuming and create the impression that financial co-operatives cannot deliver the requested products.

This drives members or potential members to seek out loans from the commercial banking system or informal loan facilities. This is a key finding of the survey and has important ramifications for the sustainability of many CFIs. Figure 4 indicates that only 59% of members believe the process to get a loan at a F financial co-operative is easy.

24. The small size and lack of human capacity in CFIs has hindered their ability to implement the financial and technical infrastructure necessary to grow.

This includes not only core accounting and IT systems that allow for loan payments to be deducted at source, but also the ability to offer payment cards, internet and mobile-based financial services that members increasingly seek and expect. Even some larger co-operative banks lack facilities to deduct loan payments at source.

25. Deposit insurance in CFIs and cooperative banks could help improve confidence in the sector, but it alone will not be enough to spur growth.

A recent survey from the International Credit Union Regulators' Network, (Figure 5) shows that in 88% of G-20 countries financial cooperatives have deposit insurance. South Africa is a notable exception as neither banks nor financial cooperatives have deposit insurance as of this writing in February 2021. However, the largest banks in South Africa continue to benefit from an implicit "too big to fail" guarantee and market confidence.

[12] Although the National Credit Regulator is the reason for needing the additional license to lend, none of the survey participants mentioned this regulator by name. Which is indicative that many board members were not even clear on the channels needed to be fully licensed and that there is a special exemption for developmental finance.

DO CREDIT UNIONS HAVE DEPOSIT INSURANCE IN YOUR COUNTY?

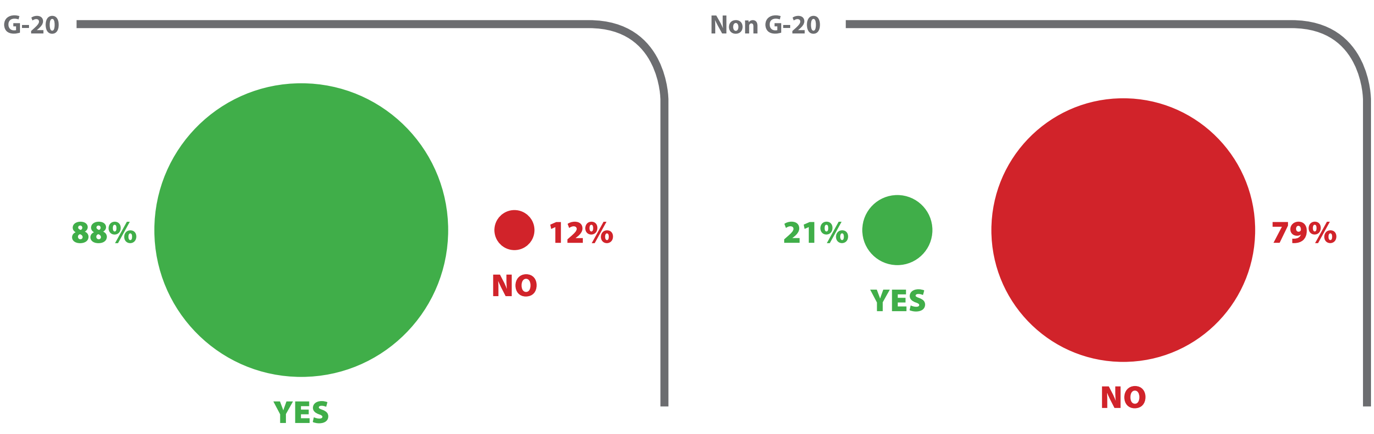

Figure 5: Deposit Insurance for Financial Cooperatives **Sources:** *2020 ICURN Member Baseline Survey Results.*

26. The lack of public awareness, limited human capital, and weak capacity have created significant barriers for CFIs.

While many of these challenges exist in other SADC countries, they are more pronounced in South Africa because the financial co-operative system here is younger, does not yet have an established public reputation, and the competition from large banks, non-bank credit providers and stokvels is intense.

27. When non-members were asked in the Members Survey what their key considerations are for determining where they will save their money themes of confidence, safety and return arose – all areas of weakness for financial co-operatives.

Negative perceptions of financial co-operatives are usually driven by a lack of information and knowledge about what they are. Some survey respondents noted that community financial co-operatives s can be perceived as a poor man's alternative to banking, which in turn does little to attract young professionals. This poor perception is compounded as some financial co-operatives have shut down and people, especially the poor, have suffered great losses from the ones that have failed. Existing members felt that there is lack of information and understanding of what a financial co-operative is and does. A lack of confidence in financial co-operative, such as occurred in the VBS Mutual Bank saga, has made people more sceptical about the sector.

28. Members are waiting to see the benefits of their decision to join a CFI and need a sense of security in relation to their funds before starting to save more with their CFIs/CBs.

Some respondents indicated that in an ideal world, there would be other members who want to save with their financial co-operative, but as some of these entities are relatively new there is a lack of confidence in them. Surety is one of the key barriers to saving, as past members mentioned that they have lost money through failed financial co-operative. Figure 6 indicates only 57% of members where currently saving with the financial co-operative. While some of this could be impacted by the economic impact of COVID-19, confidence in financial co-operative remains a chief concern.

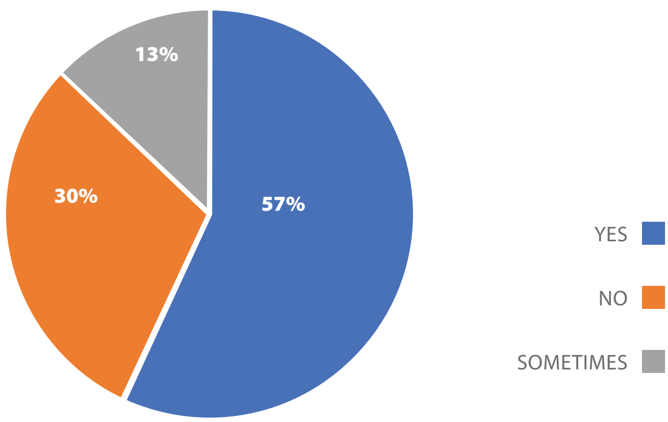

Figure 6: Currently Saving with your Financial Co-operative

Sources: *Cooperative Financial Institution/Co-operative Bank Members Survey 2020, World Bank/CBDA*

29. Unlike other countries during the startup phase of financial cooperatives, South Africa has imposed more restrictive prudential and operational norms that have hindered growth.

Kenya, Poland, USA, Brazil and Uganda all had limited prudential requirements and regulation for their financial cooperatives in the early years of their growth and did not have regulatory constraints on fixed assets and borrowings. This allowed them to be more creative, leveraged, and take on greater risks than the financial cooperatives in South Africa. Each of these countries introduced prudential supervision on financial cooperatives once they reached a critical mass of serving approximately 10% of the adult population and failure of the sector would create larger economic and social problems. In comparison, financial cooperatives in South Africa currently serve 0.08% of the adult population. This concern was highlighted in the results of the Members Survey where some financial co-operatives have found it a difficult process to register and operate because of the many requirements and processes they must follow in order to become operational. After what CFIs/CBs consider a daunting registration process, they then have to go through another long licensing process to issue loans.[13]

[13] This is unique in South Africa as the licensing process for a financial cooperative enables an organization to provide both savings and lending services without taking additional licensing steps.

IV — POTENTIAL VISIONS FOR FINANCIAL COOPERATIVES IN SOUTH AFRICA

30. Given the challenges for CFIs and cooperative banks and the existing market players it's reasonable to ask what can financial cooperatives contribute and why are they needed?

While improvements in financial inclusion and the cost of banking services in South Africa are desirable, the question remains if financial cooperatives should be part of the solution, or can fintech providers, mobile money or the existing banks and credit providers or even stokvels fill the gap? Financial cooperatives have generally been created and thrived where there is a market failure but after 25 years of mixed results in South Africa a defining vision is needed by and for the sector.

31. Financial cooperatives, unlike banks and fintechs, can help develop the financial and governance skills of a broader set of community members.

Board seats of banks and fintechs are generally occupied by a limited number of highly-educated and socially well-connected financial professionals, lawyers and international experts. In contrast, financial cooperatives develop financial and governance skills of teachers, health care workers, micro/small business owners and other community members in smaller towns and villages.

32. Financial cooperatives are the epitome of local development.

They are designed to mobilize local savings, provide loans to members and then redistribute reasonable profits to the community. Their profits, loans and skills are focused on their members and are not siphoned off to foreign owners or far away cities. In the current COVID-19 crisis there is already anecdotal evidence globally of a kinder and gentler approach that member-owned financial cooperatives are taking with their borrowers compared to other lenders.

33. In theory, financial co-operatives can reach more vulnerable communities because they don't have profit as their primary driver.

While financial co-operatives are subject to the costs in the broader market for labor, deposits, etc., successful financial co-operatives abroad find that members use them because they offer good services, a good deal and are easier to work with than banks and microfinance firms which also comes through some in the Members Survey. Financial co-operatives can potentially reach low-income groups with reasonable rates and fees through internal cross-subsidization by other members. However, some degree of scale is needed to be able to effectively cross-subsidize the business model. Regardless of the vision selected, for financial co-operatives to grow substantially they need to have a compelling value proposition for potential members.

34. An underlying assumption in all of the visions is that there is a desire by stakeholders to make a bigger positive impact in South Africa – but what kind of impact needs to be determined.

Will the impact be on financial inclusion, local economic development, improving the functioning and competition of the financial sector? To make an impact significant upscaling of the current membership of 29,500 is needed. Over the next 10 years a target goal of growing the number of active members in financial cooperatives 10 times to reach 500,000 active members is an aggressive but realistic goal that would require more cooperation and funding. In Rwanda, with aggressive support from government, the rural financial cooperative sector has grown to 3.8 million members in less than a decade.

35. Before a strategy for the financial cooperative sector can be determined, a shared vision for the sector over the next 10 years is needed.

Based on previous engagements with the sector's stakeholders, three very different visions for financial cooperative membership growth have been developed for consideration. While aspects of the visions do not have to be mutually exclusive and while the visions can be further refined and adapted, a big part of setting a strategy is deciding what not to do. All of these visions assume that financial cooperatives will serve un-and underbanked communities, however, the particular segments of society which comprise the target market should be considered before determining the strategic vision. The three potential visions are below:

1. **Improve broad-based black economic empowerment in the financial sector and expand financial inclusion to vulnerable communities.**

OR

2. **Provide a competitive, cooperatively-owned alternative to the commercial banking sector to lower the cost, and improve quality of banking services.**

OR

3. **Improve financial literacy and community engagement through local or national government-led initiatives and cooperative institutions/stokvels.**

36. **Vision Option 1: Improve broad-based black economic empowerment (BBBEE) in the financial sector and expand financial inclusion to vulnerable communities.**

This vision puts BBBEE at the center of the vision and financial inclusion as an additional, but secondary goal. This vision recognizes that part of the power of financial cooperatives in South Africa is the building of business and financial skills in local communities through the involvement of members in the Board, committees and annual general meetings. As such, not only are financial cooperatives helping to bolster financial inclusion in hard-to-reach communities, but they also provide the building blocks for a broader base of economic development and empowerment by building the skills of members. This will be done via local financial cooperatives which focus on niche markets.

37. **Vision Option 2: Provide a competitive, cooperatively-owned alternative to the commercial banking sector as a means to lower the cost and improve quality of banking services.**

This is a bold vision for the next 10 years to build a nation-wide alternative to the commercial banking system which would also improve outreach to vulnerable communities. While financial inclusion or local community development could occur as a consequence from creating the national cooperative bank, they are not the goals as described in this vision as they would require a moderately different focus. This vision could serve lower income groups and microenterprises, as well as salaried consumers. It provides savings for consumers and the economy – which could be substantial, if realized.

38. **Vision Option 3: Improve financial literacy and community engagement through local or national government-led initiatives and cooperative institutions.**

This vision would focus the efforts on financial literacy and community education by utilizing cooperative groups as the recipients of these local or national-led educational efforts. This credit or savings with education vision is a different vision of financial cooperatives than in many countries, but not dissimilar from the reality on the ground today in some smaller CFIs and the experience of microfinance institutions in Asia and parts of Africa. CFIs could also provide other community education programs regarding maternal health, vaccination education, etc. Under this vision CFIs do not intermediate funds between savers and borrowers but rather focus on one service or the other. They could on-lend funds from community development programs, banks that they borrow from or international microfinance investment funds (as it happens today in Myanmar and in the United Kingdom in the 1980s/90s). Or they could be savings clubs (as in Hong Kong) that allow members to save any amount at any interval so as to differentiate from stokvels.

39. **There should be significant engagement with local communities, the existing CFIs and their members via the Members Survey, their associations and policymakers around these three potential and very different visions.**

The decision on which vision to pursue has to have both community-level buy-in and support from senior officials within government. The World Bank is explicitly not making a recommendation on which vision should be selected but it will help facilitate the dialogue towards selecting such a vision.

V — STRUCTURE FOLLOWS VISION

40. The structure of the financial cooperative system and related support mechanisms must follow the vision being pursued.

Some recent past efforts to analyze and support the financial cooperative system have assumed a vision (or been given direction) without adequate local buy-in on the vision. Once the vision is determined and consensus is reached among all stakeholders, then National Treasury and CBDA, local governments, the national association(s) of financial cooperatives and development partners can determine how they can reposition their activities to support the vision.

41. Under all of the proposed structures the financial cooperatives would follow the seven international cooperative principles.

The organizations would all be financial co-operatives and subject to the following cooperative principles:[14]

1) **Voluntary and Open Membership**
2) **Democratic Member Control**
3) **Member Economic Participation**
4) **Autonomy and Independence**
5) **Education, Training and Information**
6) **Cooperation among Cooperatives**
7) **Concern for Community**

42. The structures that are needed to attain the three visions are very distinct and would require different resources over the next 10 years.

The structures required by the three visions are summarized below in Figure 7. For simplicity this figure identifies eight key characteristics needed for a financial cooperative to achieve the vision. However, these structural characteristics are not mutually exclusive across the structures and many permutations exist.

Structural Characteristic	Vision 1: **Improve BBBEE and Niche Approach**	Vision 2: **Competitive Alternative to Banks**	Vision 3: **Financial Literacy and Community Engagement**
Target Market	Niche communities	Mass market	Low income only
Products/Services	Savings, loans and payments tailored to specific needs	Full service (savings, loans, bill pay, mobile, home loans, payments, private banking)	Savings only or lending only
Source of funds	Savings or borrowing	Savings or borrowing	Government support, borrowing and/or savings
Brand/offering	Locally determined, low fee	Standardized, low fee	Locally determined
Structure	Many legal entities affiliated at 2nd tier for scale	One legal entity with local branches	Many legal entities
Common bond[15]	Optional	None	Keep as is
Desired financial infrastructure	Deposit insurance, payment system, lender of last resort and credit bureau	Deposit insurance, payment system, lender of last resort and credit bureau	Credit bureau
Government and/or banking sector support	Political, financial, and lighter touch risk-based prudential supervision	Political, financial, risk-based prudential supervision	Political, financial and technical assistance, light oversight and market conduct approach depending on if they accept deposits.
Resources required	Moderate level of resources needed to establish new financial coops and grow the existing ones.	High level of resources needed to establish the required infrastructure to be competitive in the near-term	Low level of additional resources needed.

Figure 7: Financial Cooperatives Structural Characteristic to Achieve the Visions

[14] The International Co-operative Alliance's Co-operative Principles can be found here.

[15] This work recognized that in addition to cooperative banks and CFIs there is a mutual bank license in South Africa which does not require a common bond, but does require significant start-up capital which is barrier for newer financial cooperatives. We are aware of the on-going process of tiered licensing in South Africa.

A. **Vision 1: Improve BBBEE and Niche Approach**

43. To help achieve the vision of shared prosperity and BBBEE, where skill development is as important as financial inclusion, it is essential to have many CFI boards and committees involved at the local level.

This approach would envision that financial cooperatives focus on serving vulnerable/unbanked communities in rural towns, labor unions, tightly affiliated groups of teachers and police officers. Each financial cooperative would be managed independently and continue to have its own board and committees. While some new financial cooperatives may be needed, the target would not be to establish new entities but serving many more members in a sustainable manner without the current restraints of the common bond.

44. While this approach may appear similar to the structure existing today, it requires greater coordination in back-office operations to make financial cooperative offerings more attractive.

This approach envisions utilizing technology, highly trained employees and well-paid managers, and a strong second tier organization that focuses on business services of IT, audit, and connection to the payment system to enable deduction at source payments. It also envisions that all cooperative banks and CFIs have a deposit insurance scheme at the Corporation for Deposit Insurance. This could help provide confidence to CFI savers, but to make it cost effective, a 10-year premium holiday, or until the sector reached a certain size, would be provided to the sector. The costs for this premium holiday would be borne by other deposit insurance participants as part of a required corporate social responsibility as has been the case in the UK.

45. Although this approach focuses on serving markets that are un/under-served by existing players, the common bond requirement would be optional.

A careful study of the current common bond requirements indicates that the rules provide a degree of flexibility as financial cooperatives grow.[16] However, the common bond rules have created a perceptual barrier and misunderstanding for some groups regarding the intention of financial cooperatives given that people are very familiar with stokvels. Before a new financial cooperative starts its operations, it should have a strong understanding of the market need that it will fill, the size and shape of the customer segment it will reach, and the services needed by the segment. However, this approach does not need to be enshrined and limit growth through common bond regulations, but rather a requirement as part of a business plan that is submitted as part of an initial application, as is the case in Rwanda. Given the availability of sophisticated credit information systems and more frequent job changes and flexible work arrangements, the concept that the common bond is a useful risk mitigation tool among thousands of consumers is outdated and no longer credible. As such, the implementation of a common bond will be optional among financial cooperatives as is the emerging practice in other countries. The only credible reason to enforce the common bond today it that it limits competition to banks.

46. A lighter touch risk-based regulatory approach could help spur growth.

To a large extent South Africa has pursued a regulatory-led approach toward the development of the sector. There have been significant investments in the legal, regulatory and supervisory structure for financial cooperatives with the idea that an enabling policy environment would facilitate the growth of the sector. This led to strongly embracing some financial "recommendations" as prudential norms regarding borrowing, non-earning assets, liquidity and capital. As a result, there is a relatively strong, but extremely small financial cooperative system that may have comparatively higher compliance costs. Re-calibrating this framework will be needed if the vision for the sector is to reach many more people on a sound basis.

47. While 61 percent of respondents in the Members Survey indicated that they use a financial co-operative because it is black owned, 22 percent of respondents indicated that they disagreed or strongly disagreed with this statement.

Members love the idea that financial co-operatives give black people a chance to become owners and help the black community to participate in the formal

[16] The current common bond requirements allow for CFIs to apply to SARB to have their common bond expanded if they can show that they have the ability to serve the expanded common bond.

financial sector, as they were previously disadvantaged as a result of the apartheid regime. However, they also believe that financial co-operatives should not discriminate according to race.

48. Less than half of survey respondents strongly agree that they use their financial co-operativeF because it provides quality services.

These members feel that they receive better services compared to commercial banks, and they also appreciate the personal relationships that are formed between members. Figure 8 indicates only 47% of members strongly agree with this statement. For an organization that relies on word of mouth for growth this is a challenge. For members that were neutral regarding this view, was usually because their financial co-operative was still in its infancy.

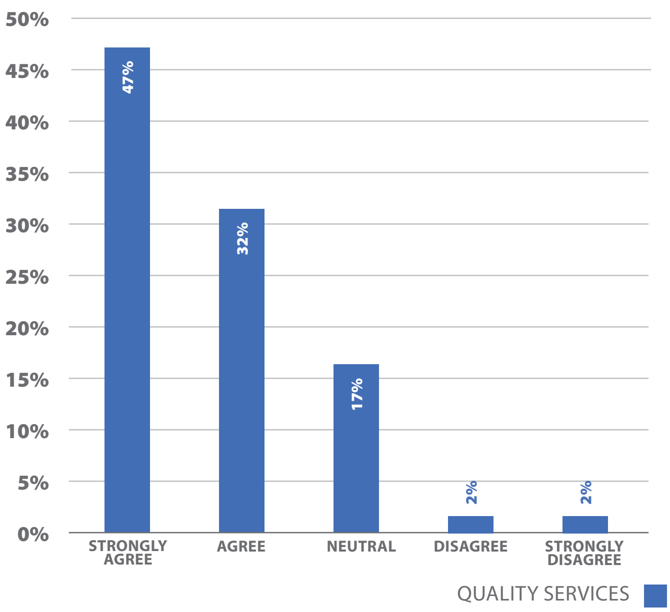

Figure 8: Quality of Services in Financial Co-operatives

Sources: *Cooperative Financial Institution/Co-operative Bank Members Survey 2020, World Bank/CBDA*

48. A moderate to high level of resources would be needed to reach this vision.

To grow the membership tenfold additional technology is needed, as well as shared back-office services and training. The low level of coordination and cohesion among the current largest cooperative banks would require additional outside funding costing R10 to R30 million per year over the next 5 years.

PROS AND CONS OF APPROACH #1

Improve BBBEE and Niche Approach

Pros

- Takes a "Blue Ocean"[17] approach to serving segments of the population that others may serve but don't focus on.
- Includes large numbers of people at the local level in boards/committees and decision making to grow their skills and expand BBBEE.
- Has the most continuity with the activities to date.
- Can have realistic successes in the next 10 years to broaden the base of development outside the major cities.
- Uses outsourcing of back-office functions to gain efficiencies.
- Could develop over time to compete with banks to a greater degree.

Cons

- Could be assumed to be maintaining the status quo but would require changes.
- Will require recruiting and retaining strong managers of CFIs and cooperative banks at the local level.
- Requires acknowledgement that radical changes are needed to move beyond the challenges and limited success of the past 25 years.
- Could encounter resistance from banks and credit providers.
- A moderate to high level of additional resources need to be invested.

[17] The work by Chan Kim & Renée Mauborgn in the 2005 book Blue Ocean Strategy highlights focusing on areas that are less competitive.

B. Vision 2: Competitive Alternative to Banks

50. Developing a cooperatively-owned competitive alternative to the existing commercial banks could benefit the South African economy.

Bringing more competition to the retail and MSME banking sector would in theory help lower the costs of banking for consumers and underserved groups in the overall economy. Among G20 countries South African banks have one of the highest levels of return on equity ratios (16%) and relatively moderate operating costs (60.4%) compared to gross income, albeit moderate by Southern African standards, and a deposit to loan ratio of 57.6% thus suggesting a high reliance on non-interest fee income.[18] As such, an alternative that focuses on loans to clients and lower fees could be a welcome benefit as many consumers dislike the high fees charged by banks.

51. Financial Co-operatives are already seen as a way to save on fees and a place to save money by their members.

The Members Survey revealed 87% of respondents either agreed or strongly agreed that financial co-operatives save them money. This was the 3rd most important reason that members use their financial co-operatives following local community development and member ownership. Respondents who strongly agreed indicated that this is because there is no transaction or monthly fee on savings products, and it is also compulsory for members to save. They also indicated that members encourage one another to save because the benefits come to them, as owners of the institution.

52. This is a bold vision for a financial sector reform requiring a large investment.

To achieve such an objective within 10 years would be a heavy undertaking under the best circumstances and require significant public or private investments at a time that South Africa's fiscal space is limited.

53. From a pure efficiency perspective, a single national cooperative bank with a single board, brand and balance sheet would be the most financially efficient way to create a competitive entity.

A national cooperative bank would need branches and a strong on-line presence and digital offerings. Depending on the path taken, existing financial cooperatives could continue as is or voluntarily merge into the national cooperative bank.[19] If merging, local CFIs would gain economies of scale but lose much of their independence and the role they play in the decision-making process and with it how broad their economic empowerment will be. A national cooperative bank could still have community input committees at the provincial and local levels but a highly-centralized structure would be most efficient for the management, product development and issuance of debt and borrowing, if needed.

54. Globally there are not many examples of a single national structure as most financial cooperative systems have evolved over the years from bottom up to achieve a greater degree of integration.

The National Cooperative Bank of Kenya is the most notable regional example, but it evolved over 40 years and it still competes head on with many SACCOs.

55. There would be no common bond requirement in this model but individuals and/or legal entities using the financial cooperative would have to purchase shares and become members.

As the national cooperative bank would seek to serve members throughout the country, the concept of a common bond where members would know and vouch for each other would not be applicable.

56. A cooperative bank with a national reach and scope should be subject to prudential requirements and have access to the financial infrastructure more in-line with commercial banks, albeit on a risk basis.

Under this framework competitive neutrality in terms of the regulatory framework and expected deposit insurance premiums would apply once deposit insurance is established.

57. A high level of resources would need to be invested in this approach with an uncertain near-term return.

[18] International Monetary Fund, Financial Soundness Indicators latest available data accessed on May 21, 2020.

[19] IAn existing state-owned bank could such as Post Bank could also potentially be mutualized.

To scale up quickly a greenfield operation which starts from scratch that has a national presence and effectively competes with commercial banks in the retail banking space is possible as banks charge high fees and consumers hate paying the fees – as such a unique niche could be carved out. However, there are limited global examples of a greenfield national cooperative bank as they have generally evolved slowly over time. Domestic or foreign investment in a cooperatively-owned enterprise can be difficult to source as the primary profits should remain in South Africa.

An estimated funding cost including capitalization of R30 to R50 million per year will be required over the next 5 years. Evidence in other markets from private greenfield microfinance banks that they can become sustainable in 4 years.[20]

PROS AND CONS OF APPROACH #2

Competitive Alternative to Banks

Pros

— Is the most financially efficient approach and a single brand.

— Could provide wide economic benefits and faster member growth.

— Would provide for economies of scale in the financial cooperative sector.

— May be able to attract foreign investment for growth

Cons

— Is very difficult to achieve in the next 5 -10 years as there are limited number of successful examples of greenfield national cooperative banks.

— Could encounter significant resistance from banks, credit providers and existing CFIs.

— Requires a significant funding from foreign or domestic investors or a government that is already cash strapped.

— Is a high-risk strategy to compete head-to-head with well-established and well- funded banks.

[20] Greenfield Microfinance in Sub-Sahara Africa. International Finance Corp. Field Notes. February 2014.

C. Vision 3: Financial Literacy and Community Engagement

58. To provide platforms for community engagement and financial literacy the national, provincial or local governments can work through village-level financial cooperatives.

To limit the potential financial risk for the financial system, these financial cooperatives or village savings or loan associations would have strict limits on their size and scope of activities. A path for migration into a co-operative bank could remain an option.

59. Financial education is an important desire of existing members of financial co-operatives.

Figure 9 shows 86 percent of respondents agreed or strongly agreed that they use their financial co-operative because it provides financial literacy. Respondents indicated that new members receive information about the institution and its products and there is advice given regarding loans and savings products. There are also ongoing educational programs, webinars and regular member meetings.

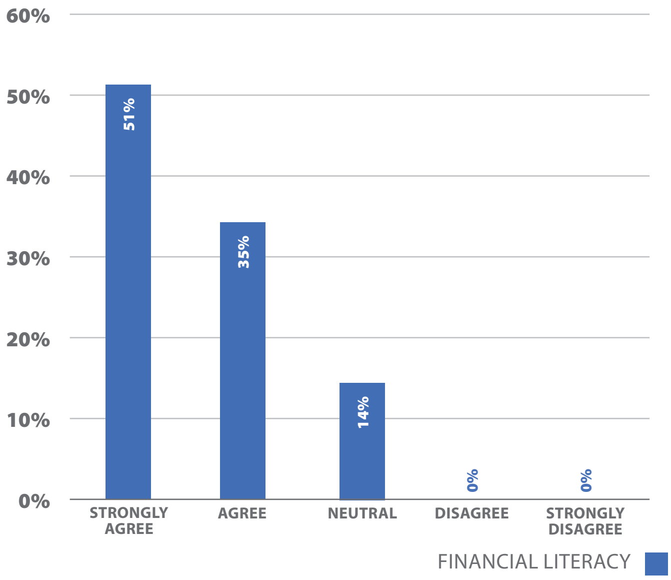

Figure 9: Importance of Financial Literacy in Financial Co-operatives

60. These new or transformed financial cooperatives would not be allowed to intermediate funds among members and financial services would be one activity offered but not necessarily the most prominent.

Members could choose to allow their cooperative to be a savings club or a facility for borrowing like credit providers, but it would be cooperatively owned. The existing financial cooperatives could continue to operate as they currently do.

61. These new or transformed financial cooperatives would operate below the CFIs thresholds for registration and differ from stokvel in that they would be formally registered as cooperatives and would not have a periodic share-out meeting.

Unlike stokvels (which self-liquidate usually at least annually at a share-out meeting where everything is paid back to members), these financial cooperates would not self-liquidate and they could allow members to save and withdraw at any interval or to borrow at any interval subject to available liquidity and approvals.

62. In addition to the limited financial services offered by these cooperatives, they would serve as platforms for educating members about financial literacy and other issues.

Financial cooperatives could be platforms for education on a range of issues such as health and entrepreneurship. As cooperatives they would be independent and autonomous from government and caution would be needed to ensure they are not political platforms. Under such a proposed structure their operating costs would need to be minimal.

63. Financial cooperatives under this structure would have limited financial risk and could have much lighter financial sector supervision.

Financial cooperatives would not intermediate funds among their members. Those financial coops that chose to be savings clubs would have limited investment options for their funds and could benefit from pass-through deposit insurance if their funds were held with a financial institution that is part of the (future) SARB deposit insurance scheme. CBDA's activities would be re-oriented to develop financial and non-financial skills among financial cooperatives.

64. This could be the least costly option as it would rely more on the existing social development infrastructure at the provincial level.

A lower level of funding would be needed to get this strategy up and running but it may not be a sustainable business model and will require an on-going funding source on the long term. Depending on the approach taken by groups, loanable seed-capital may also be needed with a high expectation of loan losses. This approach could be launched with R5 to R20 million per year over the next five years.

PROS AND CONS OF APPROACH #3

Financial Literacy and Community Engagement

Pros

- Recognizes the headwinds of competition in the marketplace and problems in the past 25 years.
- Focuses on building financial capability and other important community health topics.
- Limits financial risk in organizations by not allowing the intermediation of funds among members.
- Provides a more flexible form of stokvels where funds can be accessed at any time.
- Could be the least costly option to implement depending on the model and structure.

Cons

- Financial sustainability of these cooperatives will be challenging as they have limited resources and will depend on outside funding.
- Credit-only financial cooperatives will have to borrow in the marketplace or from local government programs.
- There is a risk of politicization of the financial cooperatives that could be reliant on government.
- There could be a lack of focus of these financial cooperatives as they try to accomplish educational, health, community engagement and financial goals.
- Weak value proposition in terms of meeting pressing financial needs.

VI — CONSULTATION & NEXT STEPS

65. Recommendations regarding which option should be pursued are explicitly not provided in this paper.

The purpose here is to present potential visions, strategies for attaining the visions, and the pros and cons of each vision and implementation structure. The visions and structures are very different but would all be implemented through financial cooperatives.

66. Broad consultation, consensus on a common vision and a greater level of details are needed on these proposed visions and key performance indicators in the coming months.

Key performance indicators can be structured around Board and committee members who have demonstrated financial literacy skills, the number of members using financial co-operatives and amount mobilized in savings and granted in loans. Consultations should include the existing financial cooperatives, their members via the Members Survey, their associations, civil society groups, National Treasury, CBDA staff and board, SARB, FSCA, PA, NCR and senior level government officials. Once there is consensus on the vision to be pursued resources will need to be identified as well as key performance indicators to measure the progress toward success. The Co-operative Banks Development Agency is planning an Indaba in March 2021 to discuss these options for the sector.

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South Africa FSDRP II

February 2021 | Report No: AUS0002080

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