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Building a financial services sector that serves all South Africans

An update on the reform agenda

By channelling savings into investment and credit, the financial services sector plays a key role in growing and transforming the economy. Government's ambitious reform agenda, originally outlined in *A safer financial sector to serve South Africa better* (2011), focuses on strengthening the safety and soundness of financial institutions, improving market conduct, financial inclusion and transformation, and combatting financial crime. Work will continue in 2018 to build on the substantial progress already made in these areas.

Mitigating the impact of illicit financial flows

Illicit financial flows are movements of money or capital from one country to another, where the funds are illegally earned, transferred or used. The National Treasury, in close cooperation with the Reserve Bank, the Financial Intelligence Centre and the South African Revenue Service, is taking several steps to detect, disrupt and deter illicit financial flows. These measures include:

- Increasing capacity to detect, analyse, investigate and report suspicious cross-border transactions.
- Conducting an awareness campaign involving authorised dealers to promote the early detection and reporting of suspicious cross-border transactions or activities involving their clients.
- Sharing information with other authorities/agencies including law enforcement.
- Participating in a multi-agency workgroup, including law enforcement, which has been established to target illicit financial flows.
- Introducing a requirement that state-owned companies must obtain prior written consent from the National Treasury on certain categories of cross-border transactions.
- Commissioning a study in 2018 to identify gaps between the capital flows and anti-money-laundering frameworks, with the aim of cutting red tape while minimising illicit flows.
- Coordinating a national risk assessment in 2018, involving all institutions that combat money laundering and terrorism financing, to bolster the strength of the risk-based approach adopted in the Financial Intelligence Centre Amendment Act (2017). The assessment forms part of government's international obligations to minimise corruption and money laundering under the Financial Action Task Force and includes commitments to the international common reporting standard introduced in 2017.

FinTech and the future of finance

Technological advancements have brought about significant changes in the business model of financial systems around the world. In South Africa, these changes have the potential to improve competition, reduce cost structures and enhance inclusion.

In 2016, government established an Intergovernmental Working Group on Financial Technology and Innovation. The group, which includes the National Treasury, Reserve Bank, the Financial Services Board and the Financial Intelligence Centre, aims to support a coordinated approach in this area. It will ensure that policymakers and regulators encourage the prudent and sustainable development of financial technology ("FinTech") to reap its benefits, while mitigating potential social costs associated with such advancements, such as retrenchments. In 2018, the working group will engage several government departments, including the Department of Home Affairs and the Department of Science and Technology, to draft a financial innovation framework that introduces regulatory, financial and human capital incentives, and innovation zones.

Increasing competition

New technology offers substantial opportunities for new entrants into the financial sector and can help to keep costs down. In 2017, the Reserve Bank granted three bank licences – two for banks with significant digital banking capabilities and one for a new digitally focused mutual bank.

The Reserve Bank is working with the National Treasury, the Financial Services Board, and industry and international experts to modernise its governing payment system legislation, the National Payment System Act (1998). This may allow new players, such as retailers, to participate in the payment system and support more affordable account technologies like mobile money and e-wallet.

Regulatory sandboxes

Financial sector regulators will introduce a simplified licence regime for financial institutions in the start-up phase. This regime will allow start-ups to provide new innovative financial services and products to consumers within an appropriate regulatory framework (a "regulatory sandbox"). For example, firms wishing to offer unregulated digital financial services will be able to operate in a test environment under close supervision. This will support a path to full regulation.

Cryptocurrencies

In 2018, the Reserve Bank, together with the other domestic financial sector regulators, will publish a position paper on the evolving uses of private cryptocurrencies. A cryptocurrency is a digital asset that is used as a medium of exchange. It uses cryptography to secure transactions, both to control the creation of additional units and to verify the transfer of assets.

Strengthening the safety and soundness of financial institutions and the financial system

During 2017, Parliament passed the Insurance Act. It introduces a solvency and asset management programme – a new approach for insurance companies that hold capital for risk. In addition, the National Treasury and the Reserve Bank published a new policy framework, which introduces deposit insurance and replaces bank curatorship with a new approach to restructure banks in severe financial distress ("bank resolution") that will reduce the fiscal risk they pose.[1] This approach will also apply to other systemically important financial institutions. Amendments to the Financial Sector Regulation Act (2017) to give effect to this policy will be tabled in 2018.

[1] Available at www.reservebank.co.za

Implementing Twin Peaks and improving market conduct

Regulatory architecture

Parliament passed legislation enabling the Twin Peaks system of financial regulation in 2017. The two authorities will be established on 1 April 2018, or shortly thereafter. The market conduct authority will only be fully functional after all transitional arrangements are concluded by 2019. In addition, a Conduct of Financial Institutions Bill will be tabled in Parliament in 2018.

The responsibilities of the new Financial Sector Conduct Authority include oversight of market conduct in the retail banking sector. Ahead of the Conduct of Financial Institutions Bill, the authority will develop a market conduct regulatory framework that prioritises the fair treatment of banking customers. The National Treasury, in partnership with the World Bank, assessed the conduct of retail banks and how well they treat their customers in 2017. The recommendations based on this review, to be published in 2018, will inform the emerging regulatory requirements.

The current ombud system for financial services is fragmented, with overlapping mandates. As part of the Twin Peaks reforms, this system will be overhauled. A draft policy framework was published in 2017.[2] A new Ombud Council was created in the Twin Peaks legislation and will begin work in 2018.

Over-indebtedness

In 2016, the National Treasury launched an investigation into emolument attachment orders on public-sector employees' salaries. The project aims to assist over-indebted employees by verifying the validity of existing orders and ensuring that those that are invalid or erroneous are not taken from employees' salaries. This has led to significant savings. As at the end of December 2017, the project had saved employees more than R211 million. In addition, the number of emolument attachment orders has reduced by 31 per cent, with a 27 per cent reduction in the total number of employees with such orders.

Financial literacy

To help South Africans make sound financial decisions and anticipate their financial needs, the National Treasury, the new Financial Sector Conduct Authority and the National Consumer Financial Education Committee will pilot MoneySmartWeek, an education and awareness platform involving financial institutions, companies, schools and communities.

Wholesale market conduct

In the 2017 Budget, the Minister of Finance announced a financial markets review, chaired by James Cross, a former Deputy Governor of the Reserve Bank. In 2018, the Financial Markets Review Committee will publish its draft report, and the recommendations will be considered in future legislative reform.

Financial sector transformation

The introduction of the Financial Sector Charter in 2004 increased the sector's focus on deepening financial inclusion and sustainable transformation. But progress has been slow. More work is needed to ensure that a transformed financial sector contributes to inclusive economic growth. Government's holistic transformation agenda includes increasing competition, broadening ownership and directing lending to high-growth, labour-intensive firms.

The new Financial Sector Code will take into account South Africa's historically low savings and investment rates, and will balance the policy objectives of attracting foreign investment with the need for transformation. Foreign capital supports growth through direct investment, and by facilitating the

[2] Available at www.treasury.gov.za/twinpeaks

transfer of new skills and technologies, and expanding South Africa's access to global markets. Foreign investors hold about 38 per cent of the market capitalisation of the Johannesburg Stock Exchange (JSE) and 37 per cent of national debt stock (R2.2 trillion).

Parliamentary hearings

During 2017, Parliament conducted hearings on financial sector transformation. The full report is available on Parliament's website. The hearings noted the slow progress in meeting the Financial Sector Charter objectives, and identified key themes for further work. These include improved data collection, monitoring and reporting, strengthening sanctions for firms that do not meet the objectives of the Financial Sector Code, aligning licensing conditions to the code's requirements and raising the transformation targets.

Results of first annual ownership monitor

To improve monitoring of transformation in JSE ownership, the National Treasury has introduced an annual ownership monitor. The first edition, published in 2017, notes that net black ownership may be difficult to determine, as shareholders often borrow funds to purchase shares in a company. Retirement funds account for the biggest share of household savings in South Africa, and represent a substantial portion of household wealth. These institutions are the main vehicles through which millions of South Africans save for retirement and other purposes. In 2015, 16.4 million people were members of a retirement fund. The Financial Sector Code should be amended to reflect this reality.

National Treasury ownership monitor: Black ownership of JSE-listed companies

Category	*Estimate*
Direct black ownership (BEE)	9 per cent
Black ownership through institutional funds	11 per cent
Total black ownership	20 per cent

Source: National Treasury Ownership Monitor, available at www.treasury.gov.za/transformation

The table above includes the top 100 South African and foreign-domiciled companies listed on the JSE. The black economic empowerment (BEE) ownership category includes BEE ownership of the listed company itself, BEE ownership achieved through transactions at subsidiary level and direct black retail holdings. The percentage reflects ownership as measured according to the Broad-Based Black Economic Empowerment Codes, as opposed to a narrower measurement of the listed entity's BEE ownership. Black ownership through institutional funds measures the ownership of the top 100 companies through the vested rights of black beneficiaries in institutional funds, in particular retirement funds.

Introduction of project bonds

Government and banks alone cannot fund South Africa's infrastructure programme. From 2018, the JSE will allow the listing of "project bonds". This new funding instrument will offer an opportunity for institutional investors to participate in infrastructure projects through listed, tradable securities that can offer superior risk-adjusted returns. These bonds will be underpinned by the cash flows of a ring-fenced project (such as infrastructure or energy projects).

Financial inclusion

Financial inclusion refers to the provision and use of regulated financial services by those segments of society where financial services are needed but are either unavailable or inadequate. Inclusion enables social and economic development, particularly for low-income people, women, the youth and SMMEs. Financial products and services should be available to and used by most South Africans. Furthermore, they should be convenient, affordable, fair and trusted. A policy document outlining South Africa's approach to achieving financial inclusion will be released in 2018.

Finance for small, medium and micro enterprises

The expansion of small, medium and micro enterprises (SMMEs) can help transform the economy. SMMEs employ 47 per cent of the workforce,[3] contribute more than 20 per cent of GDP and pay about 6 per cent of corporate taxes.[4] The 2015 SMME Survey shows that the majority of small businesses do not borrow from financial institutions, with only 2 per cent indicating that they rely on banks for funding.

In 2018, the National Treasury in partnership with the World Bank will publish a diagnostic assessing financing constraints on the SMME sector. It will inform new interventions, expected to include credit information sharing, a review of credit guarantee initiatives and further work on a movable asset register.

Further steps to manage capital flows and encourage investment

Government is taking additional steps to manage capital flows and support investment.

Managing capital flows

- Review of significant and strategic transactions: To support cross-border investment and increase transparency, the National Treasury will release a paper later this year on a proposed policy framework for the review and approval of complex cross-border transactions.
- Increasing the prudential limit: To increase investment in diverse assets, the offshore limit for funds under management by institutional investors is increased by 5 percentage points for all categories, including the African allowance.
- Reforming loop structures: Loop structures take place when South Africans invest in South Africa via an entity in another country. Such structures may be set up for genuine reasons, for example, when the entity has investors from around the world. But sometimes these structures are set up to avoid tax. The loop structure provision is increased from 20 per cent to a maximum of 40 per cent for bona fide business investment, growth and expansion transactions. The current minimum requirement of 10 per cent is abolished. This applies to companies, including private equity funds, provided that the entity is a tax resident in South Africa. Loop structures above the prescribed threshold will require Reserve Bank approval with due consideration to transparency, tax, equivalent audit standards and governance.
- Modernising holding company (HoldCo) policy: The policy for holding companies will be extended to help South African companies expand, in particular, this will include financial services companies. Transfers to holding entities will be increased from R2 billion to R3 billion for listed companies and from R1 billion to R2 billion for unlisted companies, subject to Reserve Bank reporting requirements.

Inward listings

The inward listing policy is aimed at deepening South Africa's capital markets, but it may create distortions. In 2018, the National Treasury will release a comprehensive inward listings review paper, which will address various matters, including the standards of reporting and information provision, company track records, arms-length arrangements, valuation of the acquiring company, management arrangements, funding arrangements, deployment of listing proceeds, due diligence, audit history, stakeholder protection, better treatment of holders of securities, and confidence among market participants.

Improving the treatment of retirement fund members

Government's retirement reform programme will continue in 2018. Progress on the annuitisation of provident funds and preservation has been slower than anticipated because of a delay in the release of the discussion paper on comprehensive social security reform. As a result, consultations in the National Economic Development and Labour Council are still in progress and expected to be completed by the end of the year. As soon as an initial agreement is concluded, a set of recommendations can be finalised.

[3] Department of Planning, Monitoring and Evaluation (2017). Payment of legitimate invoices within 30 days by government departments. Parliamentary Monitoring Group.

[4] Bureau of Economic Research (2016). The small, medium and micro enterprise sector of South Africa. Research Note No 1, 2016. Small Enterprise Development Agency.

Other issues to be referred to the National Economic Development and Labour Council include broadening coverage to low-income earners who fall outside the collective bargaining system or work for small employers, and bringing all public retirement funds within the same regulatory framework as private funds.

Government has also directed the Financial Services Board to proceed with the following reforms:

- *Lowering costs and consolidating funds:* A key driver of costs is the large number of very small and uneconomical retirement funds (there are currently 5 144 funds, of which 1 651 are active). The Financial Services Board will oversee a significant reduction in funds (preferably to less than 200).
- *Modernising and improving the governance of all retirement funds to King IV standards:* All retirement funds must now submit audited financial statements annually and include a minimum number of independent trustees.
- *Ensuring benefits are claimed:* The Financial Services Board estimates that, in 2016, over R40 billion in pension and provident funds were not claimed. Working with government, the Financial Services Board will consult with the National Economic Development and Labour Council on more efficient measures to find beneficiaries, including by centralising data and funds.
- *Strengthening enforcement measures to deal with criminal and unethical practices:* The Financial Services Board will publish directives in 2018 to improve disclosures by both retirement funds and administrators, and to outlaw unethical practices.