

# **The visible hand: shaping stability and inclusion in the South African financial sector**

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## **1. Introduction**

The South African financial regulatory authorities have the concurrent stated aims of macroeconomic stability (SA Reserve Bank), financial inclusion and development (National Treasury), prudential soundness (the Registrar of Banks and the Financial Services Board), the protection of consumers (Financial Services Board and the National Credit Regulator), access to credit (National Credit Regulator), competition in the sector (Competition Commission) and anti-money laundering and anti-financial terrorism (the Financial Intelligence Centre). Moreover, these authorities fall within the remit of three national departments, the National Treasury, the Department of Trade and Industry and the Department of Economic Development.

Over the past 20 years the financial sector has been characterized both by a plethora of new legislation with these differing mandates, as well as relative stability.

Regarding the former, firms operating in the financial sector—be they in provision of credit, savings, payments or insurance services—have found themselves subject to an increasingly broad array of legislation and regulation. This is perhaps unsurprising as study after study has identified gaps in the regulatory framework.<sup>1</sup>

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<sup>1</sup> Including the following reports: *The Cost Volumes and Allocation of Consumer Credit* (2003); *The Competition in South African Banking* (2004); *The Appropriate Framework for Financial Regulation* (2005); *The Future of*

The process has served to reduce the space for ‘informal’ activity—as even small micro-lenders and funeral parlours are subject to regulation and legislation.<sup>2</sup>

Regarding the latter, the South African financial sector has achieved relative stability at a time when the financial crisis has wreaked havoc in other jurisdictions. The financial stability in South Africa has been partly attributed to exchange controls, but also to a regulatory approach that has encouraged and engendered stability.

While the financial crisis showed that access to inappropriate credit may undermine financial stability, poor people nevertheless have a need for appropriate financial services products that innovatively meet their needs. This chapter explores the need to reassess the emphasis on stability and how best the goals of stability and innovation for inclusion can be simultaneously pursued by the financial regulatory authorities.

Section 2 sets out the theoretical underpinnings of the discussion. Section 3 sets out the general trends discernible in financial regulation over the past 20 years that have created the existing institutional framework. Section 4 suggests guidelines for regulation in a world where innovation and access matters, and Section 5 concludes.

## **2. The ‘visible’ hand behind the invisible hand**

Over 200 years ago, Adam Smith put forward the idea that individuals seeking to benefit themselves through trade were led as if by an invisible hand to a situation in which society as a whole could benefit. The invisible hand metaphor has been used to symbolize the operation of free markets. What should be immediately obvious,

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*Micro-Insurance* (2008); *Treating Customers Fairly* (2009); and *A Safer Financial System for All* (2011).

<sup>2</sup> While the National Credit Act (NCA), for example, does not require micro-lenders with fewer than 100 credit agreements to register with the regulator, it does require them to comply with the provisions of the NCA. Regulation has also caught up with small cooperatives and funeral parlours.

however, is that markets will operate differently, and will have different outcomes, if different laws governing behaviour are in place. Markets can be seen as delicate mechanisms that need to be supported by institutions such as the legal system, and equally can be destroyed by them. Extending the metaphor a bit further, we can envisage a visible hand behind the invisible hand. That visible hand, which encompasses the role of government and its legislation and regulations, provides the environment in which economic activity takes place (see [Mittermaier, 1986](#)).

Pragmatic free marketeers thus argue that the kind of institutions that free markets require in order to operate do not emerge spontaneously through market forces. Such institutions (including legal structures) have to be purposefully created in order to fulfil that function. There must be a visible hand (appropriate legal environment) behind the invisible hand in order for markets to operate fairly and efficiently.

The outcomes in the South African financial sector can be described as a balance between varying regulatory agendas and legislation, as well as between regulation and market forces. The following section sets out some of the discernible trends influencing regulation of the financial sector.

### **3. Regulatory trends over the past 20 years**

Three discernible trends of the visible hand that will concern us here are: the alignment with international standards; conservatism towards new participants; and the rise of consumer protection regulation.

#### **A. ALIGNMENT WITH INTERNATIONAL STANDARDS**

Following democracy, the opening of the economy to financial flows and global influences facilitated and encouraged alignment with international norms and

standards. This is evidenced in South Africa's early adoption of the relevant standards, even where local voices suggested a more cautious and sequenced application in keeping with other developmental priorities.<sup>3</sup>

The early application of the Basel requirements set by the Bank for International Settlements (BIS) is a particular case in point (at one stage South Africa took pride in being one of the first countries to implement Basel II for all its registered banks). South Africa was also ahead of other more developed nations in the application of the International Organization of Securities Commissions (IOSCO) early settlement requirements for both bonds (t + 3) and equities (t + 5). Other standards adopted include those of the International Association of Insurance Supervisors (IAIS) and the Financial Action Task Force against Money Laundering (FATF).

While the adoption of such standards did much to enhance the profile of the sector as a sophisticated and stable one, they have also been seen to undermine some of the other policy goals of inclusion and access.<sup>4</sup>

A case in point is the Financial Intelligence Centre Act (FICA), designed initially as 'know-your-customer legislation'. It was quickly discerned that operation of such legislation in South Africa would be difficult in areas (such as in informal settlements) where no municipal rates were levied or collected. Exemption 17 was provided as a solution. It exempted financial institutions from having to obtain proof

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<sup>3</sup> Interviews with regulators and key financial stakeholders in 2004 showed that there were some dissenters regarding the adherence to the need for this alignment. Views ranged from those who saw adherence to international best practice as a national obsession, to those who suggested that the drive to adhere to international standards deflected energy from other imperatives such as market conduct and improved access to financial services. (See *Appropriate Framework for South African Financial Regulation*, 2005: 50.)

<sup>4</sup> The following quote is attributed to Jacko Maree, head of South Africa's Standard Bank, by *The Banker* (January 2013), 'With Basel III coming in, mortgage lending will become harder', he says. 'It's all very well to talk about matching assets and liabilities if you're operating in a country with deep bond markets. In South Africa, the situation is not so simple'.

of address from low-income individuals (with low-value accounts). When FICA was amended in 2004, Exemption 17 was not amended and, as it stands, accounting officers in financial institutions are not protected from liability relating to financial terrorist activity on such accounts. For this reason, there is still uncertainty as to what constitutes good practice and FICA remains a barrier to access savings accounts, for example, where no proof of residence can be provided.<sup>5</sup>

## B. CONSERVATISM TOWARDS NEW PARTICIPANTS

For most of the period since democracy, a conservative approach to new entrants is discernible. This is apparent in the entry criteria into the sector—such as in banking or participation in the clearing system—but also the regulatory stance towards new entrants and innovations.<sup>6</sup> Regarding the latter, for the most part this has favoured the incumbents—for example, as was borne out by the transcripts of the Banking Enquiry (2008), membership of the of the Payment System Association (PASA) was subject to membership of the Banking Association and registration with the Registrar of Banks,<sup>7</sup> and so on.

Apart from a brief spring following 1994, when the exhilaration of the opening of the economy encouraged new participation in the sector, entrance has been almost exclusively through the acquisition of new shares of incumbents rather than new licences. The banking sector is a case in point, where following the failure of the ‘middle-sized banks’—Saambou and BOE—in 2002, the number of banks declined from 45 to the current 17 registered banks. No new bank licences have been issued

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<sup>5</sup> See ‘Agency Banking in South Africa’, a document prepared for the National Treasury by FinMark Trust.

<sup>6</sup> The view that the regulatory stance is overcautious in allowing for new innovation is regularly recorded for the Banking sector in particular (see [FinMark Trust, 2012, Agency Banking in South Africa](#)).

<sup>7</sup> Since the Banking Enquiry, this has been waived, but given that clearing remains the preserve of the registered banks, this change has failed to engender more entry into the payments space.

since 2002<sup>8</sup>. Moreover, there has been little progress with second-tier banking in spite of the publication of a draft Bill in 2005.<sup>9</sup>

In the case of payments system participation, there has been little change since the Banking Enquiry (2008) identified structural barriers to non-bank entry. South Africa still restricts the issuance of e-money to registered banks, for example, and those who wish to offer mobile transactions services, such as Wizzit or MPESA,<sup>10</sup> must operate through a registered bank.

### C. RISE OF CONSUMER PROTECTION

A third trend in regulation of the financial sector since 1994 has been the increasing emphasis on consumer protection. The impetus for this has come from: (i) policymakers who acknowledged that the historical emphasis on the stability of financial firms had given little regard to how the profitability underlying such stability was achieved; (ii) firms that were faced with a growing imperative to provide services beyond the narrow and privileged customer enclave of the past; and (iii) customers whose desire to break away from the living standards of the past thrust them into contractual arrangements with financial services providers.

Specific consumer protection legislation that has been promulgated in the sector includes the Financial Advisory and Intermediaries Services Act (FAIS) 2002, the Financial Services Ombud Schemes Act 2004 and the National Credit Act (NCA) 2005.<sup>11</sup> Consumer protection was explicitly made part of the remit of the Financial Services Board (FSB) as the Market Conduct Peak of the Twin Peaks framework for

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<sup>8</sup> A new mutual bank licence was granted to Finbond, a micro lender, in 2012. There are now three mutual banks licensed in South Africa

<sup>9</sup> The Dedicated Banks Bill 2005. The Bill has never been promulgated.

<sup>10</sup> The success of MPESA as an innovative transmission mechanism in Kenya, where a less conservative approach to regulation exists, has been well-documented (see e.g. Hawkins, 2011).

<sup>11</sup> The Consumer Protection Act 2008 was also promulgated, but this had a broader focus than financial services

financial regulation,<sup>12</sup> with the adoption of the Treating Customers Fairly (TCF) programme for retail firm supervision (in 2011).

The influence of the visible hand on the market is evident in the case of unsecured credit. Since the advent of the NCA, unsecured credit has become more popular with providers—primarily because the pricing thresholds set by the NCA favour unsecured credit. The flow value of new unsecured credit regularly exceeds the value of new mortgages, and unsecured credit now makes up 11 per cent of the total credit extended to households. The latest data from the NCR show that around 65 per cent of the unsecured credit accounts are current.<sup>13</sup> Given the high levels of distress, it is likely that at least some of this growth represents inappropriate access.

While data on financial inclusion show some progress over the past two decades (access to transaction accounts now exceeds to 60 per cent of the South African adult population, from around 51 per cent in 2004), it is also true that the data suggest that the inclusion levels have plateaued. Moreover, the use of certain financial services remains very low (20 per cent of the adult population save, 25 per cent have short-term insurance and 4 per cent use non-bank remittance facilities).<sup>14</sup>

#### **4. Balancing stability and innovation: the way forward?**

The policies that national departments and regulators adopt need to take into account both the need to balance stability and innovation, as well as the fact that inappropriate access may increase the risk of instability.

Regulators need to recognize that new technologies may enable new firms to spread financial services to a large number of poor households. Regulators can play a role in ensuring that this wider access is appropriately designed and not at odds with

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<sup>12</sup> Announced by the National Treasury in February 2011.

<sup>13</sup> NCR, Consumer Credit Market Report, December 2012.

<sup>14</sup> FinScope, 2012: 6.

the stability mandate of the policymakers.

Regulators also need to play a risk-proportionate role and an enabling role in allowing and monitoring innovations that address other policy mandates. This, together with promotion of responsible provision, will place additional burdens on regulators.

Perhaps most importantly, policymakers and regulators need to be more explicitly aware of the role they play as the visible hand and be more sensitive to how they help shape the outcomes of the market.

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