Policy initiatives to expand financial outreach in South Africa

Paper delivered at World Bank/Brookings Institute Conference 30&31 May 2006

Marié Kirsten

Development Bank of Southern Africa
Johannesburg, South Africa

World Bank, Washington DC

“The apartheid system severely distorted the South African financial system. A handful of large financial institutions, all linked closely to the dominant conglomerates; centralize most of the country's financial assets. But they prove unable to serve most of the black community, especially women. Nor do they contribute significantly to the development of new sectors of the economy. Small informal-sector institutions meet some of the needs of the black community and micro enterprise. They lack the resources, however, to bring about broad-scale development” (RDP, 1994).

Introduction

The South African financial sector presents an ideal case study in financial sector development. Before 1994 the Apartheid Government supported financial sector policies that resulted in gross financial sector inefficiencies. The democratic government came into power in 1994 and inherited a financial sector that developed within the context of inward looking policies, designed to protect and benefit only a few. The financial sector was also highly concentrated and limited competition was allowed. Since then the new government has worked hard to promote the deepening of the financial market and the provision of a wide range of financial services to previously disadvantaged South Africans. I would like to illustrate how government *policies and interventions* are starting to expand access and reduce inefficiencies, and how one *non-government initiative* is bringing innovation to microfinance in South Africa.

The key challenge the new government faced was to reconcile the first world banking sector, characterized by well established infrastructure and technology, but limited participation, with the enormous demand for financial services - with over 60% of the adult population excluded from any formal financial services in 1994. What did the new South African government do? They continued with their famous three-pronged approach to South Africa’s unique dilemmas. This is what President Mbeki said: “Our response to the challenges of poverty and underdevelopment rests on three pillars: encouraging the growth and development of the First Economy, increasing its possibility to create jobs; implementing programmes to address the challenges of the second economy[1]; and building a social security net to meet the objectives of poverty alleviation.” The financial sector was recognized as an important tool to bridge the divide between the first and the second economy.

This paper reflects on the rapidly changing nature of the South African financial landscape, and how both supply and to a lesser extend demand issues determine these changes. On the demand side the changing face of South Africa’s population (with poverty and unemployment increasing) influence the nature and characteristic of demand for financial services by low income and poor households. On the supply side, policy, legal and regulatory changes impact on the provision of services to low income and poor households. Despite, or notwithstanding all government’s efforts, South Africa’s microfinance, or poverty lending industry is best known for the

[1] When President Mbeki introduced the “two economies” terminology in 2004 the second economy was described as the space within which those who are marginalised from the first economy operates.

success of the Small Enterprise Foundation. The paper concludes with a brief overview of SEF.

State of the financial sector

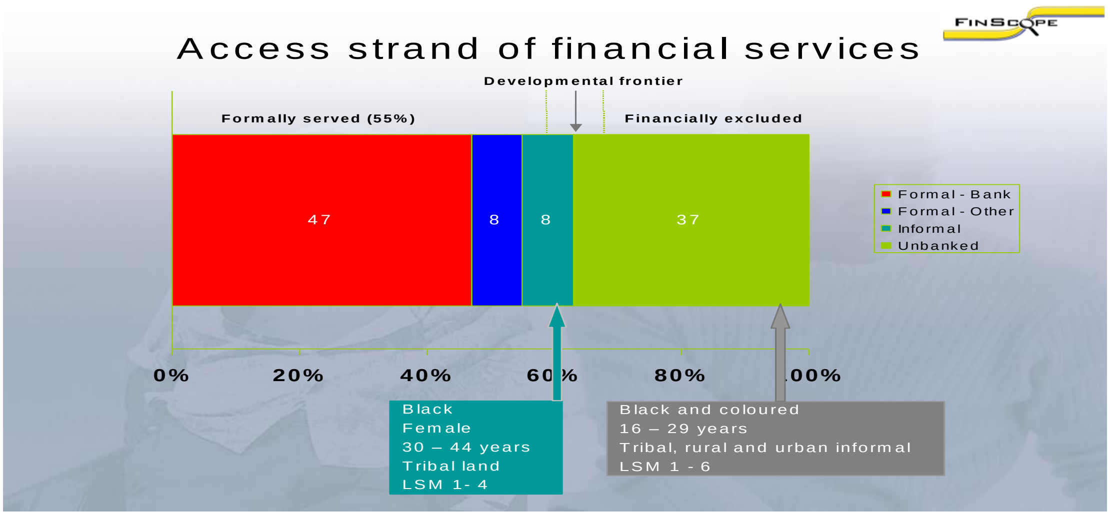
Recent data available from the annual FinScope survey (FinScope, 2005) suggests that 53% (16.4 million) of South Africa's adult population is excluded from formal financial services and does not have a bank account. These 16.4 million people are marginalized or formally excluded from credit. 99% of those without access are black, 49% live in rural areas and 55% are women.

The diagram below shows South African adults with full commercial banking access – about 47%. We do not need to unpack the characteristics of this group. The next box (8%) represents people with access to financial products but not from a bank – they access funeral policies or store credit. The next box indicates another 8% of the South African adult population – this time people with access to informal, non-legalized financial products – burial societies, savings clubs, and loan sharks. The last box, representing 37% are the un-banked adults in 2005. They are:

- Black (99%)
- In the 16 – 29 age group
- Live on tribal land (rural) or in urban informal settlements
- Owns no property or assets

Diagram: Access to Financial Services

POLICY INITIATIVES T EXPAND FINANCIAL OUTREACH IN SOUTH AFRICA



Source: FinScope South Africa. 2005.

Clearly the excluded are the victims of Apartheid; suffering from years of statutory exclusion in terms of the Usury Act, restrictive property ownership and demographic disparities caused by Apartheid spatial planning.

The same FinScope (2005) study indicates that only 13% of South African adults have some form of life insurance, and only 9% have a short-term policy. However 34% claim to have funeral cover of some kind. Also, 33% of South African adults claim they use a savings/transmission account.

Placing these statistics in context – we know that the un-banked in South Africa are the marginalized poor black people, they form part of the 20% of South Africa's population that earn less than US$1 a day, with many being part of the 30.5% officially unemployed (DBSA, 2005). So what are the issues? Since the papers at this conference seem to be slightly undecided about the tension between the ideologies of the "financial systems approach" and the "poverty impact approach", I will try to satisfy both ideologies. The former I do with limited enthusiasm, the latter I do as a matter of principle. Below are some of government policies and legislation that are now starting to expand financial outreach, followed by a story about a pro-poor non-government organization that is actually impacting on poverty.

Government policy and legislation to transform the financial sector

Prior to the first exemption notice issued in 1992, the vast majority of the South African population did not have legal access to formal credit. The Usury Act limited pricing and effectively restricted the product offering in the market. The 1992 Exemption to the Usury Act of 1968 exempted small loans from interest-rate restrictions. As a result, micro lending increased rapidly due to pent-up excess demand, and disbursements reached nearly R15 billion in 1999. This is consistent with a broader trend in the South African banking industry. Between 1994 and 1999, the number of domestic banks increased by 17 percent, and the number of foreign banks increased by 50 percent. This exemption essentially licensed micro-lenders to create a separate, largely unregulated, tier of credit provision to people on the fringes of the banking system.

A brief 16 months after the exemption notice South Africa's first democratic elections took place, and the new government hastily created new parastatals, or development finance institutions, wholesaling financial support – the National Housing Finance Council (NHFC) and Khula Enterprise Finance (Khula). The general perception is that these institutions have not been a great success. Khula at first restricted its dealings to non-profit MFIs, later opened up to other institutions but could never succeed in building their clients capacity and expanding outreach. During 2005 a new government institution, SAMAF (South African Microfinance Apex Fund) was created to replace Khula – see below.

By 1999 government realised that the 1992 exemption created an environment conducive for high interest rates and abusive practices. The Micro Finance Regulatory Council (MFRC) was established under the 1999 Usury Act Exemption Notice, as part of the process of financial sector liberalization. The 1999 Exemption Notice made it a condition of all micro-lender operations (those who extended credit up to a new maximum of R10,000 at rates above the statutory cap) to register with the MFRC. This Section 21 Company supervise the operations of those institutions lending under its unrestricted interest rate window, in order to enable more effective consumer protection and regularization of micro-lender operations in a growing market. In 2002 it became compulsory for all suppliers of microfinance to register with the National Loans Register (NLR). The NLR is a database that records all loans disbursed by lenders registered with the MFRC.

Financial sector charter

The next prominent event was the Financial Sector Charter, launched in 2003. The Charter embodies an agreement among the major players in the financial sector – banks, insurance companies, brokers and exchanges – on a set of service provision and empowerment targets in such areas as banking services to low income populations, black employment and ownership in the financial sector, and support for black entrepreneurship. All financial services companies are expected to pursue these targets, to report periodically on their progress to a monitoring body set up under the Charter, and to be graded on their performance in the form of a public scorecard. On the release of the Charter in 2003 David Porteous said: “If the targets are achieved, this will have a dramatic impact, adding some 8m clients to the existing base of some 13m in the financial sector.” The Charter aims to achieve, by 2008, the following targets: 80% of people in the Living Standard Measure (LSM) 1 - 5[2] should have access to transaction and savings products. The Charter also set ambitious targets for increasing access to retail insurance services, aimed at increasing penetration of short term insurance by over six times from approx 1% to 6% of the population and increasing penetration of life insurance products from 5% to 23% of the adult population. Clearly these targets were very ambitious, with 16.4 million people (or 53.5% of all adults) still lacking access. To achieve the 80% access, another 8 million people will have to move from the un-banked category to the banked category over the next 18 months.

Financial Sector Charter - Access Targets

PERCENTAGE OF LSM 1 – 5 WITH EFFECTIVE ACCESS TO:	2008 ACCESS TARGET	2003 ACTUAL USAGE
Transaction Accounts	80%	32%
Bank Savings Products	80%	28%
Life Insurance Products	23%	5%
Collective Investment Savings Products	1% plus 250 000	Negligible
Short Tern Risk Insurance Products	6%	Negligible

Source: Napier, M. 2005

Mzansi bank accounts

One of the initiatives flowing from the Charter is the innovative Mzansi[3] account, a low cost national bank account, launched in October 2004. All that is required to open an Mzansi account is a valid ID number. Transactions are limited to deposits, withdrawals, transfers (anywhere in the country) and debit card payments. No management fees are charged, and one free cash deposit

[2] The poorest 60% of the population
[3] Mzansi means “south”

per month is allowed. “The profile of the Mzansi account holder is mostly female, with an average account balance of R300 (US$50)”, says Colin Donian, the initiatives director[4]. Mzansi accounts, available at any of South Africa’s “big 4”[5] or the Post Bank, extends banking services to low-income earners and those living beyond the reach of the banking services. The Mzansi bank account has seen a good deal of success with more than 1,5 million new bank accounts opened since its inception. Most of these accounts come in the form of a savings and/or transaction accounts. According to the Banking Association of South Africa, “…91.3% of the Mzansi accountholders are new to the institution at which they have opened their account…, [perhaps an early indicator] that the account is achieving its aim of providing affordable and accessible banking to the previously unbanked population…. The majority of account holders (62%) are between 25 and 54 years, and the largest take-up comes from black communities, which has the largest unbanked population…. Between October 2004 and April 2005 an additional four percentage points of South African population have been banked via the Mzansi Account, placing the country at the same level as Argentina and a step away from Malaysia”.

Other legal and regulatory interventions

Three different pieces of legislation will most directly impact the structure and market response in the South African financial services arena, namely the National Credit Bill, the Dedicated Banks Bill, and the Cooperative Banks Bill. These initiatives will deepen the financial sector. They are discussed individually below.

National Credit Bill

A recent review of credit laws found that interest rate caps contained in the current Usury Act and Credit Agreement Act have not been effective in protecting consumers. Credit allocation has been distorted to the detriment of low-income clients. Misleading disclosure, anti-competitive practices and very high costs of credit subsequently undermined the potential benefit for access to credit. The problems in the microlending industry are also to a large extent a symptom of the failure of the banking sector to meet the needs of low-income earners. South Africa’s Department of Trade and Industry (dti) has in this context introduced the National Credit Act, as a strategy that would allow the credit market to function in a robust and effective manner. The National Credit Act replaces the Usury Act (1968), the Exemption Notices thereof and the Credit Agreements Act (1980).

Consumers have historically been subject to the high cost of credit and exploitative practices by non-reputable credit providers. The legislation focuses on consumer interest as the government seeks to redress imbalances in the South African consumer credit market and aims to create a more efficient market in which all South Africans will be able to have access to credit at affordable rates.

---

[4] www.southafrica.info.public_services

[5] South Africa’s four major retail banks – ABSA, First National Bank, Nedbank and Standard Bank (together owning 83.7% of bank assets), as well as the Post Bank, offers the Mzansi account.

The National Credit Act aims to regulate the granting of consumer credit by all credit providers, including microlenders, banks and retailers. This new legislative framework would create formal bodies referred to as the National Credit Regulator and the National Consumer Tribunal, which will play a vital role in ensuring enforcement, promotion of access to redress and adjudicate contraventions of the Act. The MFRC currently mandated to regulate the micro lending industry pending the establishment of the National Credit Regulator, has 2056 registered entities with a gross loan book of R22.9 billion as at February 2006.

The National Credit Act is envisaged to facilitate the creation of a fair, balanced and transparent credit market. The Act becomes law on June 1, 2006.

Dedicated and Co-operatives Banks Bill

National Treasury has proposed a banking regulatory framework that seeks to create a tiered structure, thus making way for a new class of low-cost banking institutions whose focus will be to provide retail financial services to clients currently not serviced through products provided by the commercial banks. The second tier banks would be commercial enterprises with banking licenses that allow for restricted banking services (dedicated banks) and third tier would be member-based deposit-taking financial services cooperatives and credit unions (co-operative banks). Legislation for the proposed banking institutions were drafted in 2004, and are currently reviewed - both Bills will be presented to Cabinet in August 2006.

Cooperatives Banks Bill

This Bill seeks to formalise the Cooperative banking industry by affording it a legal standing in its operations. Secondly, it seeks to bring the industry into the regulatory framework to afford its depositors the same safety and stability as enjoyed by the formal commercial bank's depositors. Thirdly, the Bill provides for the creation of support organisations for the Cooperative banks in order to ensure a continuous and sustainable capacity programme for the industry. This is necessary to ensure the growth and the stability of the industry.

Co-operative (Village) banks are member-based financial institutions that currently operate under the exemption from the Banks Act. The Co-operatives Banks Bill would place fewer burdens on the capital and entry requirements for the industry.

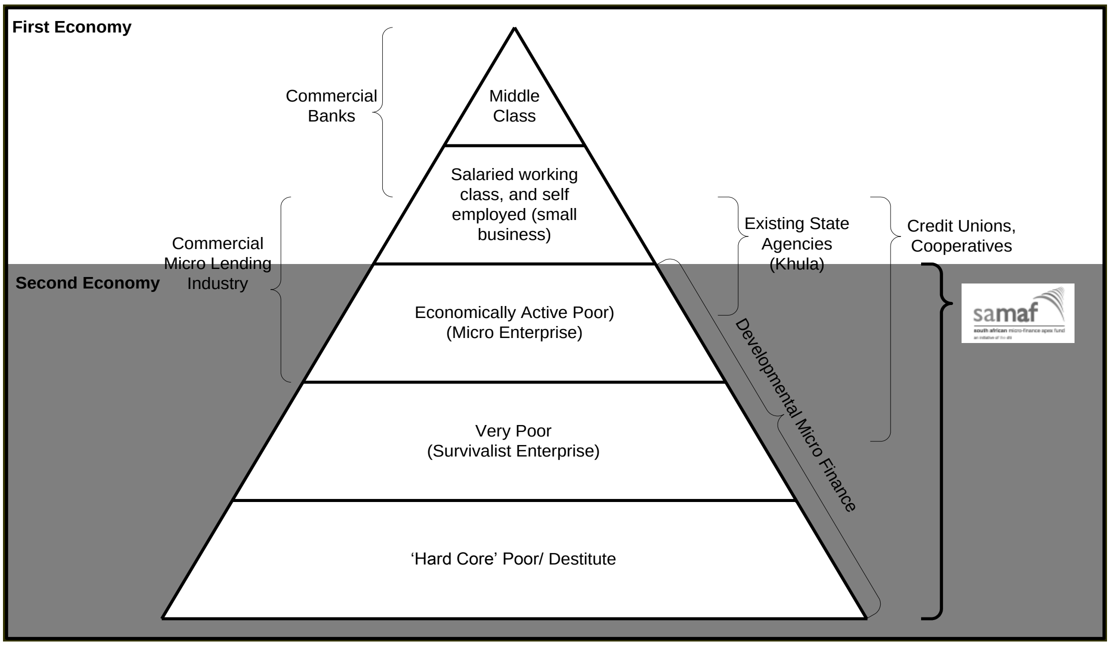
Dedicated Banks Bill

This Bill seeks to create a second tier of commercial banks. These banks will be sub-divided into Savings Banks and Saving & Loans Banks. A Savings Bank will be required to maintain minimum qualifying capital and unimpaired reserve funds of R10 million, whilst the Savings and Loans Bank will be required to maintain R50 million of the same capital and reserve fund.

These banks will be allowed to take deposits from the public. They will also be allowed to provide secured loans and limited unsecured loans. Their investments will be restricted to liquid assets (Government Bonds; Treasury Bills). Should they wish to take on riskier investments (and on unsecured loans), they will be required to maintain a prescribed first-tier, unencumbered capital against such risk-weighted exposures.

Further government support for microfinance

Apart from extensive legislation and some facilitation, the South African government has not provided financial services directly to those excluded from the financial system. The only government support flowing to those on the margins of the financial sector was indirectly, through government's parastatal organizations and its support to the Post Bank. The parastatal organizations were created to solve small business and housing market



failures, rather than to provide direct microfinance support. The Department of Trade and Industry (the dti) presented the new microfinance apex institution, South African Microfinance Apex Fund (SAMAF) to Parliament on 17 May 2006. SAMAF aims to provide seed capital, wholesale finance and institutional development support to micro-credit programmes (read NGOs) that focus on the poor, financial service cooperatives, credit cooperatives and burial societies. The initial concept paper of SAMAF outlined the Apex institution's mandate as: *The pilot fund would contribute to poverty alleviation by ensuring that the poor have access to affordable credit, and empowering and motivating them to use it effectively. The pilot fund will strengthen and incentivise intermediaries (MFIs) to increase their outreach to the poor.* The final version seemed to have moved away from this to include more small business finance.

SAMAF will operate in the grey area illustrated above – the so-called second economy. SAMAF will provide loan access and capacity building to institutions operating in the poverty alleviation market segment (70% of its book), it will mobilise grants towards micro-enterprise activities (30% of its book). The SAMAF model, together with the Department of Agriculture's new initiative called MAFISA (Micro-Agricultural Finance Schemes of South Africa)[6] are new initiatives by national government to reach down towards the low-end credit market. Both schemes are severely criticized at the moment and appear to be again reflecting governments' impatient reaction to queries about lack of access at the poverty level.

This is why I feel it necessary to tell you a true story of success and sustainability, a story that happened not as a result of government intervention, but despite it. My story is about the Small Enterprise Foundation.

The Small Enterprise Foundation (SEF)

As mentioned earlier, 20% of the South African population lives below the poverty line of $1 a day. The deepest poverty is experienced in the Eastern Cape and the Limpopo Provinces. The Limpopo province is the setting of this story, where 60% of households live below the poverty line while 40% live below half this poverty line.

SEF was created in 1992 to provide tiny loans to the very poor, unemployed people of rural Limpopo. The goal of SEF is to work towards the elimination of poverty and unemployment in a sustainable manner by providing credit for self-employment, combined with savings mobilisation and a methodology that substantially increases the poor's chances of successful self-employment. The organisation follows a solidarity group lending methodology very similar to that pioneered by the Grameen Bank of Bangladesh. SEF has gained considerable international recognition for its poverty-targeting methodology and its success in reaching and ensuring positive impact on the very poor. The organisation's poverty targeting tool, Participatory Wealth Ranking, was one of the first such tools officially recognised and promoted by the Microcredit Summit Campaign.

SEF strives to attain its goals through two operational streams, the Micro Credit Programme (MCP) and Tšhomišano Credit Programme[7] (TCP). Whilst MCP, SEF's original programme, only works with those with existing enterprises, TCP uses Participatory Wealth Ranking to identify the poorest in target communities. Although similar in philosophy and basic structure, the motivational techniques, loan utilization checks, on-going follow-up and other aspects of this program have been adjusted to address the needs of the poorer population.

SEF commenced operations in January 1992. At the end of March 2006, the programme served 32,695 self-employed clients with a principal outstanding of R30 million[8]. Since inception, SEF has disbursed 264,972 loans for self-employment, to the value of R309 million. SEF also encourages the poor to

[6] MAFISA will work with financial institutions to implement the provisions in the financial services charter relevant to the development of small-and medium-farming enterprises. There is R1 billion immediately available to start the scheme. The 10 million potential beneficiaries include farm and non-farm entrepreneurs such as farm workers, tenants, household producers, landless, small landholders, food garden producers and rural micro-entrepreneurs.

[7] Tšhomišano is a Northern Sotho word meaning "Working Together".

[8] The Rand / US Dollar exchange rate is currently (May 2006) R6.50: US$1

save with the Post Office and the total of SEF client savings as held in their Post Office savings accounts currently stands at R3.7 million.

SEF has achieved remarkable performance in terms of loan losses. From inception to date, total bad debt write-offs have amounted to less than 0.54% of the cumulative amount disbursed. At the end of March 2006, the portfolio at risk over 30 days stood at 0.6%.

As described above, due to the inequality of its inherited economy, South Africa is recognised as a particularly tough environment for microfinance organisations to attain financial sustainability. This is even more the case where the objective is to reach the very poor. While the attainment of sustainability has always been a core value for SEF, the organisation first focused on ensuring that it was reaching the very poor and that it was achieving positive impact. With these fundamentals well entrenched, in September 2002 the organisation moved its focus to the attainment of financial self-sufficiency. Full financial sustainability was attained by September 2004. SEF has benefited from Khula loans, but has received very little government support. Mostly financed by donors, and more recently increasingly by private sector, SEF has now attained self-sufficiency and will carefully considering entering into government loan agreements.

Currently 99% of SEF's clients are female. Typical enterprises include hawkers of fruits and vegetables and new or used clothing, small convenience shops, and dressmakers. On average, each business employs 1.4 individuals, including the owner, on a full-time or part-time basis.
SEF utilises a participatory impact monitoring system that provides testimony to the success of microfinance for the very poor. Even from the first loan people's lives change radically. Very poor families are able to afford three meals a day rather than one. Other families pay school fees and buy uniforms to send their children to school - even to college or university. After a few loans many families electrify their houses or expand their business to hire employees. In addition, increase in income, sense of independence and self-reliance results in significant empowerment for SEF clients, especially its women clients.

With all the fundamentals in place SEF decided it is time for further innovation. SEF is currently hosting a HIV/AIDS and gender violence research programme – the IMAGE[9] Project. This four-year research, which started in 2001 in eight villages (2500 borrowers) in Limpopo, is now showing amazing results, amongst others:

- A substantial improvement of the financial performance at the centres where the IMAGE programme has been operating.
- A significant decline in gender based violence amongst the recipients of gender and HIV training.

SEF is also now pioneering life insurance products for its almost 35 000 clients. This product, to be launched in June, will make it possible for the very

[9] Intervention with Microfinance for AIDS and Gender Equity

poor to buy life insurance for themselves and their families. Premiums will start as low as R25 (US$4) a month.

Conclusion

The South African government has tended to facilitate and regulate, rather than provide financial services directly. Direct provision of financial services by the government relates only to the provision of wholesale finance in housing, agriculture and enterprise finance through Development Finance Institutions, such as NHFC, MAFISA and Khula.

There has much activity over the past four years as far as financial sector legislation is concerned, and the government has been content to accept and support the private sector's commitment under the Financial Sector Charter to deliver broad-based access by 2008. The next few years will be crucial in determining whether recent legislative developments (most of which will be implemented in the next 12 months) bear fruit in terms of extending access to financial services. The targets set in the Charter is far from achieved and new innovative approaches will have to be agreed upon soon.

At the same time the Small Enterprise Foundation is growing steadily, going from strength to strength. SEF spent 10 years refining its methodology. By 2002, ten years after the first loan was made, SEF had only 14 000 clients. But once it has found the blueprint for South African pro-poor finance, SEF engaged in an expansion strategy, and by end June 2006 SEF will have 35 000 clients. At this rate SEF will reach 90 000 poor women before 2010. Maybe many Small Enterprise Foundation branches countrywide, serving the unbanked, is South Africa's only sustainable solution.

Sources:

DBSA. 2005. Overcoming underdevelopment in South Africa's Second Economy. Report published by the DBSA. 2005 www.dbsa.org.

ECI Africa and IRIS. 2005. The Evolution of the South African microfinance sector from 1002 to 2004: The role of the Microfinance Regulatory Council. March 2005. www.mfrc.co.za

FinScope. South Africa. 2005. Survey Highlights including FSM Model. FinMark Trust. www.finmark.org.za

Mbeki, Thabo. 2004. Address to parliament. 21 May 2004. Cape Town.

Napier, M. 2005. Country Case Study Provision of Financial Services in South Africa. www.finmark.org.za

Porteous, David. 2003. Is Cinderella finally coming to the Ball? SA micro finance in broad perspective. www.finmark.org.za

Press Release 17 October 2003. Finmark Trust Welcomes The Release Of The Financial Sector Charter. www.finmark.org.za

Reconstruction and Development Programme, Government of South Africa. 1994.

SAMAF. 2005. Trade and Industry Portfolio Committee. 17 may 2006. Progress Report: APEX Fund.

SEF. Organizational Profile. March 2005. www.sef.co.za

www.southafrica.info.public_services