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South Africa's Financial Sector Ten Years On: The Performance of the Financial Sector Since Democracy

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democracy

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**F** **E** **A** **S** i b i l i t y  
**F**inancial **E**conomic **A**nalysis **S**trategy

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# Abbreviations and Acronyms

FSB	Financial Services Board
GDP	Gross Domestic Product
HHI	Herfindal – Hirschman Index
MFRC	Micro Finance Regulatory Council
NPS	National Payments System
SARB	South African Reserve Bank
SME	Small and Medium Enterprises

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# 1. Executive summary

1. Analysis of the contribution of the financial sector to the growth of the economy is not straightforward, and is complicated by the fact that the banking, insurance and securities industries possess different characteristics. The performance of the sector is evaluated firstly in terms of the balance between stability and innovation and secondly in terms of the balance between efficiency and allocation of resources.
2. In macroeconomic terms the contribution of the financial sector to the economy has grown consistently between 1993 and 2002 when measured in terms of value-added contribution and growth in assets.
3. The advent of democracy in South Africa heralded the opening of the financial account of the balance of payments to global influences to a greater extent than before. Together with deregulation, this has brought new foreign and local entrants to the sector.
4. The new entrants have stimulated contestability in certain market segments and eroded market share of the top incumbent firms. Standards have been raised among both the incumbent firms and the regulators, and the liquidity of the financial markets has improved.
5. After the initial euphoria surrounding new opportunities, associated with democratisation, liberalisation and deregulation, a period of consolidation followed. In the banking sector, this is evidenced by a decline in the number of registered banks and in the securities markets by a fall in the number of listed companies.
6. In the banking industry, the period of consolidation increased levels of concentration. The levels of concentration (in terms of market share of assets) in both the banking and insurance industries remain high. While the number of firms involved in an industry is not in itself of concern if the market is contested, it may be of concern if the contestability of the market is stifled.
7. While regulation can do much to enhance stability in fragile financial systems, a balance needs to be found between ensuring stability and allowing new development. Regulation

can stifle competition if it creates barriers to entry. Market participants in the banking industry suggest that the cost of regulatory compliance is high and may have been a factor in the surrender of the licences of smaller banks in 2002.

8. Macroeconomic growth performance in terms of indicators such as loans and advances, insurance premiums and market capitalisation suggest that the sector has facilitated, rather than inhibited, growth over the past decade. However, these macroeconomic data may mask bottlenecks in certain market segments.
9. While there have been bank failures over the decade under review (less than one a year), these have mostly remained isolated and do not appear to have affected public or external perceptions of the soundness of the banking system.
10. The most recent crisis surrounding Saambou which precipitated a withdrawal of funds from small to large banks and undermined the credibility of the growing micro credit industry and public perceptions of small banks.
11. The cost-to-income ratios of South African banks have recently increased due to costs associated with mergers and changes in regulatory and compliance practices. The failure of banks to adopt norms in the disclosure of prices makes it difficult for consumers to shop around.
12. The notion that banks ration credit to small businesses appears to be confirmed. In many cases, however, this may have been due to obstacles to assessing creditworthiness. An attempt to address these obstacles - which include blacklisting and inadequate preparation of financial statements - would do much to enable greater provision at this end of the market.
13. Improved entry to the market on a selective basis since 1994 has meant that while the high-net worth and corporate market segments have been hotly contested, the same is not true in the retail markets. This, together with only one form of banking licence, and domination of the payments system by the largest incumbents has discouraged competition in the markets. These issues need to be addressed.



14. The current levels of under-provision of financial services to the majority of South Africans is unsustainable and appears to be receiving belated attention through processes like the commitment to the financial services charter. The changes in licensing requirements for smaller banks, which may bring with it renewed contestability in certain market segments, is a significant step to improving provision.
15. The financial sector has gone through a period of rapid change over the last ten years. There is little to suggest that the pace will decrease. Given the pressures to adopt international standards and the pressures for increased market access, the industry and regulatory authorities need to apply greater resources to understanding the impact of these changes on the local economy.

## 2. Economic overview of the sector

As is the case with other service sectors such as transport and telecommunications, the importance of a well-functioning and well-developed financial sector is apparent often only when the sector is disrupted or fails. This begs the question of how to evaluate the performance or functionality of the financial sector when it is not in crisis<sup>1</sup>. One way would be in terms of efficiency – which could be measured by intermediation costs between saver and investor. However, such a narrow evaluation of the performance of the financial sector inadequately describes its importance<sup>2</sup>. While financial systems perform as intermediaries between saving and investment, where efficiencies are important, they also enable saving through finance and allocate saving through funding. In this broader view of the *functionality or performance* of the financial system, the financial sector can be evaluated both in terms of its stability at the macroeconomic level and in terms of the allocation of real resources at the microeconomic level (Stuart, 1995:65).

In the macro sense, the functionality of the financial system is associated with its ability to keep an inherently fragile fractional reserve system reasonably stable. A stable system helps minimise the likelihood of a run on the banks and the associated disruptions to the financial system. Costs of banking crises expressed as a % of GDP can easily be more than 10% (Borio 2003). Since the failure of the fragile system is associated with both economic demise and the undermining of confidence in the monetary system, much regulatory effort has gone into ensuring macro economic stability. However, while stability is important, a financial system also needs to allow for innovation and change. A financial system with only four large banks may be considered stable, but may be socially costly in terms of their ability to capture profits, and the complacency of such a structure may prohibit new developments. Hence the successful macroeconomic performance of a financial system implies striking a balance between stabilising a fragile system and allowing for new development.

In the microeconomic sense, the functionality of the system is associated with the allocation of real resources, with a view to facilitating economic activity. Two banking systems may have the same intermediation costs, but if the one is able to provide loans to more successful projects than the other, this makes it more functional. It is the ability of banks to influence the rate of investment through financial provision that gives them a key role in the economy (Keynes,

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<sup>1</sup> The debate is highlighted by Rajan and Zingales (2000), for example

<sup>2</sup> From a social perspective, the term 'efficiency' can have perjurious implications: the gas chambers in the Second World War could be regarded as efficient.

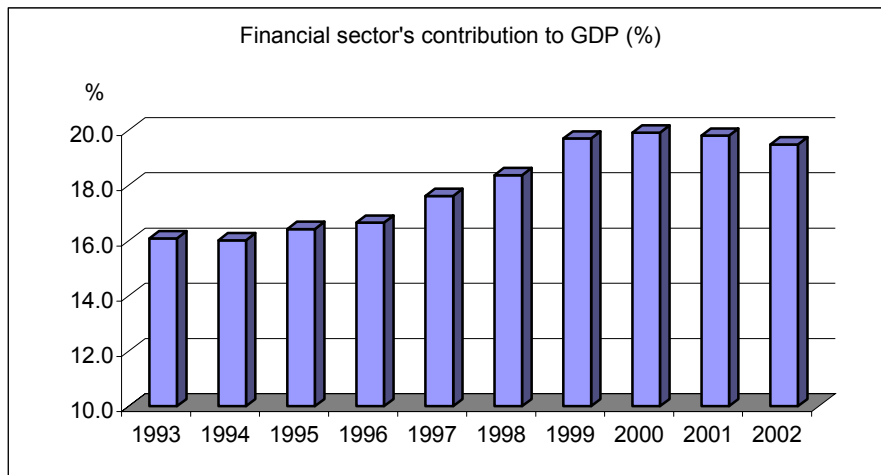
1971:327). The concept of influence on economic activity can also be extended to financial provision for households. In this sense, the successful microeconomic performance of the financial system involves striking a balance between the cost of financial services and the ability to allocate these resources in a socially desirable way.

The analysis that follows turns on the notion of functionality in terms of macro economic stability and influence on micro economic activity. Since these concepts are more complex than say, the intermediation price between saver and investor, a number of indicators will be used to form a picture of the functionality of the sector.

In section 3 the competitive and regulatory environment in the banking, insurance and securities industries, is examined. This will provide insight into changes in the competitive structure and regulatory approach over the decade. In section 4 the macroeconomic performance of the sector will be evaluated. In section 5, the influence of the financial sector on economic activity and its provision of services to all South Africans will be evaluated. Section 6 will provide a summary evaluation of performance. Section 7 will highlight existing and future factors affecting performance. Section 8 concludes.

## 2.1 Contribution of the sector

Figure 2.1 Contribution of the financial sector\* to GDP



\*Financial intermediation, insurance, real estate and business services

Source: SARB Quarterly Bulletin; Registrar of Banks Annual Reports

The contribution of the financial sector to South African Gross Domestic Product (GDP) has grown steadily over the past decade. The data in figure 2.1 show that the financial sector contributes around 20% to economic activity measured in terms of GDP. The contribution of the sector appears to have leveled off within the 19-20% range over recent years. The data in

figure 2.1 are for the entire financial sector, including real estate and business services. The banking industry contributes an estimated 35 per cent<sup>3</sup> of the value added of the financial sector and the insurance industry around 16 per cent<sup>4</sup>.

The significance of the financial sector can also be examined in terms of the size of the sector's assets. In Table 2.1, it can be seen that the size of the **banking industry's** assets has increased steadily (as a percentage of GDP). By 2001, the value of banks' assets exceeded GDP for the first time. It could be argued that the size of these assets relative to GDP underlines the importance and potential influence of the banking sector to the South African economy. Of course, this is merely a rule of thumb, but it is commonly used in analysis of this sort.

Banks' assets are predominately loans and advances to the private non-bank and government sectors. While the ratio of loans and advances to assets has been on a declining trend over the past decade (from 79% of assets in 1993 to 72% in 2002), the increase in the sector's growth has meant that loans and advances have grown from around 55% to 73% of GDP. In Brazil, where loans are a scant 25% of GDP, banks are seen as inhibiting economic growth (Economist, 2003).

Table 2.1 Assets and loans as a percentage of GDP

Banking industry				
	Value of Assets R billions	Assets as a % of GDP	Value of loans and advances R billions	Loans and advances as a % of GDP
1993	R 294.6	69.1%	R 233.3	54.8%
1994	R 344.2	71.4%	R 270.8	56.2%
1995	R 399.1	72.8%	R 315.3	57.5%
1996	R 472.1	76.4%	R 373.0	60.4%
1997	R 550.5	80.3%	R 440.4	64.2%
1998	R 654.8	88.6%	R 510.7	69.1%
1999	R 728.0	90.9%	R 554.7	69.3%
2000	R 819.0	92.2%	R 612.6	69.0%
2001	R 1,049.9	106.8%	R 732.8	74.6%
2002	R 1,100.7	100.2%	R 800.2	72.8%

Source: SARB Banking Supervision Reports, Various

Since the **insurance industry** cannot create assets by offering loans and advances in the same way that banks can, it seems to be more appropriate to compare the ratio of assets less liabilities to GDP for the insurance industry. The liabilities of the long term insurance sector have outgrown assets in recent years, so that the industry's assets less liabilities now make up

<sup>3</sup> As calculated using the gross values of net interest income and non interest income (see Wallis, 1997)

<sup>4</sup> Based on the FSB's estimates of the insurance industry's contribution to GDP

just over 8 per cent of GDP, relative to 14.9 per cent in 1999. The cumulative assets of the short-term insurers are small relative to those of the long-term Insurers.

Table 2.2 Assets and liabilities of the insurance sector as percentage of GDP

	Long term insurance			Short term insurance		
	Value of Assets Rand billions	Assets less liabilities Rand billions	Assets - Liabilities as a % of GDP	Value of Assets Rand billions	Assets less liabilities Rand billions	Assets - Liabilities as a % of GDP
1994	R 317.30	R 57.70	12.0%	R 22.40	R 14.10	2.9%
1995	R 369.70	R 64.70	11.8%	R 26.70	R 17.10	3.1%
1996	R 443.20	R 88.40	14.3%	R 31.90	R 20.50	3.3%
1997	R 498.0	R 95.8	14.0%			0.0%
1998	R 515.8	R 83.1	11.2%	R 35.62	R 20.38	2.8%
1999	R 645.1	R 119.4	14.9%	R 39.12	R 19.34	2.4%
2000	R 709.4	R 108.1	12.2%	R 37.73	R 19.79	2.2%
2001	R 744.4	R 80.4	8.2%	R 34.54	R 16.20	1.6%

Source: FSB Annual reports various

A proxy to assess the relative importance of the securities market is the market capitalisation of the securities exchange. Market capitalisation refers to the sum of the values of the shares of all listed companies, expressed here as a ratio to GDP. The market capitalisation peaked in 1999, at over twice the value of the economy's GDP. By this measure, the JSE Securities Exchange SA is massive and far bigger than for some higher income countries like Australia and Spain. At a market capitalisation of R1.5 trillion, the JSE Securities exchange SA is the world's fourteenth biggest exchange (Business Day, 2003a).

Table 2.3 Market capitalisation and GDP

Year	Market capitalisation (Rbn)	GDP (Rbn)	Market cap/GDP
1993	801	426.1	188.0%
1994	921	482.1	191.0%
1995	1023.4	548.1	186.7%
1996	1130	617.9	182.9%
1997	1129.4	685.7	164.7%
1998	1001.6	738.9	135.6%
1999	1616.2	800.6	201.9%
2000	1551.5	888.1	174.7%
2001	1770.7	982.9	180.2%
2002	1584.2	1098.7	144.2%

Source: SARB Quarterly Bulletins and JSE Securities Exchange SA

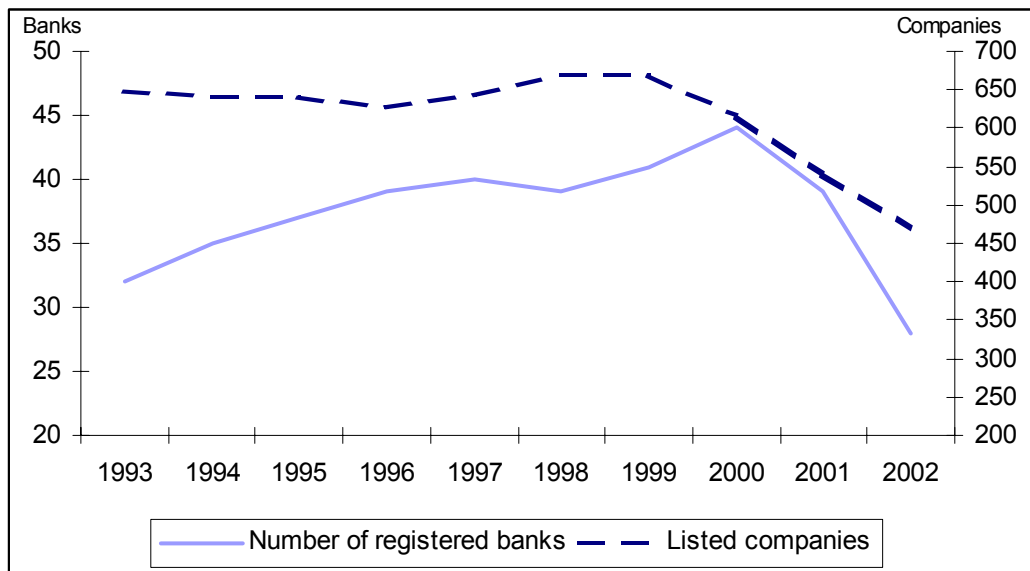
The financial sector has made a steady contribution to the economy over the decade. The importance of the sector as measured by value added, size of loans and assets and market capitalisation, has grown.

## 2.2 Market dynamics

The South African financial sector has undergone substantial structural change over the past ten years. Evidence for this can be seen in the change in the number and range of players, the change in product offerings and the change in institutional and regulatory arrangements. These changes have different causal forces, not least of which are democratisation and the associated liberalisation of the South African economy since 1994.

Democratisation has brought into relief the lack of financial provision to the majority of South Africans. This has stimulated new forays by the financial players into new areas. Not all of the forays have been successful, and the demand for a financial sector that functions for all South Africans has not yet been satisfied, as is evident in the current negotiations around the Financial Charter.

Figure 2.2 Number of registered banks and listed companies



Source: Banking Supervision Annual reports, African stock markets handbook, 2003

The opening of the South African market to financial flows and liberalisation of its economy since 1994 followed on the advent of democracy, heightened international awareness of the country as an investment destination and changes in regulation. The impact of the period of liberalisation followed by a period of consolidation on the banking and securities industries is revealed in part by an examination of the number of fully registered local banks (excluding

mutual banks and local branches of foreign banks) and number of listed companies in Figure 2.2.

The number of banks increased more or less continuously until 2000. In 2001 it fell slightly and in 2002 dropped sharply (a 28 per cent drop from the previous year – and some 36 per cent from the high in 2000). The decline in numbers since 2000 is a consequence of the demise of a number of the A2 banks<sup>5</sup>. Some A2 banks were acquired by larger banks as part of the consolidation going on in the industry, including Imperial bank, Mercantile Lisbon and McCarthy bank. Others dissolved for reasons of poor financial management such as Regal Treasury bank and Saambou. Others, such as African Merchant Bank, Brait Merchant Bank, Cadiz Investment Bank and Corpcapital bank, did not apply for renewal of their licences in 2002. The banks in the latter group surrendered their licences, as the benefits of retaining a bank licence no longer appeared to outweigh the costs associated with it.

Between 1994 and 1997, there was little change in the number of listed companies on the JSE Securities Exchange SA, which stood at around 640. In 1998, the number increased sharply to 668, where it remained in 1999, the year in which the market peaked. The progressive fall-off in the number of companies thereafter to 472 was associated with a global bear market and investors moving to assets more stable than equities. Listed companies whose shares trade below their intrinsic value have little incentive to stay listed, unless they have future capital requirements, and since 1999, there has been a 29 per cent drop in company listings.

The impact of expansion and then consolidation on the competitive structure and regulatory environment in all three financial industries is further examined in section 3.

### 3. The competitive and regulatory environment

The decade since democracy has been one of structural and regulatory change. During this period, there has been increasing competition from niche players and foreign entrants, as technology and financial liberalisation created the stimulus for competition from new areas. In addition, the sector has been subject to changes regarding new regulation, compliance and

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<sup>5</sup> The term A2 banks is a term applied by the ratings agencies to the smaller SA banks (essentially all local banks except the Big Four and Investec)

transparency. The process of democratization has also required the banks, insurance firms and securities markets to examine the extension of services to the great number of South Africans excluded from formal financial provision. Some of the more apparent trends and outcomes of the decade include:

1. Since 1994, the number of banks and firms offering insurance and the number of listed companies on the stock exchange first increased and then decreased. Economic conditions and industry related shocks have pared down the number of players in the industry in recent years.
2. The luring of wealthy individuals and clients away from the major banking players to new niche and foreign operators has eroded profit margins. This competition has eliminated cross-subsidisation both within and between branches and between cohorts of clientele. Transaction costs and fees have risen.
3. The need to reduce cost ratios has resulted in attempts to improve economies of scale. This in turn has led to mergers and out-sourcing of back office operations. While the finance ministry rejected the merger of Nedcor and Stanbic<sup>6</sup> in 2000, the merger between Nedcor and BOE<sup>7</sup> went ahead in 2002. This reduced the major players in an already concentrated industry from 6 to 5.
4. The top four banks (ABSA, FNB, Stanbic and Nedcor) have addressed the delivery of services to the mass market, either through existing branding, such as the 'Eplan' range of products employed by Stanbic, or through a new distribution brand, such as People's bank of Nedcor. They have achieved mixed success.
5. Smaller banks have come under increasing pressure. The recent shocks to this sector of the industry include:
  - the demise of Regal Treasury bank;
  - the acknowledgement of poor management and inadequate loan-loss provision by ABSA's Unifer;
  - the run on Saambou bank, its subsequent curatorship and sale, and the downgrading of six other smaller banks at the same time;
  - the voluntary withdrawal and de-registration of a number of smaller banks

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<sup>6</sup> At the time Nedcor and Standard bank were respectively the fourth and second largest banks

<sup>7</sup> At the time, BoE was the sixth largest bank in terms of assets



have all contributed to poor sentiment, and boosts the trend to even further concentration in the industry. This is taken up again in section 3.1.

6. There has been an increasing trend towards conglomeration within the sector as banks and insurance interest have merged. This has reinforced a trend where interest income is reduced as a proportion of bank earnings. Transaction fees, brokerage and consultation fees, now make up around half of the income of the banking industry.
7. The fall-out in the insurance industry stemming from the attacks of 11<sup>th</sup> September 2001 has stimulated consolidation in the short term and re-insurance market segments.
8. The JSE Securities Exchange has become increasingly integrated with global exchanges, with dual listings of major companies on the London and New York Stock Exchanges and the adoption of the same trading system as the London Stock Exchange.
9. The Alternate Exchange (Alt-X) for smaller businesses has been launched, and the ball set in motion for the creation of an African stockmarket using the JSE Securities Exchange SA.

Regulation has changed frequently, often in response to some of the above trends. In addition, the competitive environment has been fluid. The following sections explore these aspects more fully.

### **3.1 The competitive environment**

The competitive environment will be discussed in terms of the changes in market structure, the market share of the major players, and their associated concentration indices. The focus will be on the banking and insurance industries because of the paucity of comparative data on the securities brokers.

#### **3.1.1 Market structure**

Over the decade and until the last two years, a growing number of players has entered the **banking industry**. However, it remains a concentrated industry, with a few players dominating, particularly in the provision of services in the retail market. The top four banks still

account for around 70% of the industry's assets, although this understates their dominance in terms of certain market segments.

Table 3.1 Market share of assets: banking industry

<b>Banking Sector: Market share of major players</b>				
Expressed as a % of Total Assets	1994	1998	2001	% Change 1994-2001
	ABSA	29	23	19.3
Stanbic	21	19.5	17.6	-16.2%
FNB	19	14.4	18.7	-1.6%
Nedcor	15	15.7	13.8	-8.0%
Other (including BOE)	12	18.1	16.9	40.8%
Investec	3	5.1	6	100.0%
Foreign	1	4.2	7.7	670.0%
<i>TOP 4</i>	<i>84</i>	<i>72.6</i>	<i>69.4</i>	<i>-17.4%</i>
<i>TOP 5 (Four plus Investec)</i>	<i>87</i>	<i>77.7</i>	<i>75.4</i>	<i>-13.3%</i>
<i>Share of Others and Foreign</i>	<i>13</i>	<i>22.3</i>	<i>24.6</i>	<i>89.2%</i>
<i>TOTAL share</i>	<i>100</i>	<i>100</i>	<i>100</i>	

Source: DI 900 surveys; Banking Council Annual report, 1999

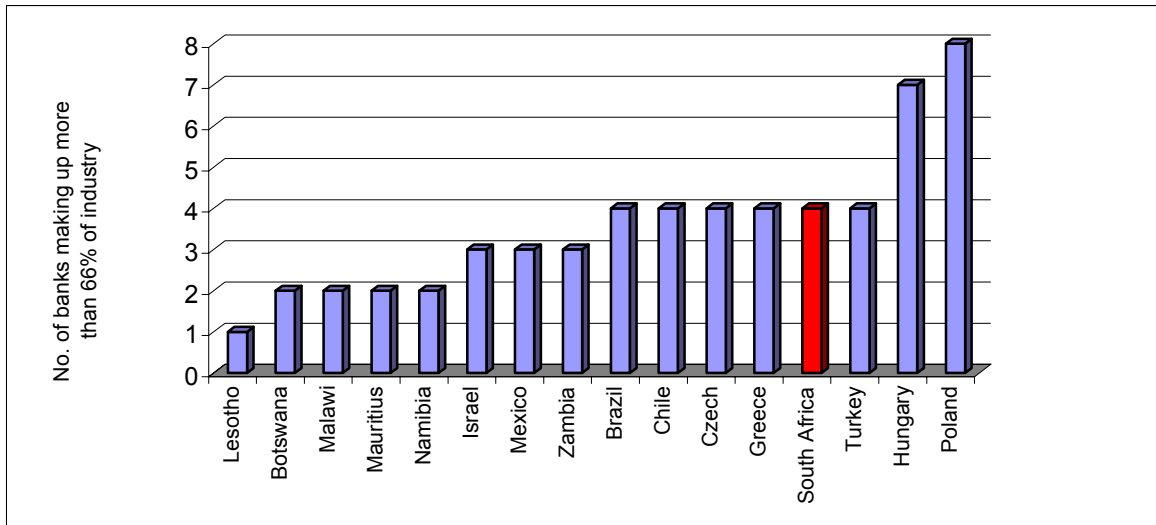
The change in market share is shown in Table 3.1. In 1994, the four major banks plus Investec made up 87 per cent of the market, but by 2001 this had slipped to just over 75 per cent. The loss of market share by the top four players and the related increase in share won by smaller niche and foreign banks since 1994 has meant that together, foreign and other banks now make up close to 25% of the share of banking assets in South Africa. This shift towards the niche players has occurred mainly in the corporate and high-net worth individual market segments, with none of the foreign or niche banks targeting the mass retail market clientele. Until recently, foreign banks were restricted to the upper income end of the scale as they were prohibited from opening accounts with natural persons with deposits less than R1 million.

Based on SARB's DI 900 returns, the share of the top four banks loans in the *corporate* market segment amounts to 68.5%, with Investec and other banks making up the rest. In the *retail* market, the four major banks have retained their market share. At the end of 2002, for example, it was estimated that the top four now account for 85% of installment sales credit within the banking industry, and over 92% of mortgages. In June 2003, 83% of total deposits by the public was in the vaults of the big four banks (Mboweni 2003).

In Figure 3.1, the number of banks that make up two-thirds of the industry for a number of emerging markets are shown. The comparison shows that high levels of concentration are not

unique to South Africa, and that the domination of the South African industry by only four banks is in keeping with other middle-income emerging markets.

Figure 3.1 Banking sector concentration



Source: NEDCOR Annual report 2003; Country survey data in SATRN report, FEASibility, 2003b

Data regarding the market share in the **insurance industry** vary for the long and short term industries. In the long term insurance industry, there are four companies with 10 per cent of the market share of assets. At the end of 2001, the latest year for which there is data, Old Mutual, Sanlam, Momentum and Liberty Group made up 35, 22, 11 and 10 per cent of the long-term industry assets respectively. The fifth largest firm with a 4.3 per cent share is Investment Solutions (FSB, 2002). While the share of the dominant three players has declined by some 9% since 1995, the shares of the top five has remained relatively stable. By contrast in the short-term market, there were two large players at the end of 2001 – Mutual and Federal and Santam, together making up 32 per cent of the market share of assets. The other big firms are Hollard and Guardian National, as well as SASRIA.

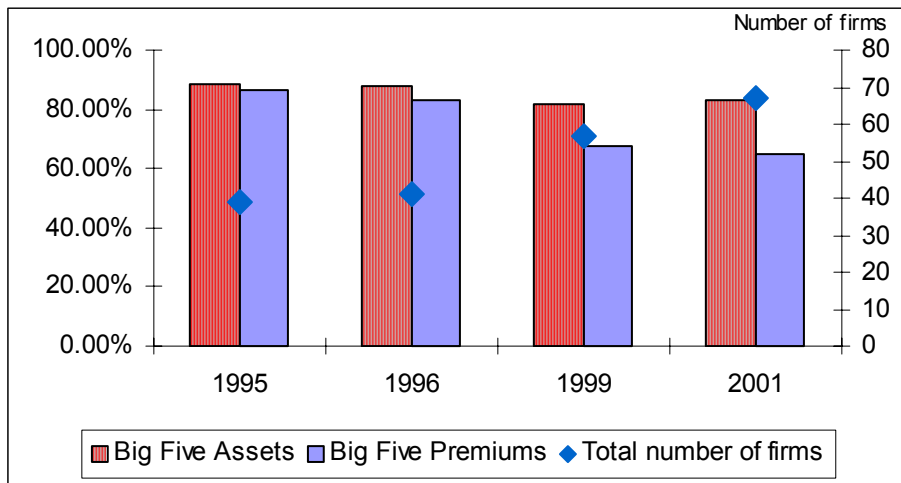
Table 3.2 Market share in the insurance industry: selected years

Market share of Assets				
	1995	1996	1999	2001
<b>Long term (life) Insurance</b>				
Big three	77.6%	76.3%	71.4%	68.3%
Big five	88.2%	87.5%	82.1%	83.3%
<b>Short Term Insurance</b>				
Big three	66.3%	66.7%	46.8%	37.8%
Big five	75.1%	74.0%	54.6%	47.1%

Source: FSB Annual reports: Various

The market share of assets of the top five firms in the long term insurance industry suggests a relatively stable one over the decade. However, this is not true of the short-term industry where the top five firms have lost close to 30 per cent of their market share of assets since 1995. Figure 3.2 plots the market share of premiums of the top five firms in the long term insurance industry, together with the market share of assets and the number of registered long-term insurance firms. Whereas the top five accounted for over 86 per cent of the share of long term insurance premiums in 1995, this had decreased to 65 per cent by 2001. Over the same period the number of registered firms increased from 39 to 67. This suggests that new entrants have begun to erode the premium income share of the biggest insurance firms.

Figure 3.2 Long term insurance industry: market share and number of firms



Source: FSB, Annual Reports

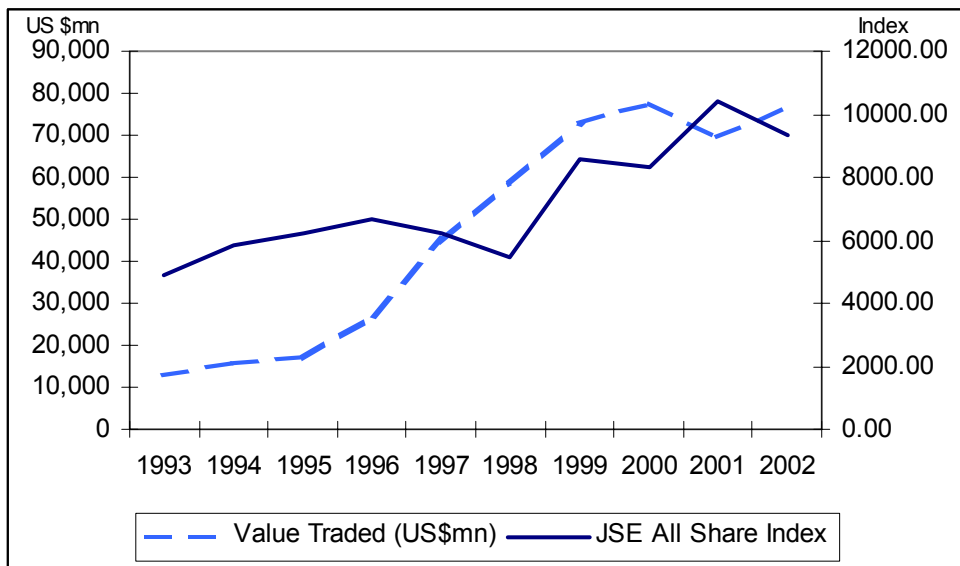
In the short-term industry, the new entrants affected the market share of premiums of the top five companies less noticeably, with the share of premiums in 1995 some 49 per cent and 46 per cent in 2001.

Industry sources suggest that the largest **local brokerage firms** in the South African securities markets are BJM Securities, Investec Securities, and Standard Equity. The largest international brokerages are Merrill Lynch (SA), Deutsche, USB Warburg Securities and JP Morgan. No league tables are published currently, although this may change in future. The sector has waxed and waned in response to liberalisation of the sector, changes in the operations of the exchanges, and perceived market opportunities.

Prior to 1995, the JSE Securities Exchange SA, (then the Johannesburg Stock Exchange), was run by committee and corporate membership was not permitted. The expansion of the JSE

rules to permit corporate membership in 1995, brought with it foreign ownership<sup>8</sup>, increased equity to the securities firms and increased liquidity on the exchange. South African stockbrokers announced deals with international counterparts, such as David Borkum Hare with Merrill Lynch, Martin & Co with Robert Flemming and Ivor Jones, Roy & Co with Deutsche Morgan Grenfell. Barings-Ing and other international players applied for membership of the JSE. The change in structure and ownership were associated with new skills and improved quality of research in the securities industry (Rebe, 2003 in interview). While initially this period of consolidation meant that the number of registered stockbrokers (at 47) did not increase, in 1996 the number of stock broking firms grew to 54. By 2002, there were 63 firms. Coinciding with the influx of foreign interest was an improvement of regulatory standards and compliance on the exchange. The entry of international players can be attributed to the opening of the South African market, which was growing in importance in emerging market portfolios. The perceived business associated with privatization was also an important draw card. By the end of 1999, the strength of these pull factors had waned and in the light of a global bear market and the need to reevaluate global placement of resources, some of the international players began to withdraw or downgrade their presence.

Figure 3.3 Value of shares traded and index of the JSE Securities Exchange SA



Source: JSE Securities Exchange, African Stock Markets handbook, 2003

Figure 3.3 shows the steady increase each year of the value of shares traded (in dollar terms) on the JSE Securities Exchange SA, as well as the rise in the share index values. Following the

<sup>8</sup> For example, as some of the premier broking firms were bought out by foreign banks

liberalisation of the JSE rules in terms of corporate membership, the value of shares traded grew by around 60 per cent in 1996 and 1997, after which growth tapered off somewhat, although the overall trend is still positive. The opening of the securities market increased the liquidity or thickness of the market, and number of trades as the electronic settlement and clearing system was set in place, JET, meant that the number of daily trades increased from 2500 to 17000 (Burke, in interview).

### 3.1.2 Concentration indices

Several indices may be used to measure competition and concentration in a sector. The most widely used index in the literature is the Herfindahl-Hirschman Index (HHI). The HHI accounts for both the number and relative size of players in the system and is therefore preferred to other measures of concentration. It is most commonly calculated by summing the squares of the market shares (Stiglitz, 1993), so that if the industry consists of a monopolist then the  $HHI = (100)^2 = 10000$ , or if it is a contested market with 100 firms, each with a 1 per cent market share, then the  $HHI = (1)^2 \times 100 = 100$ . The higher the value, the less competitive the market appears to be. Merger guidelines adopted by the US Federal Government in 1982 divided markets into three categories:

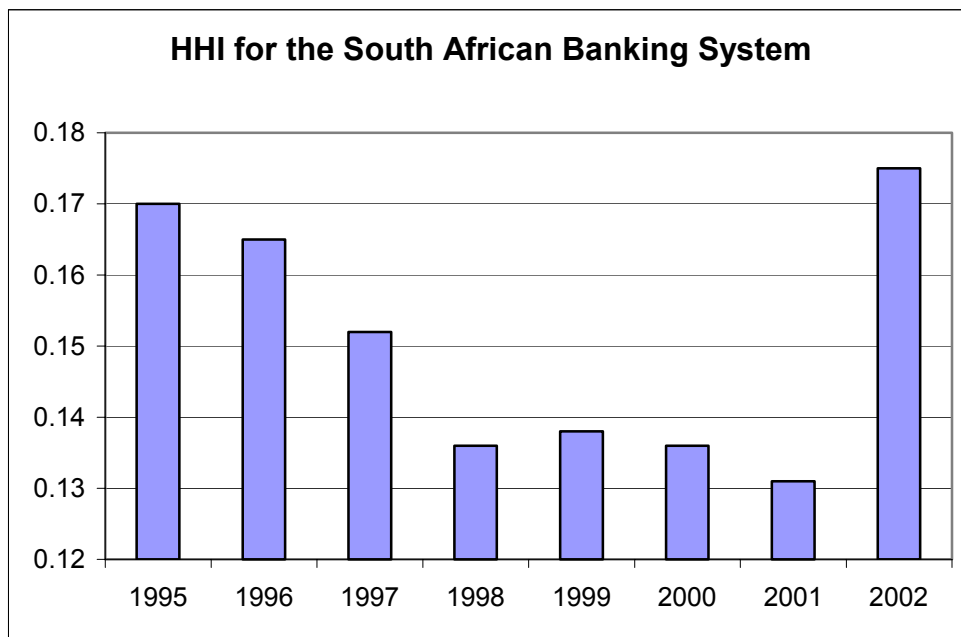
- HHI score <1000 Unconcentrated
- HHI score between 1000 and 1800 Moderately concentrated
- HHI score > 1800 Concentrated

The South African Competition Commission applies Australian and Canadian benchmarks for concentration thresholds (as used by the Australian Competition and Consumer Commission, ACCC, and the Canadian Competition Bureau, respectively). Both institutions use the (largest) four firm concentration ratio (CR4) to assess whether mergers should be challenged, with thresholds of 75% or more in Australian instances and 65% or more for Canadian (Competition report, 2000:12).

The South African banking supervision department publishes the HHI index for the registered banks, calculating the HHI in the conventional way and then dividing by 10000. Concentration levels become a concern when the index reaches a level of 0,18. The HHI declined steadily from 0,170 in 1995 to 0,136 in 1998, both as a consequence of greater foreign participation in the local banking industry and the entry of niche players. From 1998 to 2001 the HHI remained stable, before deteriorating in 2002. When the Nedcor-BOE merger is taken into account, the HHI deteriorated to 0,175 in 2002, which represents pre-1995 levels. This represents an increase of 33,4 per cent in the HHI from 2001 to 2002. This level is only slightly below the

concentration threshold. However, it may well be more appropriate to evaluate levels of concentration by sub-market rather than by firm. As is suggested by some of the market share ratios discussed above, when evaluated by product, higher levels of concentration are evident than when firm analysis is applied.

A rise in the concentration of the banking system (as seen in the South African market between 2001 and 2002) is associated in the literature with an increase in the market power of banks. Hence a higher concentration in the banking environment is associated with higher margins between lending and deposit rates and higher levels of profits earned by banks. Most data for European banking systems indicate a positive and significant relationship between



concentration and financial margins (Banking Supervision Annual report, 1998).

**Figure 3.4 The HHI for the South African banking sector**

Source: Banking Supervision Annual report 2003

An alternative argument suggests that banks will become more profitable if they are more efficient, and that efficiency will give rise to a larger market share. This suggests that the relationship between market concentration and profitability is not uni-directional. Regulation can also restrict the entry of new banks to a market, enhancing the opportunity available for incumbents to take excessive profits. In general, if a market is contestable, there will be less opportunity for banks to generate excessive profits or to have unduly wide margins (Banking Supervision, 2002). These themes are explored further below.

## 3.2 The regulatory environment

Regulation of the financial sector, particularly the banking sector, remains a contentious issue. The free banking argument maintains that banks are no different from other firms and hence should not be regulated at all. Benston and Kaufman (1996) argue that regulation is not justified by poor distribution of wealth or lack of competition but may be justifiable on the basis of bank fragility. However, there are also those who argue that the modern monetary system is based on the convention of the general acceptability of money (Dow, 1996). If there is not general confidence in money, the system is undermined. The perspective offered here agrees with the latter view that regulation is justified because banks are vulnerable as a consequence of the fractional reserve system and unguarded vulnerability can lead to bank runs, spillovers to innocent banks and firms, a credit crunch (where there is reduced availability of credit); impairment of the payments system and costly uncertainty. Prevention of bank failures can generate welfare benefits (Llewellyn, 2000). However, the difficulty for regulators is to know when to intervene, and to what extent. Like the market players that they hope to influence, they do not have perfect insight. If regulation generates stability, an evaluation of the financial sector implies an evaluation of the regulatory system as well. This matter is addressed in section four.

Over the past decade, there has been a number of identifiable trends in regulatory approaches applied to the sector. While there is some overlap in these trends, they may be categorised as the liberalisation of market access phase; the adoption of international norms phase; the market conduct and consumer protection phase and the corporate governance and money laundering prevention norms phase. A major factor affecting these trends has been the opening of the economy to financial flows and global influences. As a consequence there has been increased pressure for the adoption of international norms. The discussion will briefly examine these phases.

The initial phase, immediately subsequent to the democratic election, was associated with liberalisation of market access. In the banking, insurance and securities industry alike, foreign entities could now be licensed. In the securities industry, prior to the change of rules governing brokerages in 1995, only South African citizens could register brokerage firms. In 1994, the



Banks Act was amended to allow for foreign banks to establish branches. While foreign insurance firms can establish subsidiaries, licensing for branching is not yet permissible.

In line with the greater openness of the sector, a greater commitment to international standards was increasingly apparent, with each of the local regulators affiliated to the relevant international industry body. These international norms do not necessarily represent an improvement – as recent scandals such as the Enron and Anderson debacles have reminded us. Nonetheless, integration with the world economy appears to be associated with the adoption of its standards. In the securities industry, the application of international norms resulted in dematerialisation of shares to allow for electronic trading; the adoption of the STRATE system to allow for smoother settlement of trades and the adoption of the electronic trading system of the London Stock Exchange. International pressure for higher prudential standards arose primarily from the standards associated with the IMF's Financial Sector Assessment Programme (FSAP), with its 25 core principles, as well as the Second Basel Accord (Basel II). These standards led to changes in the Banks Act and amended regulations relating to banks in terms of prudential compliance in 2000.

The trend towards adoption of international norms has also lead to greater regulatory imposition regarding market conduct and consumer protection, particularly in the banking and insurance industries. Both the Long and Short Term Insurance Acts of 1998 and the Financial Advisory and Intermediary Services Act of 2001 have set down minimum standards in terms of training and accreditation and in terms of disclosure to clients. These standards aim to reduce consumer exploitation.

Over and above these trends has been the concurrent tendency towards corporate governance. This has influenced regulatory requirements in a number of areas: corporate governance in all three industries has been standardized in each of the industries in recent years, involving accounting disclosure and reporting. Reserve Bank officials point out that the requirements for banking executives are more onerous than for any other South African companies. In addition, the Financial Intelligence Centre Act (FICA) requires compliance from all financial players in terms of greater information about the client base, with a view to reducing the use of the domestic financial system as a money laundering mechanism.

These trends suggest that while access to the market has been improved, this has been accompanied by an increase in the regulatory burden. Compliance for South African banks involves four prudential sessions a year with the Reserve Bank, a joint meeting with the

external auditor and the Reserve Bank as well as a further meeting with Reserve Bank officials, all of which involve substantial preparation. Small banks in particular complain that this implies an onerous cost. These requirements, together with the minimum capital requirement of R250 million, provide a substantial barrier-to-entry. The absence of more than one licensing mechanism for deposit-taking institutions remains a barrier to entry which proposed future legislation on second and third tier banking will address. This topic is taken up again in section seven.

### **3.3 Conclusion**

With the advent of democracy and with the liberalisation of the financial account and the deregulation of the sector, the entrance of new local and foreign firms has provided a much-needed competitive stimulus to the three financial industries.

While the new entrants have eroded market share in the banking, insurance and securities industries, there is still a high degree of concentration of assets. This appears to be in keeping with other emerging market countries.

The effects of the more recent trends towards consolidation do not appear to have been fully played out, although high levels of concentration in certain market segments remain a concern.

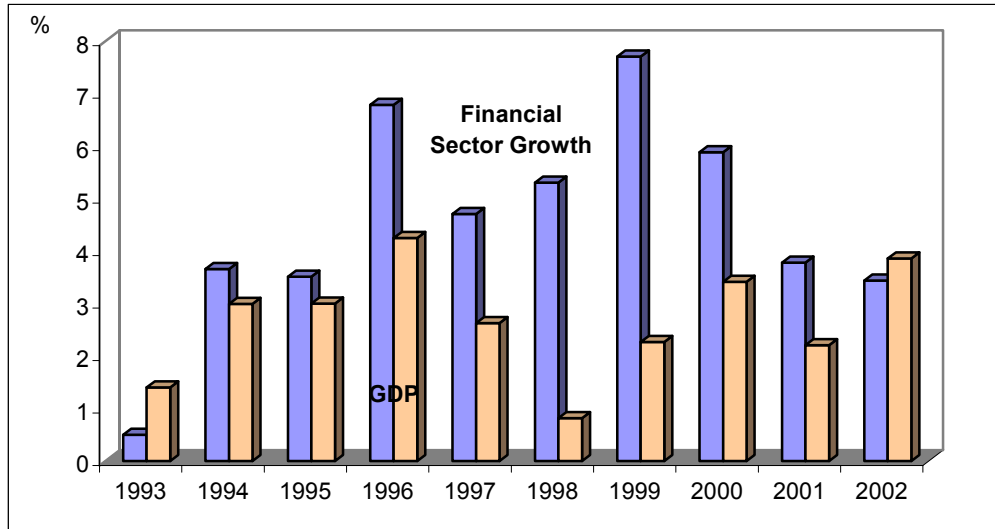
The changes in regulation over the decade have done much to align the South African financial sector with international regulatory norms. This has brought with it a number of increased costs associated with compliance.

## **4. Macroeconomic performance**

This section examines the performance of the South African financial sector from a macroeconomic perspective. As suggested in the introduction, good performance at the macroeconomic level requires striking a balance between stabilising a fragile system and allowing for new development. To evaluate the latter, a number of indicators associated with growth and change will be used. This is followed by a discussion of the stability of the sector.

## 4.1 Growth performance

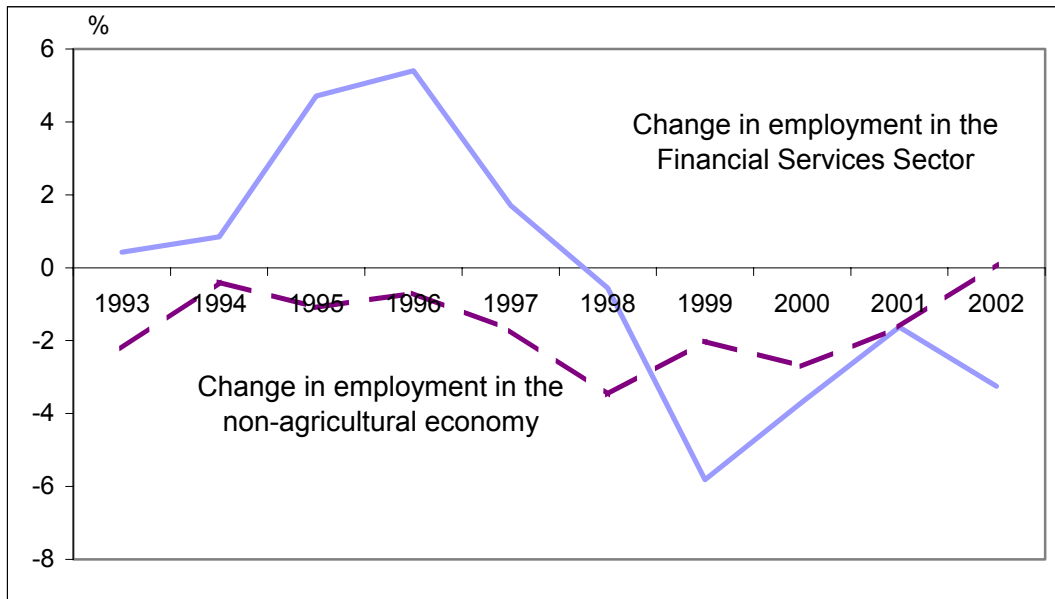
Figure 4.1 Real annual growth of the financial services sector relative to the economy (GDP)



Source: South African Reserve Bank Quarterly Bulletin, Various

Between 1993 and 2002 real growth of the South African economy averaged around 2.6% per annum. During the same period, the financial services sector grew nearly twice as fast, at an average of 4.5% per year (see Figure 4.1). The data show that the financial services sector has been relatively buoyant since 1996, outgrowing the rest of the economy each year (apart from 2002) and proving to be a source of growth for the economy overall.

Figure 4.2 Change in employment in the financial services sector relative to the economy



Source: South African Reserve Bank Quarterly Bulletin, Various

Since 1997, however, the financial services sector has been shedding jobs, as depicted by the data in Figure 4.2. The data show that employment in the economy as a whole has been declining annually, for the whole period shown except the last year, 2002, when employment grew by 0.1 per cent. Over this period, employment grew in the financial services sector in 1994, 1995 and 1996, but has declined each year since then. The top 22 banks have indicated that they cumulatively terminated 9000 jobs in 2002 (PriceWaterhouseCoopers, 2003), and in addition, the closure of some of the smaller banks, also led to employment losses. The absorption of some insurance firms into bigger groups in 2002 also reduced employment in the insurance industry.

Table 4.1 Year-on-year industry growth compared to nominal GDP

Growth statistics	1994	1995	1996	1997	1998	1999	2000	2001	2002
<b>Nominal GDP</b>	<b>13.1%</b>	<b>13.7%</b>	<b>12.7%</b>	<b>11.0%</b>	<b>7.8%</b>	<b>8.4%</b>	<b>10.9%</b>	<b>10.7%</b>	<b>11.8%</b>
Long Term premiums	..	34.1%	10.7%	20.6%	38.9%	0.9%	27.9%	-2.2%	..
Short Term Premiums	..	19.7%	20.0%	12.8%	11.4%	-6.4%	16.1%	7.6%	..
Loans and Advances	16.1%	16.4%	18.3%	18.1%	16.0%	8.6%	10.4%	19.6%	4.8%
Market capitalisation	15.0%	11.1%	10.4%	-0.1%	-11.3%	61.4%	-4.0%	14.1%	-10.5%

Source: SARB Quarterly Bulletin, FSB Annual reports, Banking Supervision Annual reports; JSE Securities Exchange SA  
- Information Bureau

The data in table 4.1 allow comparison of economic growth (as measured by GDP in current prices) with a number of industry growth indicators, such as income from premiums, loans and advances and market capitalisation. In most years, the financial industries outgrew the economy as a whole. While these data cannot provide insight into any bottlenecks in particular market segments, they suggest that the sector has facilitated growth in the economy. More details on possible microeconomic bottlenecks are given in section 5.

Another indicator of development in the sector is the extent to which it is associated with innovation. There are a number of possible factors affecting innovation including technology, globalisation and consumer needs. New developments are frequently a consequence of the interplay of these forces. Over the ten years under review, a number of facilities have been introduced or enhanced by the banking industry, sometimes earlier than other higher income countries. These innovations include:

- An increased number of ATMs and expansion of services through ATMs
- Telephone banking
- Debit cards
- Debit order facilities on transmission accounts
- Internet banking
- Banking via mobile phones
- Smart card banking
- Portable banking service delivery

The next section evaluates the stability of the sector over the decade.

## **4.2 Evaluation of stability**

While the failure of an insurance firm can cause economic distress, it is less prone to cause contagion than the failure of a bank. Although the bursting of a stock market bubble is also likely to have a negative impact on the economy, speculation that causes the number of bulls and bears to wax and wane is not subject to the same evaluations of industry-wise soundness. Since banks are by their nature fragile institutions, and the most important institutions in the sector, much of the discussion that follows focuses on the stability of the banking industry.

The type of financial instability associated with failure of the banking system, brings with it a host of potential costs. Some of these are private costs that accrue to the shareholders, depositors, bank creditors and borrowers of the institution. Others are social costs that spill over to the community. Loss of confidence in the banking system may cause withdrawals that

jeopardize previously unaffected banks and firms. Firms and households may be unable to adjust their balance sheets as they are denied access to deposits and credit facilities. The emergence of a credit crunch as banks become risk-averse may cause or exacerbate a downturn in the economic cycle. While the private costs of banking failure may be disastrous to individuals, it is the more general social costs that regulation aims to avoid.

Financial instability is associated with an unexpected change in the values of financial assets, which may lead to the failure of financial firms and disrupt the payments mechanism and the capacity of the financial system to allocate capital (Neuberger, 2000). Stability from the perspective of the investor relates to protection from unexpected changes in asset values. From the perspective of an entrepreneur, it implies stable relationships with bankers and stable financing conditions. For consumers, financial stability is related to the protection of deposited funds and the avoidance of capital loss.

The cost of bailing out bank failure after bank failure may have its own welfare costs. This raises the familiar issue of moral hazard. If banks perceive that they will be bailed out, they may conduct risky business at will. Successful regulation is a demanding task – regulators must let aberrant banks fail, but not so often that there is loss of confidence in the system.

As the discussion on regulation has suggested in section 3.2, we should not suppose that a regulatory decision to save a bank on the brink of failure is done with perfect information. The nature of the banking process is such that the quality of assets (mostly loans and advances) cannot be guaranteed. The value of such assets depends on other economic outcomes and expectations. It is difficult to assess whether a bank has a problem of liquidity (which could be temporary) or solvency (which could be terminal). Economic processes are by their very nature interlinked and influence each other. The outcome is more than the sum of individual actions. Even if we assume the most transparent process of disclosure, and the most up to date forecasts, the regulator makes decisions under conditions of uncertainty. Many of the discussions relating to how a particular crisis should have been handled (such as the current debate regarding the apparent difference of opinion between the ex-Registrar and the National Treasury in the Saambou case) are made with the benefit of hindsight. Many of these arguments appear to be implicitly underpinned by the fallacy that the regulator (be it the Registrar or the Minister of Finance) acts with perfect knowledge.

The case for regulation stems from the need for confidence in the monetary system and in its systemic stability. It may be useful to examine the events around the recent Saambou debacle

with this in mind. At the time of Saambou's suspected liquidity crisis, Fitch SA, a ratings agency, downgraded six other similarly rated A2 banks. This occurred on a Friday and by the Sunday, the Reserve Bank had persuaded Fitch SA to reconsider its rating. This action by the Reserve Bank is perfectly in keeping with the notion of reducing systemic risk by restoring confidence in the system. By Monday the crisis had been averted. However, confidence was still not fully restored and when Saambou (the seventh biggest bank at the time) was put under curatorship in February 2002, it became evident that loss of confidence in small banks was beginning to affect another bank- in this case BOE (the sixth biggest bank at the time). The regulators intervened once more to restore confidence in BOE, stating that demand for funds would be honoured by the Reserve bank. Shortly afterwards the takeover of BOE by NEDCOR was approved.

In this case the regulator tolerated the failure of a single bank, and attempted to ward off threats to the system as a whole. In attempting to restore confidence to the market through reassuring pronouncements, the regulator injects knowledge into an uncertain system - essentially attempting to convince depositors not to undermine the system. In the absence of such assurance, depositors may feel compelled to confirm their individual liquidity by withdrawing their funds from the system and in turn, increase the likelihood of systemic crisis.

Bank regulation has traditionally focused on the supervision of individual banks through the assessment of credit risk, capital requirements and so. This approach has been termed microprudential (Borio, 2003), with the focus on protection of deposits. However, another source of bank crisis is the common exposure to macroeconomic risk factors across institutions. where the origin of the crisis lies not with the imprudent decision-making of one bank, but with the exposure of a number of banks to a particular risk, such as a foreign exchange risk or large exposure to a particular sector or segment of the population. The high degree of overlap in the clientele of Saambou and African bank, which was only brought to light after African bank took over the Saambou book, suggests common exposure to an already overstretched client base. Given the possibility of common exposure as a source of systemic bank crisis, the need for macroprudential regulation (ibid) arises. While a saver's funds may be protected by microprudential regulation, the saver may not be protected from the macroeconomic fall-out of a bank crisis such as unemployment. Reserve Bank officials point out that the Asian crisis in 1997 was an important impetus in setting up the Financial Stability unit in the Banking Supervision Department.

A commonly used indicator for instability is the number of bank failures. Bank failures disrupt stability from the perspective of individual investors, entrepreneurs and consumers as well as on a broader social front. However, while some banks are allowed to fail, others are bought out when they face failure. While eight banks were liquidated between 1994 and 2002, significantly more (48) deregistered or were taken over. In total, some 56 banks were either liquidated, acquired, taken over or deregistered over the decade under review. While the use of number of failures is frequently used as an indication of instability, it is a blunt indicator and potentially masks information on those banks that perhaps should have been allowed to fail. While an absence of failures can mean that moral hazard is encouraged, this does not appear to be the case in South Africa<sup>9</sup>.

**Table 4.2 Bank deregistration and failure**

Reasons for deregistration	1994	1995	1996	1997	1998	1999	2000	2001	2002
	Liquidated (Curatorship)	1	1	0	1	2	1	0	1
Deregistrations, takeovers, acquisitions etc.	1	2	4	6	4	1	7	9	14
<b>Total</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>7</b>	<b>6</b>	<b>2</b>	<b>7</b>	<b>10</b>	<b>15</b>

Source: South African Reserve Bank

An alternative measure of stability is the public perception of banks. This is important given that the monetary system is underpinned by public confidence. This can be measured qualitatively in attitude to banks, as well as through the quantitatively through fluctuations of deposits before, during and after crisis periods. The latter may not always be a good indicator as unless there is widespread loss of confidence in the banking sector, as occurred in Argentina in December 2001, depositors may merely shift their funds to more stable banks. Some of the bigger banks have indicated for example, that their client base has grown as a direct consequence of the problems associated with A2 banks in 2002.

**Table 4.3 Consumer perceptions regarding the advantages of banks**

Perceived advantages of banking money			
	% Of Respondents Agreeing		
	Fully Banked*	Partially Banked	Unbanked
In a bank, my money cannot be stolen	84%	85%	83%
Banks not always a safe place	42%	45%	44%

\* implies that the respondent has access to some high level product such as a credit card, or current account with an overdraft. Source: Finscope Financial Products Survey 2003

<sup>9</sup> It could be argued that the Saambou/BOE incident suggests that a 'too big to fail policy' exists, which potentially reinstates the moral hazard for big banks.



Table 4.3 shows the perceptions of South Africans towards banks after the Saambou crisis. The table suggests that regardless of whether or not the respondents use the banking system, they perceive it to be relatively crime-free. However, banks are not always seen as a safe place to store money. The majority of respondents nonetheless seem to regard banks as sound, relative to other alternatives.

Table 4.4 EIU's evaluation of financial soundness

EIU's evaluation of Financial Soundness*			
		1998 – 2000	2003 – 2007
1.	Openness of banking sector	4	4
2.	Stockmarket capitalisation	3	3
3.	Distortions in financial markets	4	4
4.	Quality of the financial regulatory system	3	4
5.	Access of foreigners to local capital market	4	4
6.	Access to medium-term finance for investment	3	4

\*Value out of 5 – where 5 is the maximum value e.g. Completely open.  
Source: EIU Country Survey: South Africa.2003

Since the monetary system depends crucially on public confidence and perceptions of stability, ratings of rating agencies may be used as a litmus test. In its Country Survey on South Africa, for example, the Economist Intelligence Unit, rates the soundness of the financial sector in qualitative terms according to the criteria listed in Table 4.4. The rankings suggest that the sector is seen by external players as both reasonably sound and stable. The sector is expected to perform even better in the next five years.

Table 4.5 Performance ratios

	Total Assets \$ mil	Soundness: capital/asset ratio	NPL to total loans	Cost to income ratio	ROA%
Argentina	13626	8.8	12.2	54.4	1.1
Australia	98475	5	1.3	55.8	1.6
Brazil	38662	8.5	0.8	66.6	2
Malaysia	16316	9.4	5.6	40.4	1.3
<b>South Africa</b>	<b>23967</b>	<b>6.3</b>	<b>3.6</b>	<b>59.1</b>	<b>2.2</b>
Thailand	19634	6.1	21.7	87	-1.1
UK	423887	4.2	2.1	54.7	1.4

Source: The Banker July 2001. As quoted in ABSA Economic Perspective 2002

Another performance indicator is the proportion of share capital to assets (loans) or examination of non-performing loans as a percentage of all advances. Table 4.5 sets out some of these ratios for the top 5 banks of selected countries. The table indicates that South Africa's system is relatively sound, both on a capital/assets ratio basis and on the basis of non-

performing loans. While its cost-to income ratio is comparable with other countries, its return on assets is notably higher than for other countries. This will be further examined below.

### **4.3 Conclusion**

Good macroeconomic performance requires a balance between stability and new development. There is evidence that this balance has been achieved in the South African banking system. The growth of the financial industries and the adoption and adaption of new technology suggest that there is impetus for new development in the sector. In terms of stability, while there have been bank failures over the past decade, these do not appear to have undermined public confidence. Externally, the sector is well-rated.

## **5 Microeconomic performance**

Good performance at the microeconomic level of the banking system can be seen as a balance between the cost of providing financial services and the ability to allocate resources in a socially acceptable way. These issues will be explored by examining cost efficiency; the sector's support for economic activity and provision of financial services to households. The term provision is preferred to access to financial services since it suggests an evaluation of what is being provided and whether or not it meets the needs of the client-base.

### **5.1 Cost of provision**

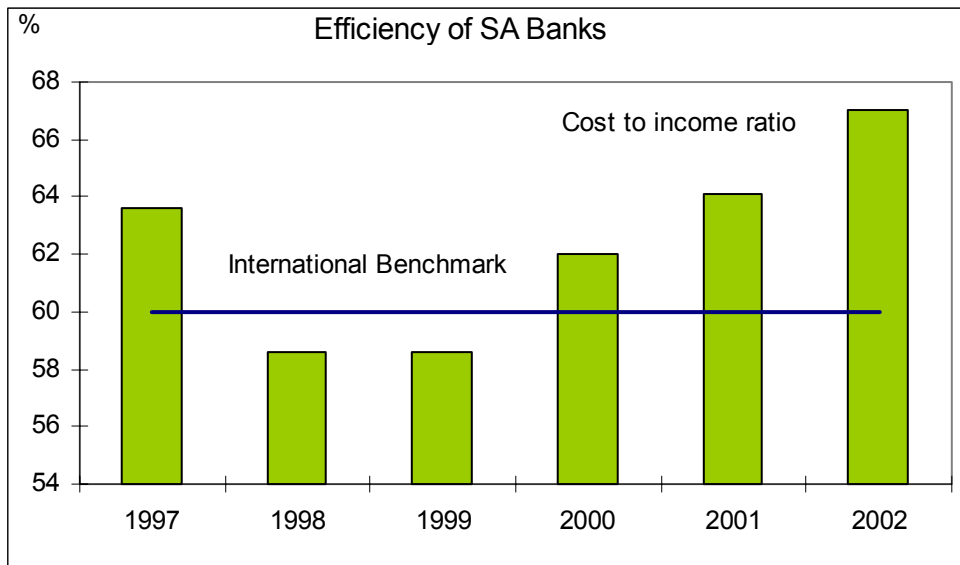
Efficient provision of financial services and products, as in other industries, is assumed to ensure that consumers pay fair prices for products and that scarce resources are allocated to their highest value uses (Wallis Report 1997: 601)<sup>10</sup>. As in so many cases, it is difficult to find a measure which adequately captures fair pricing. In the discussion here, the banking industry standard, the cost-to-income ratio is used, together with some pricing data. Comparable measures for the efficiency of the different industries in the financial sector are not available. For example, while cost-to-income ratios are used in the banking industry, in the insurance industry, expenditure includes payout of benefits, which undermines the comparability of such data. Only one of the local brokers, BJM, is listed on the stock exchange and hence there is not comparable cost data for the securities industry.

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<sup>10</sup> A full evaluation of the notion of fair pricing and reasonable costing in the industry requires detailed pricing and costing information, which falls outside the scope of the project

In the banking industry technical efficiency is often measured by expressing operating expenses as a percentage of total income, under the assumption that efficient delivery is associated with keeping costs below a certain proportion of income. The current international benchmark of 60 implies that banks with a ratio of over 60 are considered inefficient. Average cost-to-income ratios for 2001 in Brazil (66.6%), Italy (62%) and France (61%) are moderately above the international benchmark. While South African banks have managed to keep this ratio below the international benchmark in the past, in recent years the ratio has risen. Increasing consolidation, together with changes in regulated accounting and compliance practices appear to have had a stimulated costs in the industry: Since 2000, operating expenses have outgrown industry income. For example, while total income grew by over 5 per cent in 2002, expenses grew by 9.6 per cent. According to the Banking Supervision report (2002, page 50), while expenses for branches are on a declining trend (associated with branch closure), and employment is down, staff costs continue to rise. The data suggest that there is room for the South African industry to become more efficient.

Figure 5.1 Cost to income ratios of the banking sector



Source: Banking Supervision reports

Local banks argue that the diversity of their client base increases their cost relative to banks in other countries. For example, ABSA, which has long had the highest cost to income ratio of the big four banks, points out that it has 2.3 million Flexibank clients, out of a base of 5.9 million.

These Flexibank clients are more likely to use branch services than relatively low cost technology such as internet banking. This they maintain, increases their costs.

While the use of a cost-to-income measure is appealing it is not a perfect measure. Where institutions have significant market power, for example, they may be able to increase income at a faster rate than costs, hence an improvement in the ratio may mean a worse, rather than better deal for consumers. Towards the end of the 2002, there was a strong increase in the bank interest margin (to 3.8% from an average of 3.2% during the year), which may reflect market power to extract a higher margin (Banking Supervision, 2002, page 13).

Evaluation of whether or not consumers are getting a fair deal is very difficult in an environment where cost data is withheld and there is no requirement for standardised disclosure of prices. In the South Africa, banks tend to compete on advertised interest rates, but do not consistently reveal all the fees and charges that may be attracted by a transaction. Recent research commissioned by the MFRC revealed that canvassed bank clientele were surprised by fee charges (MFRC, 2003).

While costs are seen as strategic and disclosed only reluctantly, the increase in non-interest income (and hence fee income) to around fifty per cent of banks income in South Africa suggests that standardised disclosure of fees would be a first step to enabling customers to assess whether they are paying fair prices for financial services.

## **5.2 Influence on economic activity**

An appropriate measure for the financial sector's contribution to economic growth would be the ease with which companies can access financial institutions and the ease with which investors can get an adequate return (Rajan and Zingales, 2000). Unfortunately, the world over, these numbers are not easy to compute. In section 4.1, data on certain growth indicators showed that in the majority of years, loans and advances, insurance sales and market capitalization on the stock exchange outgrew nominal GDP. While this suggests that the financial sector may not be constraining growth, it does not reveal the extent to which growth in particular market segments could be further encouraged.

Given that large companies often have their own treasury departments and are listed on an exchange, access to finance at reasonable terms is less likely to be a constraint. Much of the discussion here has focused on small and medium firms, which are important generators of

wealth and employment. In South Africa, the debate on the provision of finance (from banks and other institutions) or funding (from investors) is ongoing. While there is some evidence that access to finance is a problem, other evidence makes it clear that other obstacles complicate financial relationships. There is no current requirement on banks or other providers to report the rejection rates or reasons for rejection, and such statistics would in any case probably be skewed as it may be that a significant proportion of would-be applicants simply never approach banks for fear of being turned away. Such evidence as exists points to high rejection rates<sup>11</sup>, which suggests considerable unmet demand. From the supply-side, some banks have complained that the Usury cap, which applies to all loans up to R500 000, inhibits their small business exposure as they are unable to price for risk.

In the Global Entrepreneurship Monitor, 2002 a survey of South African disadvantaged entrepreneurs in urban areas revealed that entrepreneurs are likely to be more successful when applying for credit card or overdraft finance (which attract higher charges) than a bank loan. Thirty three per cent of the sample received offers of some form of finance, the majority of which was bank finance, none received venture capital and a small fraction received finance from informal commercial sources. While the study did not look at loans from friends and family (which are known to be an important source in micro businesses), the survey suggests that there are few non-bank commercial alternatives. The survey confirms credit rationing in this market segment.

Table 5.1 Global Entrepreneurship Monitor 2002 Applications for finance

% of Entrepreneurs	Applying for finance	Successful applications	Accepted offer of finance	% of total sample that received finance
Bank loan	84.4	25.0	85.2	18.0
Bank overdraft	18.8	62.5	76.7	9.0
Bank credit card	2.3	83.3	60.0	1.2
Micro-lender	3.1	0	-	0
Stokvel	1.2	33.3	100.0	0.4
Mortgage	0.8	100.0	100.0	0.8
Venture Capital	0.4	0	-	0
<b>Average</b>	-	<b>33.2</b>	<b>82.4</b>	<b>27.3</b>

Source: South African Global Entrepreneurship Monitor, 2002

Three quarters of all applicants indicated that they had one or more of the following problems at the time of applying for finance:

- Blacklisted with one of the credit bureaux
- Did not keep adequate financial records

<sup>11</sup> For example, Business Partners, the old SBDC, noted in a recent interview that they rejected up to 90% of applications for start-up businesses. They also said they did not have any competitors in terms of providers of finance for this market segment.

- Lacked collateral
- Sought working capital

These factors place the entrepreneurs in a high risk category. Given these obstacles to finance, the blame for lack of access to finance cannot be placed exclusively at the door of financial institutions. It is when entrepreneurs have none of these problems and are still denied finance that the financial providers and their ability to distribute resources in a socially desirable way becomes questionable.

The issue of stimulating venture capital has been discussed in financial circles for some time. In June 2003, an Alternate Exchange (Alt-X) aimed at small and medium-sized firms was launched. The new exchange replaced the previously unsuccessful Venture Capital Markets and Development Capital Markets. This approach has been relatively successful in London, but not in Germany, where the dual system has deterred rather than encouraged investors (Business Day, 2003a). The success of the Alt-X needs to be judged not so much by its market capitalization, but from the values of shares traded and the number of new issues. This would give a sense of the equity raised rather than merely the equity listed.

### 5.3 Provision of financial services

In South Africa, as a consequence of public and private delivery systems, services to millions of low-income households have improved in terms of access to electricity, postal services and cellular telephony over the past decade. Noticeably absent from this list is the improvement in access to bank accounts.

Table 5.2 Provision of non-financial services

% of people with	1994	2001	No of people affected
Electricity in homes	55%	80%	6.5 million
Mail addresses	39%	68%	12.5 million
Cell phones	0%	21%	8 million

Source: Finmark Trust, 2003b, Annual Report.

In some quarters, provision of financial services is conflated with access to credit. However, financial services embrace transactions facilities, saving services, and insurance services, as well as credit. Historically, these data have not been rigorously collected in South Africa, with the best data emanating from the South African Advertising Research Foundation (SAARF), as an outcome of their annual media products survey. Their data show that over the period 1995-1999 only 40 per cent of people surveyed had a savings account. Even fewer respondents had

access to a current account or credit card. Since respondents are likely to understate the extent to which they are indebted, the access for loans in Table 5.3 appears to be low.

Recent efforts to improve the quality of data has resulted in the Finscope data sponsored by the Finmark Trust (2003a). The Finscope data estimate that 38% of South African adults have access to insurance services of some sort (including burial societies); 40% have access to transactions faculties; 44% have access to some savings facilities – including informal savings associations, and 57% are credit-active.

**Table 5.3 Provision of financial services**

Percentage of population with access to financial services					
All LSM Groups	ATM Card	Cheque Account	Credit card	Loan	Savings a/c
1995	22.8%	9.1%	5.3%	3.2%	38.2%
1996	24.9%	9.6%	5.5%	3.2%	37.7%
1997	25.7%	9.4%	5.3%	2.3%	35.8%
1998	25.5%	9.0%	5.1%	3.0%	38.5%
1999	31.8%	8.9%	5.2%	3.0%	37.0%
<b>AVERAGE</b>	<b>26.1%</b>	<b>9.2%</b>	<b>5.3%</b>	<b>2.9%</b>	<b>37.4%</b>

Source: SAARF, All Media Products Survey

These data suggest that while the situation is not as bleak as implied by the SAARF data, in Table 5.3, there is considerable room for improvement, with roughly 60% excluded from formal financial provision. The Finscope survey revealed that up to 25% of the unbanked have indirect access to financial services through a family member.

**Table 5.4 Access to financial services**

Access to Financial Services 2001/2002			
	Fully Banked	Partially Banked	Unbanked
Definition	Access to high-end products	Access to saving a/c's; burial society; etc	No accounts
Number of Adults	2,6 million	4,5 million	4,5 million
Percentage of population	22%	37%	37%*

\* 4% not categorized. Source: Finmark Trust, Finscope 2003

The data in Table 5.4 show that only a minority of South Africans have access to high-level financial products. A recent study for the Micro Finance Regulatory Council into the costs, volume and allocation of Consumer Credit (FEASibility, 2003a) revealed that the market is segmented into roughly four categories:

1. Prime clients (served at the prime rate of interest or less).
2. Clients that can be served under the usury cap rate (Prime + 1/3 of prime plus 6%).

3. Clients that can be served under the Exemption Notice to the Usury Act (up to R10 000 over 36 months).
4. Clients whose personal circumstances dictate that they are excluded from provision.

Those who have mortgageable property are able to leverage access to credit at the lowest cost. Those without security or regular formal income pay the most for credit.

The outreach of the four big banks to previously excluded consumers has not always been successful. While a detailed account of their attempts to provide for the excluded has been dealt with elsewhere (Hawkins, 2002), most such attempts have been supply-driven. That this has not always met the needs of the consumer is evidenced by the 14% of the unbanked category who said they used to have a bank account but have since closed it.

Access to saving services appears to have been particularly neglected. Rutherford (2000) has documented the need in poorer households for access to a facility that provides an easily accessible store for saving. In South Africa, access to savings accounts held in banks may be costly, with fees accruing for both deposits and withdrawals. Where small amounts are saved regularly, these fees can erode not only the modest interest earned, but the capital as well (Feasibility, 2003a).

Recent discussion around the Financial Charter suggests that targets to improve financial provision may be put in place. Along these lines, Post Bank's plan to install 3000 ATMs is an ambitious project that could go a long way to improve delivery to the roughly 60% of the adults who do not have access to savings accounts. Should this be successful, it will increase the estimated number of ATMs from 6500 to 9500 (Business Day, 2003b).

Lack of provision by banks to low income consumers arises partially from regulatory inflexibility. This inflexibility has created significant barriers to entry and high licensing fees, which may mean that this segment of the population cannot be serviced on a sustainable basis. The proposals on second and third tier banking, currently being considered for legislation may change this, as these entities will have lower licensing fees and operating costs. It is feasible, for example, that a retail food chain may register to conduct low-income banking using its existing infrastructure.

The sample selection for credit active South Africans in the Finscope survey was obtained from credit bureaux. Such an approach may understate the levels of credit provision as many



microloans, both those from registered term lenders and the banks, are not registered with the credit bureaux. Since 1994 both the large and small domestic banks have begun to compete in the low-income credit market, together with informal micro traders, who have the advantage in lower costs and better local knowledge. Some niche banks (like African Bank) have been targeting low income, formally employed, individuals previously excluded from financial provision. This accounts for some of the increases in the market share of 'Other' banks and the maintenance of the share of the Big Four. Commercial banks in this market operate by setting up debit order facilities on low-value transaction accounts that ensure repayment. While the entry of commercial banks into the low-income market provides more choice for those formally employed, there is little improvement in the options available to those in informal employment, including taxi drivers, gardeners, construction workers etc. In addition, the fee attracted if there are no funds in transaction accounts to service debit orders, is very high – on average R100 per failed transaction.

While the discussion has focused primarily on the banking industry, problems of provision also occur in the insurance industry. The high levels of surrenders and lapses in the life insurance industry have not tapered off over the period under-review. In the 1996 report of the Registrar of Insurance (FSB, 1996), the high levels of surrender and lapses were considered to be of concern. The following suggestions were put forward as reasons for these high levels: depressed economic conditions, increasing competition from non-insurance investment institutions and failure to inform the customer adequately regarding the nature of the product. Since then the levels have grown beyond the concerning levels of 1996.

Table 5.5 Surrenders and lapses of insurance life policies\*

%	1993	1994	1995	1996	1997	1998	1999	2000	2001	Average
<b>Surrenders</b>										
Number of policies	16.7	17.6	16.8	19	26.9	25.1	25.2	16.4	24.9	21.0
Annual premiums	9.7	11.8	12	15.2	16.6	17.2	24.3	21.5	24.8	17.0
<b>Lapses</b>										
Number of policies	29.3	28.63	25.9	25.5	31.6	30.9	28.8	16.9	29.3	27.4
Annual premiums	16.9	16.3	16.3	19.6	23.6	22.6	25.3	21.3	22.3	20.5

\* Excludes pension fund and group life business. Source: Registrar of Long term Insurance: Annual reports

## 5.4 Conclusion

The evaluation of microeconomic performance presented here examines cost efficiencies and provision of services to small businesses and consumers. The evaluation was constrained due to lack of series data over the period. The evidence that there is suggests that the microeconomic performance in terms of cost efficiencies and allocation of resources of the

financial sector leaves something to be desired, with little measurable improvement in either area over the decade.

The cost-to-income ratios of South African banks have recently increased due to costs associated with mergers and changes in regulatory and compliance practices, but are not out of line with overseas ratios. While banks do appear to ration credit to small businesses, in many cases this may be due to legitimate obstacles to assessing creditworthiness. The current levels of under-provision of financial services to the majority of South Africans is unsustainable and appears to be receiving belated attention. The changes in licensing requirements for smaller banks, which may bring with it renewed contestability in certain market segments, may be a first step to improving provision.

## 6 Evaluation of performance

As with any evaluation of a sector whose influence is so extensive in an economy, it is difficult to provide an unequivocal evaluation of its performance over the period of a decade. The discussion has pointed to areas of good performance, such as growth in loans and advances and the stability of the system at a time when South Asian and South American countries experienced significant bank failure and crisis. The sector also appears to be innovative, especially for the high-end market segment.

However, there are areas where the performance of the financial sector was found wanting. While the rollout of non-financial services has improved since 1994, there is little to suggest that the number of consumers being helped has increased much. Levels of lapses and surrenders of insurance policies continues to show that at least one out of every five policies sold will be surrendered over the course of a year, and one will lapse. Fourteen percent of those who previously had bank accounts have closed them. The absence of good trend data is a problem, but what there is points to a sector that has been slow to change its focus to the consumer-based development of products. This is particularly so in the case of meeting the needs of middle and low-income consumers and smaller businesses.

The picture painted here has much to do with the regulatory regime. In 1994, when foreign bank ownership was permitted, it was restricted to the individual high-net worth and corporate market segments, due to the stipulation that clients with foreign institutions were required to maintain a minimum deposit of a R1 million. While it is there is no way of telling if foreign entities would have entered the retail market if there had been no such constraint, the outcome has been that there has been considerable contestability at the high-end of the market and little elsewhere. To some extent this competition at the high-end could be said to have further polarized the provision of financial services, with increasing attention given by the incumbents to retain corporate and niche accounts, at the cost of neglecting of the universal provision of services. This scramble for the high end market segments has undermined perceptions of the possible commercial returns from provision of retail services. In the PriceWaterhouseCoopers Banking Survey (2003, pages 32 and 5) for example, where 22 banks are interviewed, only 5 banks were involved in retail banking. Four of these banks rated retail banking as very or extremely profitable. However, since the vast majority of the banks did not provide retail services, retail banking is not listed as a profitable activity under the main findings. The very recent announcement that Barclays and Standard Chartered are re-entering our banking market is encouraging, even although their entry is pitched at niche retail level, Barclays at the lucrative credit card market and Standard Chartered at internet banking.

Much of the failure to deliver services to the mass market has to do with the absolute nature of the banking license, which has one set of standards. The Mutual Banks Act has failed to facilitate institutions with a greater community flavour. Community banks, which operate under an exemption to the Banks Act, account for a fraction of the system's deposits.

Pending legislation will allow the licensing of second and third tier banks. It is currently proposed that the third tier banks will be narrow or savings banks, while the second tier banks will also be able to offer loans based on collateral. These institutions will not be allowed to offer cheque accounts and will only be able to access the NPS through a sponsor. These banks will be constrained as to how they could leverage their deposits, but will conceivably provide a range of financial services to a far broader range of society. For example, if some small range of products (such as savings, transaction and funeral policy services) could be provided from retail stores, the number of possible financial services outlets grows from 2700 bank branches and 6300 ATMs to over 100,000 outlets (Finmark Trust, 2003b). This may do much to stimulate the industry to provide services to the majority of South Africans.

One of the constraints to banking the unbanked is the Financial Intelligence Centre Act (FICA). This requires that bankers know their clients, in a bid to avoid money laundering. To the extent that the unbanked do not have fixed addresses, this may exclude them from access to the banking system. Only those with deposits of less than R5 000.00 are exempt from this requirement. It may be that formal microlenders who know how to contact their clients have a roll to play here.

## 7 Factors affecting performance outcomes

The discussion has highlighted a number of factors that have affected performance over the past decade. Primary among these have been

- Regulatory reform, which has allowed foreign ownership, and has imposed new regulatory standards,
- Globalisation and openness of the sector to foreign influences and standards,
- A changing customer profile with different needs and
- Development in technology, which has created new delivery channels.

These four factors are likely to continue to dominate the landscape of the financial sector.

In particular, there is likely to be:

- Increased financial exposure to the foreign sector and the requirement to meet new regulations relating to governance and transparency;
- An increased role for internet technology in challenging existing regulations regarding the importation of financial services;
- A more fully employed technological capability for wireless and mobile provision of financial services, potentially reducing infrastructure costs dramatically. This may also prove to be a source of innovative disruption to incumbents;
- Continued conglomeration of banking, insurance and broking entities, previously governed by different legislation. This is likely to strengthen the trend towards a single regulator;
- A revision of Usury Act legislation which may encourage greater standardised pricing disclosure;
- Legislative change to facilitate the registration of second and third tier banks. This will encourage niche players and potentially deliver services to those currently excluded; and
- A shift away from a supply-driven to a demand-driven approach towards the middle to low income consumer base. The possibility of new entrants will encourage this.

The interplay of these processes is likely to lead to a number of yet undefined outcomes; a few of which are explored below:

### *1. New players, new regulatory worries*

It is probably fair to say that the regulatory regime over the past years has erred on the side of caution. The provision of a new licensing framework will increase the number of regulated entities, bringing with it its own challenges. However, the entry of new banks will only be effective in delivery of fairly priced services if other issues such as disclosure requirements and access to the national payments system (NPS) are addressed. Access to the payments system is key. Currently the big banks dominate the system and prices are set by this shareholding. Full entry into the PASA and Bankserv ranks potentially takes years of effort, as well as considerable stamina, in terms of meeting financial and other requirements. Restricted access to the payments system serves two purposes, it allows for easier regulation by the regulator and it protects the interests of the incumbents. A new entity, for example, may not issue credit cards unless it has full access to the payments system (a requirement for both VISA and MasterCard). Access to the payments system may be via a third party, but without it, such business is impossible. While the Reserve Bank maintains that restricting access to the NPS is crucial for stability of the system, in order to address the issue of competition in the market, more successfully than in the past, the Reserve Bank and policy makers will be required to grasp this nettle.

### *2. A tendency towards polarization?*

The Basel II capital requirements (scheduled for 2007) are based on an internal based ratings (IBR) approach and a standardized approach of risk rating. Large corporations that are rated by credit ratings agencies are likely to have lower risk ranking than lesser-known smaller companies, and the capital charge imposed by Basel II on banks will vary. While the ratings method is still not finalized, it is assumed that larger banks with their own ratings capacity will use an internal ratings based system and small banks will rely on standardized ratings (from external sources). The risk capital charges currently provide an incentive for the sophisticated banks using the IRB approach to provide finance for better rated firms (BBB and above, according to the Standard and Poors ratings) and for the less sophisticated banks (using the standardised approach) to provide finance for firms with lower ratings, which may be considered to be of lower quality (Kupiec, 2001). While it seems that the complex requirements of Basel II will not be imposed on all South African Banks, the banking fraternity and the regulator need to consider the outcomes for the fragility of the system and engage with the Basel II architects on these matters.

Polarisation of institutions tend to occur when they are set apart as different in some way. A2 banks, adjudged so by credit rating agencies complained that they could not access the relatively cheaper funds from retail depositors as they were not judged to be as sound as the big banks. In a financial system, such a perception is often self-fulfilling. Commentators have suggested that the Alt-X exchange will suffer the same fate, as firms listed on this alternate exchange will be seen as riskier. From both the banking (Basel II) side and from the funding from the stock exchange side, medium sized companies may find it more difficult than before to meet their financing and funding requirements.

Another tendency for polarization arises from the openness of the financial sector to international forces. Foreign entry into the banking and insurance sectors requires a local presence, and until recently this has also applied to brokerages. It is brokerages that provide analysis of listed firms and through this, actively stimulate stockmarket activity. However, through the recent process of direct access, which has already been granted to a number of external firms, there is no need for foreign brokerages to have a local presence. In global terms, it is expensive to maintain analytical capacity in peripheral areas like Johannesburg. Allowing foreign brokers to trade on the JSE Securities Exchange SA in this way potentially undermines the local industry. London based organizations, for example, may do most of the trading, which pays the research bills. If the local brokerages are frozen out of the lucrative London trades (which already accounts for about half of the trading) (Business Day, 2003c), local brokerages will have less ability to fund research in local based companies. To the extent that the intellectual capacity of the securities industry encourages stock market activity, trading activity for locally based companies may be undermined.

A critical awareness of the potential impact of adopting international trends and standards on the domestic market needs to be fostered at both industry and policy levels, particularly in light of sequential moves to remove exchange control.<sup>12</sup>

### *3. Regulating the source of instability: a shifting target?*

Traditionally, banks and other financial institutions have been seen as distinct entities fulfilling different functions, such as intermediation for banks and insurance companies and facilitation for brokers. Increasingly, these functions have merged and the distinction between institutions has become increasingly fuzzy. This has encouraged the tendency for credit risk, associated with the banking system, for example, to be shifted to other institutions. One of these ways in

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<sup>12</sup> Such as the new regulations on foreign portfolio investment which are interpreted to be a precursor to removal of controls.

which this occurs is through securitisation. Securitisation is a process by which illiquid assets such as cash flows and connected contract rights are pooled and repackaged into marketable instruments representing claims against the asset pool. The securities are then sold on the third parties. The third party purchaser is often an institution, such as an insurer. The process is advantageous to banks as it means that these assets are removed from their balance sheets, which helps improve capital adequacy ratios and estimates of return on assets. The associated credit risk may now, however, shift to an industry where credit risk is not regulated, at least not in the same way. While the risk has shifted, it has not dissipated. Since this risk now resides in an environment that is not regulated as closely as banks, there's no saying when it might erupt. Securitisation has a tendency to provide cheaper credit for investment grade companies, but not necessarily other companies, and it has been suggested that the Basel II approach reduces the pressure for securitisation of the best assets – as the capital charge is lower. This implicitly means that it may enhance the tendency for securitisation of the poorer quality credits. The extent to which this type of securitisation will find market demand remains to be seen. The increased level of integration within the financial industries, together with a tendency to shift risk, provides grist to the mill of those advocating a single financial regulator.

## 8 Conclusion

The financial sector is a vital service sector in the South African economy, in terms of size and growth. However, it is not in itself a generator of increased employment. It does however, have the capacity to encourage employment in other sectors, to the extent that it influences economic growth positively. The capacity of the banking and insurance industries and securities market to provide finance and funding for businesses exists. The question is whether or not it is leveraged in a socially acceptable way. Banks are conscious of the need to generate profits for their shareholders and of the need to maintain a sophisticated, world- class appearance. This sometime appears to be at odds with the desire of small entrepreneurs to expand their businesses through banking finance, for example. While the debate of whether banks provide sufficient finance for small businesses is ongoing, it is apparent that there are obstacles to assessment of creditworthiness, which need to be addressed.

As to the provision of services for the majority of South Africans, there now appears to be widespread acceptance that more must be done. It is in this arena that regulation will prove to be crucial, even given favourable technology and a buoyant economy. Without a true commitment to improve contestability in the low end of the market (which will involve providing better access of new entrants to the payments system) provision of services to the low end of the market is likely to be ghetto-ised. It is not sufficient to have improvement in ownership of equity in this sector. Improved access to the means by which South Africans can manage their present and future is key to better distributing the fruits of economic growth. In a world of many pressures, including greater corporate and social governance requirements, better disclosure and more foreign competition, this remains a crucial and outstanding challenge to the sector.



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## 9.2 Interviews

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