Transforming the financial sector to make it serve SA better and be Transformative

Presentation to the Standing Committee on Finance

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Update on financial sector transformation since 2017 hearings

- **National Treasury welcomes the hearing on transformation in the financial sector, and presents a slightly updated presentation to our presentation (given that this is the first presentation to the committee on financial sector)**
- Previous SCOF/PCTI had extensive hearings on transformation in parallel with process for considering the twin peaks regulatory reform Fin Sector Regulation Bill
- Report adopted in late 2017, contained a number of recommendations, including need for a Financial Sector Summit in 2018
- Financial Sector Transformation Council currently working to update the Financial Sector Code targets
  - Financial sector needs higher standards for transformation than the generic BEE legislation requires
- Impact of slow economic growth the last few years and of state capture have had an adverse effect on mass-based transformation

Questions posed in 2017 presentation still relevant

- *Why have current transformation initiatives not been as successful as required, after 20 years of freedom?*
- Economic transformation, de-racialisation and reducing inequality critical for political stability
- Priority for Treasury is mass-based and sustainable transformation rather than for a few
  - Some tax incentives to promote empowerment and ESOPs
  - The financial sector must work for ALL South Africans
  - Need to generate more asset wealth for more South Africans
- Current BEE framework needs to be updated to address weaknesses, taking into account the following:
  - What do we mean by transformation?
  - How does the financial sector differ from other sectors?

Regulatory framework for the financial sector

National Treasury strongly supports interventions to the financial sector to serve South Africa better

Policy proposals are contained in *A safer financial sector to serve South Africa better* – mutually reinforcing

Financial Stability	Consumer Protection	Access to financial services	Combating financial crime
SARB to lead	FSB and NCR to lead	Treasury to lead	Enforcement agencies to lead
FSOC	New market conduct regulator, Conduct of Financial Institutions Act	**Support to Co-ops and dedicated banks, including Postbank; microinsurance**	Investigating and prosecuting abuses
		From access to usage	Continued work with international peers

NT multi-pronged approach to transformation

FSC commitments

- Ownership
- Management control and employment equity
- Procurement
- Enterprise development
- Access to Fin. Services
- Skills development
- Empowerment financing
- CSI and socio-economic development

Market Conduct

- Reduced Fees
- More appropriate products
- The right to complain, ombud system
- Financial Literacy

Market Development

- Dedicated banks
- Postbank
- Cooperative banks
- Micro- Insurance
- SMMEs

Financial Inclusion

- Deepening financial inclusion for individuals
- Extending access to credit for SMEs
- Financial inclusion as transformation tool

Key questions for financial sector transformation raised in 2017 still apply

- Potential for conflict between above objectives, and lessons learnt from 2008 Global Financial Crisis (GFC), led to the adoption of the Twin Peaks regulatory framework.

- Meaningful 'transformation' of the financial sector is not merely a question of ownership of financial firms, but how the sector supports real economic activity?
  - What services are provided to consumers? (Access/Inclusion, lower charges, more appropriate products)
  - Who owns the firms that manage the assets? How sensitive are they to our country's needs and challenges?
  - How are the assets in the system put to use? (Procurement, empowerment financing, socio-economic development)
  - Who decides how those assets are invested / put to use? (Management control, employment equity and skills development)

How is the financial sector different to other sectors?

- The financial sector acts as an "intermediary"
  - Mobilises savings
  - Allocates credit
  - Provides payment services
  - Facilitates trade

- In South African context, access to finance and financial services are key to achieve economic and social transformation

- Funds controlled by the financial sector ultimately belong to customers, and financial firms are merely custodians of other peoples' money. Hence govt has to regulate:
  - Safety and soundness of financial firms (prudential regulation),
  - That firms treat their customers fairly (market conduct regulation).
  - Financial stability risks, to reduce bailing out banks by taxpayers (fiscus) (taxpayers) as 2008 GFC

Financial sector comprises banks and non-banks

- South Africa's <u>financial sector is large and sophisticated</u>, consisting of banking and non-banks (insurers, pension funds, unit trusts, CIS)

- Financial sector assets make up three times GDP
  - The ratio exceeds most emerging market economies
  - Banking assets comprise over 100% of GDP

- Non-banks account for about two thirds of financial assets, also unusually large for an emerging market
  - Pension funds assets of also exceed GDP, almost equal to banking
  - Long-term insurers (mostly life) hold most of insurance assets or about two-thirds of GDP, with only a small share for short-term insurers (nonlife)
  - Unit trusts or CISs, the fastest growing segment in the financial sector, hold assets of nearly half of GDP.

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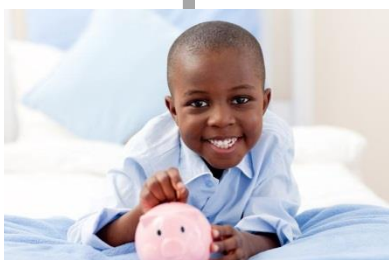
The financial sector connects savers to borrowers and facilitates economic growth (1)

Banks

Insurance companies

Pension Funds etc.

Asset Management Companies



Savers
1) Businesses
2) Households
3) Government

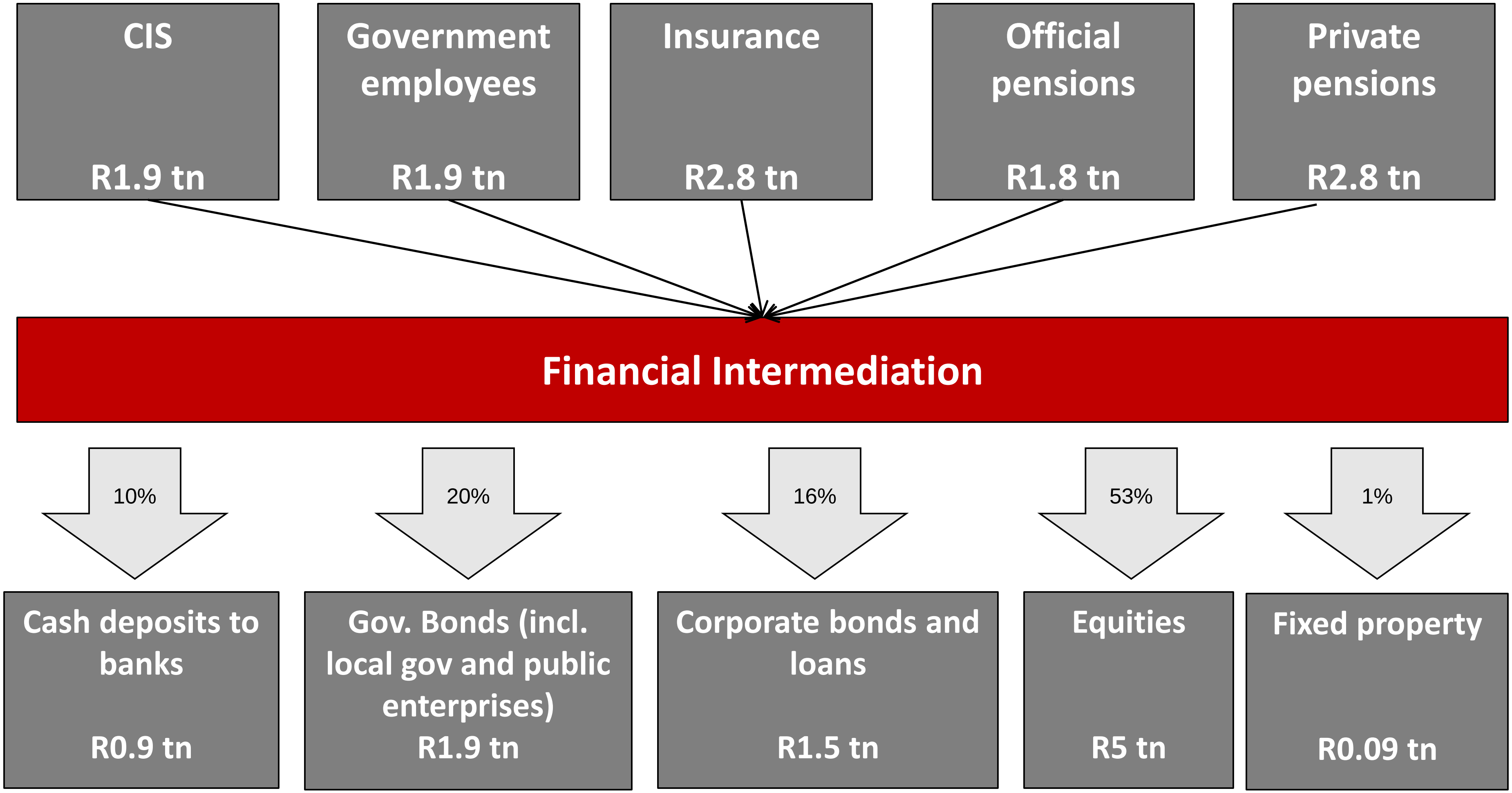
Financial Markets
(debt / equity)

Borrowers
1) Businesses
2) Households
3) Government

Investment banks

Brokerage firms

The financial sector connects savers to borrowers and facilitates economic growth (2)



Structure of the financial sector (as at end 2015)

	Number of companies	Assets of sector
Banks	55 — 10 locally controlled 6 foreign controlled 36 Foreign bank reps 3 mutual	R4.87 trillion*
Long-term Insurers (life)	82	R 2.58 trillion*
Short-term Insurers (non-life)	99	R 0.12 trillion*
Pension Funds	5150 (incl. GEPF and official funds)	R 4.04 trillion*
Collective Investment Schemes	1284	R1.953 trillion**
Asset Managers	130	Manage on behalf of sector

** End 2015 ** end 2014*

Further detail in Annexure

What do we mean by transformation in financial sector?

- A de-racialised financial sector reflected by:
  - Ownership and management more reflective of black South Africans
  - Enterprise development and procurement of services involving black households and businesses
  - Access and inclusion of black households & <u>effective usage</u> of financial services
  - Promoting asset wealth of black households
  - Providing better access to funding for small businesses
- Developmental and competitive objectives
  - Funding infrastructure and capital projects that promote growth and jobs
  - Ensuring a more competitive and less concentrated financial sector
- Ensuring <u>impact of transformation is transformative</u>, meaning a <u>financial sector that works for all South Africans</u>, helping South Africans to save, borrow, insure, transact

A holistic response is required

- To truly transform the financial sector in SA, a significantly higher savings rate be achieved. This can only happen when the economy grows in an inclusive manner, and at a higher rate.

- Together with broad structural reforms in the economy, ie more inclusive growth and broad-based benefits (higher per-capital growth - GDP growth exceeding population growth), SA savings levels will increase and create space for growth by domestic financial institutions.

- With well functioning regulatory oversight by all key stakeholders, greater influence on the "orientation" of financial institutions towards "financial transformation" can be exercised, as the gap between domestic savings and investment narrows, and reliance on foreign savings/presence of foreign financial institutions in SA economy diminishes.

Do FSC targets give effect to transformation objectives?

- Key question is whether the FSC gives effect to transformation objectives?
  - Are the targets set in FSC the right targets to ensure transformation?
  - Is the FSC succeeding in transforming the financial sector or not?
  - Are targets ambitious enough?
  - What could be refined?
- Breakdown within FSC btw 2008 and 2012 has affected the process of setting appropriate targets
- Examples of more specific or refined targets
  - Unsecured credit targets has resulted in household over-indebtedness, and needs to be refined to focus on more productive use of credit
  - Procurement in short-term insurance could be more inclusive
  - Asset management industry needs to transform more than any other subsector in the financial sector

How can we also ensure that current BEE codes are sharpened to give effect to mass-based transformation?

- Similar review of targets in BEE codes also necessary
  - Are the current BEE codes sufficient to cover all transformation objectives?
    - Current BEE regulations do not cover financial inclusion and access
    - How do the codes encourage asset wealth (free of debt!)?
  - Do BEE codes do enough to promote inclusive growth and mass-based transformation?
  - BEE codes need to protect (and in fact benefit) members of retirement funds who lose share every time there is a new BEE deal
- 2008 Global Financial Crisis categorises major banks and insurers as SIFIs (systemically important financial institutions) and imposes higher capital requirements
  - BEE Codes need to take better account of regulatory requirements
- Is the current BEE funding model used by many major companies sustainable?
  - Is it really sustainable to expect dividends to grow more rapidly than loans?
  - What happens with low growth and rising interest rates?

Structural challenges to ownership transformation in listed companies

- How do we ensure that the black ownership is less geared, and rising, and more broad based (including ESOPs for employees)?
- Direct ownership is limited to around 30% for most JSE companies
  - 10% black owned, so 20% non-black owned
  - Data does not say how much of the 10% is borrowed or geared
- Lack of savings in SA means that we rely on foreign savings to invest in or buy shares in SA domiciled companies, so foreign ownership around 37% (can go up to 50% of more when growth is higher, or for inward listed companies)
- Most ownership is institutional, so domestic institutional closer to 30%
  - BEE codes need to ensure that they do not make black members of retirement funds pay for new BEE deals
- Multi-national companies may be less flexible on ownership shares, consider JVs and non-ownership targets e.g. enterprise development, exco/senior management, staff profile (China example)

Factors to consider in transforming financial sector

- Regulatory obligations, Twin Peaks brings flexibility
  - Capital requirements applicable to banks & insurers
  - Fit and proper / qualification requirements
  - Anti-money laundering KYC compliance requirements
  - Require a proportionate, risk based and enabling regulatory framework for smaller firms
- Non-regulatory obligations as financial institutions are custodians of other peoples money
  - “Gate-keepers” asset consultants who direct investment to established businesses
  - Insurers not in sufficient control of procurement spend – outsourced to brokers e.g. separate panels for motor body repairers
- Enforcement of BEE codes and FSC targets: stronger role of the regulators at the cold-face?

Why are bank BEE deals different?

- Banks are regulated INTRUSIVELY, INTENSELY and EFFECTIVELY
- Banks are different from both other sectors of the economy and with rest of financial sector
  - A significant shareholder cannot buy banking shares by borrowing from another bank (need UNENCUMBERED CAPITAL)
  - Banks get their capital from equity (shareholders) to safeguard against losses
  - What banks lend out they obtain from depositors and bond holders
- Banks and State are interconnected, as they are biggest buyers of sovereign bonds, which they need for their regulated capital (Basel 3)
    - Greek crisis due to sovereign downgrade caused banking risk
    - EU banking risk caused sovereign risks and country downgrades
- Failure of a major bank has domino effect and causes other banks to fail, causing depression/recession in the economy, and massive loss of jobs (SIFIs)

How are bank BEE deals different? cont

- Traditional BEE funding model is to fund a BEE deal through future dividends which fund a company loan against such dividends
- A significant shareholder (or more than 15%) ideally needs to fund such shares with hard cash, that is not borrowed
- If bank fails, shareholders lose their capital and have to put in more capital to maintain their share.
  - In addition, bond holders who lend to a bank so that the bank can on lend to others lose their loans (junior, senior debt)
- Both banking and insurance have regulated capital, and this must be taken into account for ownership targets in BEE deals

- **Taking these factors into account requires innovative solutions to support black ownership in the financial sector**

Options to accelerate transformation of the financial sector

Use current state owned institutions to address market failings
- E.g. expand the risks covered by SASRIA

Government support for a large new black owned co.
- New /merger of smaller banks?

Introduction of additional State owned financial institutions
- But case not clear

Broaden ownership of current state owned institutions

State-led solutions

Market-orientated solutions

Enforced transformation of current market participants
- Rejuvenate the FSC process
- Strengthen current FSC requirements
- But problems discussed above

Using Government as a large customer to promote transformation
- E.g. PIC has an incubation programme and directs funds to emerging asset managers

Introduction of more black-owned participants
- Address regulatory and non-regulatory barriers

Proposed market development framework for banks

SA has developed a tiered banking system to allow for new entrants with proportional regulatory requirements:

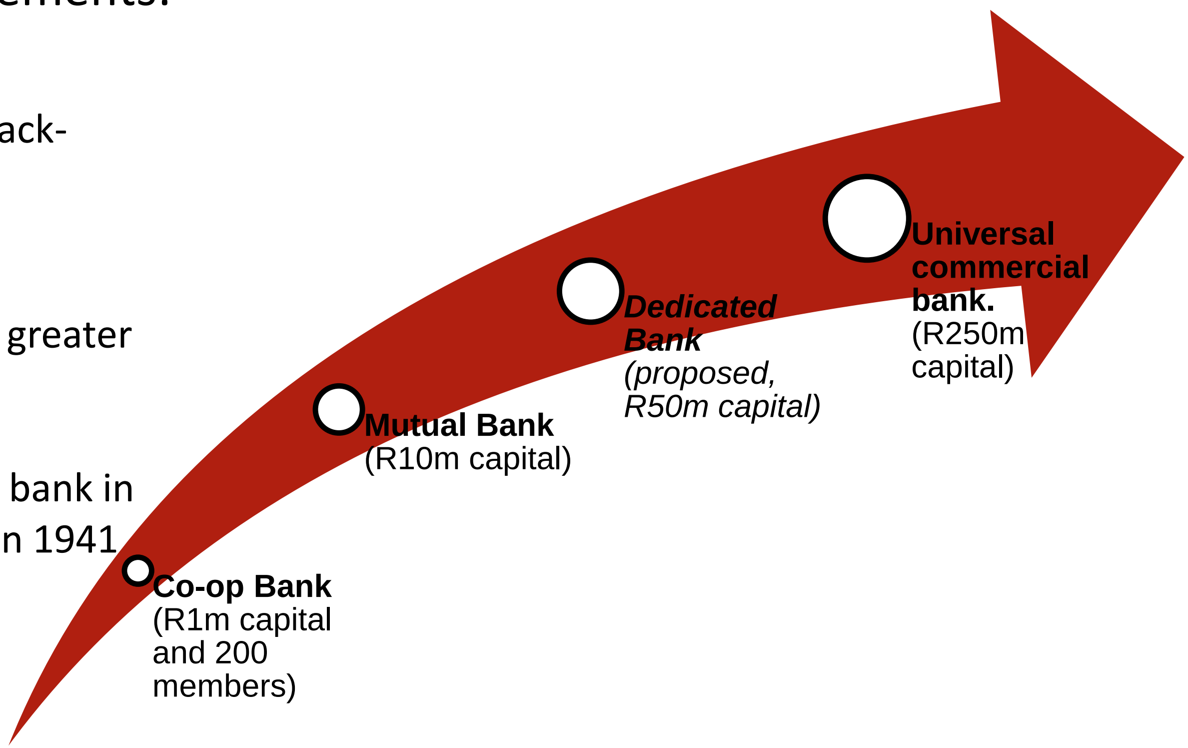
The banking sector remains highly concentrated – how to bring in new black-owned contester?

To facilitate more competition NT has introduced increased tiers to allow for greater participation

Volkskas Bank began as a co-operative bank in 1934 and became a commercial bank in 1941 and forms basis of ABSA.

Previous example VBS Bank.

Extend role of CBDA? Role of microinsurers?



Financial Inclusion Policy proposals

Pillar 1 - Deepening financial inclusion for individuals

Most South Africans already financially served, focus on usage and quality

Projects:

- Increasing financial inclusion impact of social grant distribution
- Improving savings through a low-value savings scheme
- Improving beneficial use of acquired bank accounts, appropriate insurance products
- Improving the appropriate use of credit
- Improving housing finance
- Recourse mechanisms, client onboarding, financial education

Pillar 2 - Extending access to SMEs

Finance for SMMEs important for growth, but severely constrained

Projects:

Promote access to credit

- Improve credit infrastructure
- Credit information sharing
- Data-based credit scoring
  - Shift away from collateral based lending to data-based lending
- Partial credit guarantee schemes
- Movable asset register

Other

- Appropriate insurance products for SMEs
- The use of a bank account and payment services

Pillar 3 - Financial inclusion as transformation tool

Diversification of the financial sector

Projects:

- Use of agents in the provision of financial services
- Role of state vs private banks
- Role of cooperative development banks/dedicated banks
- Promoting youth development and women
- Enabling smaller community based providers
  - Funeral parlours
  - Burial societies
  - Stokvels

Financial Sector Regulation – Legislation – Transformation Plan a requirement

- **Financial Sector Regulation Act**
- Clause 7 – Object of Act
- "the object of this Act is to achieve a stable financial system……………by establishing in conjuction with the specific financial sector laws, a regulatory and supervisory framework that promotes………f) **Financial inclusion g) Transformation of the Financial Sector**
- **Insurance Act**
- Clause 3 – Object of Act
- " The objective of this Act is to in a manner consistent with the Constitution of the Republic promote the maintenance of a fair, safe and stable insurance market ……………..by establishing a legal framework for the prudential regulation and supervision of insurers and insurance groups that …………c**) increase access to insurance for all South Africans d) Promotes broad-based transformation of the insurance sector**
- **Clause 22 (1) – Requirements for Licence**

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Financial Sector Regulation – Legislation – Transformation a requirement

- **COFI Bill (proposed clauses)**
- Chapter 3: Culture and Governance - **Section 30**
- A financial sector must promote transformation in a manner reasonably consistent with its transformation plan
- **Section 38**
- If a financial institution is subject to or has undertaken to comply with the requirements of the BBBEE Act, and the Financial Sector Code issued in terms of Section 9 (1) of that Act, it must have a plan in place to meet its commitments in terms of promoting transformation of the financial sector in line with those requirements
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Financial Sector Regulation – Legislation – Transformation a requirement

- **<u>NPS Bill (Proposed clauses)</u>**
- **Clause 3 – Object of Act**
- **Section 2 (secondary objective)** In addition the regulatory, supervisory and oversight framework that is established by this Act seeks to support –
- b) Financial Inclusion
- c) Transformation
- **Clause 4: Requirements for licensing**
- "to qualify for licensing an applicant must demonstrate to the satisfaction of the SARB that it has a plan to meet its stated commitments in terms of <u>Transformation of the financial sector,</u> including meeting the targets envisaged by the <u>Financial sector</u>

Conclusion

- Financial sector and and must do more to transform and be transformative
- Lack of economic growth and state capture have adversely affected the pace of transformation in the financial sector
- Some sub-sectors like asset management need to do more than others as they have made little progress in transforming
- FSTC currently reviewing and sharpening targets in the current code
- BEE Codes need to take account of
  - Regulatory obligations and specific challenges like SIFIs
  - Mass-based transformation objectives like access and inclusion
  - Debt-free asset wealth for the majority of SA

Thank you

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