Financial Inclusion and the Linkages to Stability, Integrity and Protection: Insights from the South African Experience

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GLOSSARY OF ACRONYMS AND TERMS USED IN THE REPORT

AFI	Alliance for Financial Inclusion
AML-CFT	Anti-Money Laundering and Combating the Financing of Terrorism
AMPS	All-Media & Products Survey
BCBS	Basle Committee on Banking Supervision
BFA	Bankable Frontier Associates
CFI	Cooperative Financial Institution
CMA	Common Monetary Area (South Africa and certain surrounding countries)
CPSS	Committee on Payment and Settlement Systems
FATF	Financial Action Task Force
FICA	Financial Intelligence Center Act (AML-CFT Law)
FinScope	Nationally representative survey of financial service access, usage and attitudes
FSB	Financial Stability Board
FSC	Financial Sector Charter
GPFI	Global Partnership for Financial Inclusion
KYC	Know Your Customer
IADI	International Association of Deposit Insurers
IAIS	International Association of Insurance Supervisors
I-SIP	Acronym used in this paper which stands for the addition of financial inclusion to the objectives of financial stability, financial integrity and consumer protection.
LSM	Living standard measure (local segmentation metric based on observables)
MCCO	Mutual, Cooperative and Community based organization (IAIS term)
ML-TF	Money laundering and terrorist financing
Mzansi	The brand name for the category of basic bank accounts launched in 2004
Nedlac	National Economic Development and Labour Council
NCR	National Credit Regulator
SACCO	Savings and Credit Cooperative
SANT	South African National Treasury
SARB	South African Reserve Bank
SSB	Standard setting body
Stokvel	Local name for an informal rotating savings and credit association (ROSCA)
STR	Suspicious transaction report
WDI	World Development Indicators
ZAR	South African Rand (local currency unit)

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Executive Summary

International standard-setting bodies (SSBs) and national policy makers – including financial regulators – pursue the core objectives of financial stability, financial integrity and financial consumer protection. The G20 leaders have recognized and endorsed financial inclusion as a pillar of the global development agenda, and have called upon five global standard-setting bodies (SSBs) – the Basel Committee on Banking Supervision (BCBS), the Committee on Payment and Settlement Systems (CPSS), the Financial Action Task Force (FATF), the International Association of Deposit Insurers (IADI), and International Association of Insurance Supervisors (IAIS) – to step up their work in this area, consistent with their core mandates. At the same time, numerous countries have introduced financial inclusion as a domestic policy objective.

These advances challenge financial regulators to consider how to optimize the linkages among the four distinct policy objectives – financial inclusion (I), financial stability (S), financial integrity (I) and financial consumer protection (P) (collectively, I-SIP). There is good reason to believe that, at the level of outcomes, I-SIP objectives may be mutually reinforcing and interdependent: no long term stability without inclusion, for example, and vice versa. In practice, at the policy level, the linkages are less well known and policy makers face choices that are unnecessarily framed as tradeoffs. This report introduces and develops the concept that a proportionate approach to any financial inclusion measure (and specifically to its regulatory and supervisory design and implementation) should seek to optimize the I-SIP linkages: maximizing synergies and minimizing tradeoffs and other negative outcomes.

In an effort to build the understanding as well as the evidence base on how financial inclusion links to the other core objectives, this paper examines examples of the linkages in practice from one country: South Africa. The South African case demonstrates that considering I-SIP linkages can result in synergies in practice, although this is not always the case. It also suggests the need to change the common mindset which considers each I-SIP objective independently, rather than as a set of linkages which can be optimized in the context of the society as a whole.

In South Africa, the four I-SIP objectives are also the four pillars of national financial sector policy; and financial inclusion in various forms has been a key objective for the post-apartheid period. We selected specific examples of linkages in practice (four *ex post*; one *ex ante*) for in-depth analysis. The four *ex post* examples studied were: (i) the passage of the Cooperative Banks Act 2007 creating a new tier of regulated institution to permit formalization of existing informal providers and the establishment of new financial cooperatives, (ii) a 2004 amendment to the "know your customer" (KYC)[1] regulations that enabled banks to offer simplified "Mzansi" bank accounts for the unbanked; (iii) the commitment by banks to provide affordable housing loans, (iv) and the permitting of payroll deductions for repayment of small loans. The *ex ante* example – a new Microinsurance Policy Framework – also introduces a new tier of regulated financial institution.

[1] The term KYC is used in this report to include both KYC rules applicable specifically to banks and customer due diligence procedures applied more broadly in South Africa's AML/CFT regime.

The study sought to understand in each case: (i) whether the I-SIP linkages were considered at the time of the intervention; (ii) what was done to mitigate potential I-SIP risks; and (iii) as far as the available data allowed, what linkages have been manifest to-date. (Where data were lacking policy maker interviews informed the analysis.)

Altogether, the South African experience of linkages informs the tentative proposal of an I-SIP methodology for policy makers to apply the principle of proportionality – the balancing of risks and benefits against costs of regulation and supervision – to optimize the I-SIP linkages: i.e., maximizing synergies and minimizing tradeoffs and other negative outcomes. The I-SIP methodology is summarized in seven Guidance Statements:

The I-SIP Guidance Statements	
1.	A proportionate approach first requires inter-agency collaboration to identify the linkages between a proposed policy and I-SIP objectives, as well as with national objectives beyond I-SIP.
2.	A linkage framework is a structured approach to identify and assess the potential risks and benefits of defined policy objectives that arise in the implementation of a specific measure. A linkage framework enables linkages to be optimized, helping to avoid false or unnecessary tradeoffs between objectives and to maximize synergies among them.
3.	A clear definitional framework for financial inclusion that includes definitions at the national, policy and product levels is needed to establish priorities, to avoid both irresponsible and misguided inclusion, and to measure progress.
4.	Segmenting the market according to whether clients are currently served with formal financial services, within reach of but not using formal financial services, outside the current reach of formal financial services, or 'self-excluded' improves the understanding and calibration of the I-SIP linkages.
5.	Policy relevant data should be collected on a regular basis to calibrate linkages *ex ante* and then monitor them in practice.
6.	Structured consultation with providers in proportion to the scale of the proposed changes helps to identify and understand linkages.
7.	Optimization of I-SIP linkages requires a commitment by policy makers to adapt policy and regulation over time in light of the evidence collected and outcomes observed.

1. Introduction

International standard-setting bodies (SSBs) and national policy makers – including financial regulators – traditionally pursue the core objectives of financial stability (S), financial integrity (I) and financial consumer protection (P).[2] In 2010, the G20 leaders recognized and endorsed financial inclusion as a pillar of the global development agenda,[3] created a standing body – the Global Partnership for Financial Inclusion (GPFI) – to implement a multi-year financial inclusion action plan, and called upon the global standard-setting bodies (SSBs)[4] to step up their work on financial inclusion, consistent with their core mandates. Over the past several years, numerous countries have formally endorsed financial inclusion (I) as a domestic policy objective[5] alongside stability, integrity, and protection objectives (collectively, "I-SIP"). Financial inclusion is defined in various ways but is generally understood to involve improved effective access[6] to financial services by those who lack it.

The SSBs provide norms and guidance intended to help national regulators and policy makers achieve three traditional core objectives of stability, integrity, and protection. The outcomes of pursuing these objectives are recognized to be mutually reinforcing: a financial sector with more integrity and consumers who feel appropriately protected is more likely to be stable, for example. While the I-SIP outcomes are considered complementary, policies or interventions designed to achieve these outcomes may not be: a policymaker at national level may have to wrestle with the potential tradeoffs resulting from a policy choice without knowing what the effect will be. New approaches carry the risk of unintended consequences; but there is also the risk of accepting false or unnecessary tradeoffs. This latter risk increases when different regulatory bodies or agencies pursue one objective without an awareness of the linkages to the others; and when the objectives are difficult to define or measure.

At first, the addition of financial inclusion as a policy objective may appear to make the situation harder for national regulators to manage. Inclusion presents additional considerations since it introduces the

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[2] These terms are generally understood but have varying definitions. "Financial stability" is rarely defined but is generally understood to refer to a lack of financial instability. The term "financial integrity" is used by some to refer broadly to all financial crimes, including money laundering, terrorist financing, fraud, theft, robbery, forgery, and others. FATF uses it to refer to anti-money laundering and combating financing of terrorism (AML/CFT), as well as financing the proliferation of weapons of mass destruction. "Financial consumer protection" is primarily concerned with the market conduct of providers vis-à-vis customers. See Appendix B for the South African regulatory definitions of these three terms.

[3] Notably, in the G20 Principles for Innovative Financial Inclusion and in subsequent communiques from G20 Leader summits — most recently, at the Los Cabos Summit in May 2012.

[4] The SSBs considered in this report include the Basel Committee on Banking Supervision (BCBS), the Committee on Payment and Settlement Systems (CPSS), the Financial Action Task Force (FATF), the International Association of Deposit Insurers (IADI), and the International Association of Insurance Supervisors (IAIS).

[5] For example, more than thirty countries have signed the Maya Declaration, committing them to specific policies and targets for financial inclusion — see http://www.afi-global.org/gpf/maya-declaration.

[6] The definition in the 2011 GPFI White Paper *"Global Standard-Setting Bodies and Financial Inclusion for the Poor: Towards Proportionate Standards and Guidance"* is: "*A state in which all **working age adults** have effective access to **credit, savings, payments and insurance** from **formal** service providers. Effective access involves convenient and responsible service delivery at a cost **affordable** to the customer and **sustainable** to the provider, with the result that financially excluded customers use formal financial services rather than existing informal service options.*"

needs of new customers and providers; and it may also seem to add risk, because financial inclusion policies bring into the financial system new customers about whom there is little or no previous formal track record. However, country experiences (such as South Africa) in implementing financial inclusion policies demonstrate that a proportionate approach – i.e., balancing the risks and benefits against costs of regulation and supervision – can be used both to support financial inclusion and to optimize the I-SIP linkages: i.e., maximizing synergies and minimizing tradeoffs and other negative outcomes.

The South African experience is the basis for the tentative proposal of a methodology for policy makers to optimize the I-SIP linkages through application of the principle of proportionality. This I-SIP methodology is summarized in seven guidance statements (see Table 1).

Table 1: The I-SIP Guidance Statements	
1.	A proportionate approach first requires inter-agency collaboration to identify the linkages between a proposed policy and I-SIP objectives, as well as with national objectives beyond I-SIP.
2.	A linkage framework is a structured approach to identify and assess the potential risks and benefits of defined policy objectives that arise in the implementation of a specific measure. A linkage framework enables linkages to be optimized, helping to avoid false or unnecessary tradeoffs between objectives and to maximize synergies among them.
3.	A clear definitional framework for financial inclusion that includes definitions at the national, policy and product levels is needed to establish priorities, to avoid both irresponsible and misguided inclusion, and to measure progress.
4.	Segmenting the market according to whether clients are currently served with formal financial services, within reach of but not using formal financial services, outside the current reach of formal financial services, or 'self-excluded' improves the understanding and calibration of the I-SIP linkages.
5.	Policy relevant data should be collected on a regular basis to calibrate linkages *ex ante* and then monitor them in practice.
6.	Structured consultation with providers in proportion to the scale of the proposed changes helps to identify and understand linkages.
7.	Optimization of I-SIP linkages requires a commitment by policy makers to adapt policy and regulation over time in light of the evidence collected and outcomes observed.

2. Background

The 2011 GPFI White Paper, *"Global Standard-Setting Bodies and Financial Inclusion for the Poor: Towards Proportionate Standards and Guidance"*[7] considered how increasing financial inclusion can change the nature and level of risks to stability, integrity, and protection in an economy. To manage these risks and optimize the I-SIP linkages, the paper recommends applying the principle of proportionality — understood in G20 Principles for Innovative Financial Inclusion as the balancing of

[7] Available at http://www.gpfi.org/knowledge-bank/white-papers/global-standard-setting-bodies-and-financial-inclusion-poor

risks and benefits against costs of regulation and supervision. In practice, many of the SSBs accept this principle explicitly.[8]

In 2012, the UK Department for International Development (DFID) commissioned the Consultative Group to Assist the Poor (CGAP), a GPFI Implementing Partner, to conduct rapid research to explore the linkages among the I-SIP policy objectives in order to build a deeper understanding by examining the experiences in South Africa, a country with significant experience in crafting and implementing financial inclusion measures. The project's goal was to commence the building of understanding and evidence that can be drawn on by regulators, supervisors and the SSBs as they incorporate financial inclusion objectives into their work. In particular, the project sought to create robust, credible methodology, using South Africa as the initial frame of reference, which could be applied to a range of countries in future to deepen understanding of such linkages based on country-level experience.

This report assesses the I-SIP linkages in practice, at the policy level through the study of experience with a selection of South African policies. Some salient background on the country context is provided in Box 1 below. South Africa was chosen as the case country for a number of reasons:

- It is a member or associate member of all five SSBs most relevant to the I-SIP policy objectives, and the Financial Stability Board;
- It has more than a decade of experience in pursuing financially inclusive policies, even though financial inclusion has only been recognized as a national objective recently;
- As a result, it has designed and implemented a range of policies and measures across all parts of its financial sector;
- It has good sources of data that have tracked financial inclusion over time; and
- It was already the subject of a 2011 AFI case study on its interaction with the SSBs and the implications for financial inclusion that created an initial baseline of relevant information.

Box 1: South Africa's policy environment and I-SIP objectives

The South African National Treasury (SANT) is the ministry responsible for the stability and health of South Africa's financial sector, as well as for its integrity and level of consumer protection. Financial inclusion was first named explicitly as a national policy objective in SANT's main policy document published in 2011, called "A safer financial sector to serve South Africa better" (commonly referred to in South Africa as the 'Red Book' by virtue of the color of its cover).

The Red Book sets out SANT's four priority policy objectives (which are defined more fully in Appendix B):

1. Financial stability
2. Consumer protection and market conduct
3. Expanding access through financial inclusion
4. Combating financial crime.

These four objectives of SANT correspond directly to the I-SIP policy objectives. The Red Book also makes clear in its very first line that these policy objectives exist to support wider societal goals: "the financial services sector

[8] The proportionality principle is articulated in the BCBS' revised Basel Core Principles (2012), the IAIS' revised Insurance Core Principles (2011), and in the revised FATF Recommendations (2012).

touches the life of each and every South African. It enables economic growth, job creation, the building of vital infrastructure and sustainable development for South Africa and her people." (p.1)

The Red Book explicitly recognizes that the four objectives "interact with one another, often generating difficult decisions for the policy maker. In particular, there are multiple tradeoffs and competing objectives which must be managed." While the emphasis of the document is on managing tradeoffs, it also recognizes that there could be synergies, citing the example of how appropriate consumer protection standards prohibit excessive lending, which reinforces stability.

Although the Red Book lists financial inclusion as a priority, it does not define the term explicitly, but rather characterizes financial inclusion as being "about ensuring that all South Africans have access to financial services that encourage them to manage their money, save for the future, obtain credit and insure against unforeseen events."

In response to the objectives of the project, we sought to understand whether and if so how South African policymakers had understood and considered the I-SIP linkages as they developed policies towards financial inclusion; and what transpired thereafter. From interviews and secondary sources, we isolated a set of policy interventions that aimed to promote inclusion in South Africa over the past decade and, in one case, before that, to anchor the research in concrete initiatives and decision-making. The interventions addressed are not exhaustive, and were chosen based on the criteria described in Section 4.

Using primary source material and existing literature, the research team examined each of the chosen cases to understand how the I-SIP objectives were considered during policy development and the results thereafter. Case experts and individuals involved at the time provided significant input to the analysis. The analysis and hypotheses were substantiated and questioned through a week of interviews in South Africa (July 16-20, 2012) including officials of the National Treasury, the Reserve Bank, Financial Services Board, the National Credit Regulator, the Financial Intelligence Center, and the Banking Association of South Africa.

3. Theoretical framework for thinking about I-SIP linkages

A recent CGAP Brief (Cull, Demirguc-Kunt and Lyman 2012) surveys a growing body of cross-country research about the relationship among the I-SIP objectives. The lack of rigorous measurements of financial inclusion over time, let alone of the objectives of stability, integrity, and consumer protection, makes it hard to draw firm conclusions, but the Brief asserts that they are "inter-related and, under the right conditions, positively related. Yet failings on one dimension are likely to lead to problems on others."

This assertion reflects an increasing consensus that, at the level of outcomes, financial inclusion should reinforce the other three objectives and should in turn be reinforced by them. For example, the IAIS Application Paper on Regulation and Supervision supporting Inclusive Insurance Markets states categorically: "Financial inclusion contributes to financial stability. It is an important element in delivering fair, safe and stable financial markets in a jurisdiction. Less than fully effective inclusion can, and has, led to financial sector instability" (IAIS 2012: clause 1.11, p.7). This view is supported by hypotheses about linkages between inclusion and each of the others. Consider the following hypotheses about the *linkage from stability to inclusion*, again at the outcome level:

- Stability builds consumer trust in the financial sector as a whole, making it more likely that individuals will want to be included.
- Stability can positively impact factors (such as inflation and interest rates) that can reduce key prices, potentially making financial services more affordable to poor people.

The reverse also applies, from *inclusion to stability*:

- An inclusive financial sector will have a more diversified, stable retail deposit base which should increase systemic stability. Similarly, inclusion may improve the diversification of lenders' loan portfolio away from large borrowers, thereby reducing systemic risk.
- An inclusive financial sector is more likely to have greater political legitimacy and thereby decrease the risk of political and social instability (which in turn could lead to financial instability).
- An inclusive financial sector has the potential to enhance economic stability, which is an essential component of financial stability.

Similar pair-wise outcome linkages with financial inclusion can be posited for both *integrity* and *consumer protection*:

- Integrity is likely to promote more trust in financial institutions and the system as a whole, therefore encouraging more usage and greater levels of inclusion.
- Inclusion increases the ability to apply and enforce consumer protection norms—after all, users of informal financial services are by definition not protected.

These statements demonstrate a strong case for the ultimate alignment between the objectives of financial inclusion, stability, and protection in the long term. However, the growing body of empirical evidence to substantiate the theory is far from complete[9] and will require econometric research not addressed in this rapid research exercise.

In practice, *the risk of negative linkages certainly exists at the level of policy interventions* i.e. that one is achieved at the cost of another; or that neither is achieved in the short to medium term. *This risk is heightened when independent agencies or even departments with the same agency are responsible primarily for one objective only. As a result, interagency coordination is required if the linkages are to be understood and explored at a policy level.*

Our focus in this report is on the pair-wise linkages between financial inclusion and each of the other three (stability, integrity and protection) - not on the inter I-SIP linkages in general, which have been

[9] Cull, Demirguc-Kunt and Lyman (2012) survey the available empirical evidence on the linkage between financial inclusion and financial stability and identify gaps for attention.

considered elsewhere. Using inclusion on the horizontal axis and stability on the vertical axis as an example, Figure 1 below shows the possible combinations from such an assessment of linkages *ex ante* or *ex post*. For each objective, the linkage could be negative (i.e. a tradeoff, where the achievement of one objective negates achievement of the other), neutral (no effect) or positive (i.e. a synergy, where achievement of one supports achievement of the other objective). The tradeoff zones, shown in red below, indicate where a positive result in terms of one objective is achieved at the cost of another; whereas light green demarcates zones where one is achieved without negatively impacting another. Dark green marks the zone of complementarity, or synergy of objectives. In theory, a policy that would have no effect on either would be ineffective (in light grey) and therefore not considered further; and the same, even more so, would apply to policies located in the dark red zones where there is loss for no gain.

The matrix highlights the challenge for policymakers: creating policies that are expected to result in the positive-positive zone, or at the very least do no significant damage. It is certainly difficult to anticipate all the possible outcomes of new and complex policies. However, a proportionate approach that aims to optimize linkages (by minimizing tradeoffs and maximizing synergies) will lead to better outcomes for the increasing number of countries that have a goal of pursuing all four objectives simultaneously.

Figure 1: Possible pair-wise linkage zones *(inclusion and stability depicted)*

		Impact on financial inclusion		
		Negative	**None**	**Positive**
Impact on financial stability	**Positive**	**Stability enhancing, inclusion reducing**	**Stability without inclusion tradeoff**	**Synergy**
	None		**Ineffective policy**	**Inclusion without stability tradeoff**
	Negative	**Lose-lose**		**Inclusion enhancing, stability reducing**

Of course, this pair-wise depiction is a simplification of real world policy making. In practice, policymakers invariably have to manage more than two objectives, and they may be well beyond the I-SIP objectives alone. Moreover, I-SIP objectives may not be pursued for their own sake, but rather as enablers of broader societal end goals, such as employment generation, poverty alleviation, inequality reduction or faster economic growth.[10] Importantly, too, financial inclusion by its nature falls within the jurisdiction of multiple policy making bodies, or different arms of a unified body, at the country level and multiple SSBs at the global level, each of which may assess linkages differently.

Policy interventions intended to promote financial inclusion tend to fall into several common categories. Table 2 below lists four of these categories[11] and lists the risks that each category may present for the other I-SIP objectives. Clearly, whether those risks are in fact present in a particular case will depend on the context and the particular policy proposed; whether any such risks are material will depend on how they are managed through the implementation of a new policy.

Table 2: Inclusion policy groupings

Common categories of financial inclusion policy	Possible risk for another I-SIP objective
1. Tiering[12] of product standards (KYC as well as consumer protection) to allow new types of financial products	Tiering KYC requirements to allow for low value accounts may bring risk of smurfing, using these accounts for purposes which compromise financial integrity. Exempting products from consumer protection standards may cause arbitrage, which undermines the system and exposes vulnerable consumers to risk.
2. Tiering of regulatory requirements to allow new categories of providers	Relaxing prudential or consumer protection requirements for a new class of providers may introduce ways to arbitrage the existing tiers; and may even threaten stability as a result of large exposure between existing and new tiers which is not well understood or managed. Since the risks of the new class of entities may not be well understood by supervisors, it may be harder to oversee. Also, creating new regulatory regimes places additional pressure on supervisory capacity, distracting attention from managing potentially bigger risks.
3. Social lending	Since this lending is typically required under direct mandate or moral suasion and may also be subject to pricing controls, it may adversely affect the solvency of affected institutions.

[10] SANT Red Book connects financial inclusion to these end goals right up front, by stating why the lack of financial access matters: "Not only does this inhibit economic growth but it also keeps people trapped in poverty." p.1

[11] This is obviously not an exhaustive list but it does include some of the most common categories.

[12] "Tiering" (or introducing a new tier) refers to the establishment of a new regulatory class/categorization of products or providers subject to modified regulatory requirements. In financial inclusion, this often refers to new categories with reduced prudential and/or market conduct requirements that enable the establishment of smaller, specialized (narrow) providers or products that present less risk to the financial system. A new regulatory tier may serve as an intermediate step or pathway to a higher regulatory category.

	Underwriting standards may be lower on required loans, leading to higher than expected losses, which can compromise stability if this happens systemically.
4. Enabling innovative approaches to be applied to payment systems or distribution systems	The risks of any new approach may not be well understood by its users or by supervisors, bringing operational risk which could in the case of payment systems and distributional channels compromise integrity (e.g. use of agents for banking) or compromise systemic stability if the system is widely used. The use of new technology may also raise consumer protection challenges such as compromised PINs or fund transfer errors, and technology challenges may be heightened for first time users. Especially if usage scales fast, existing measures for protection may be inadequate.

Identifying potential risks is the first step in policymakers' ability to understand and consider any tradeoffs or synergies between I-SIP objectives. However, as we will see in case of South Africa, risks and benefits are rooted in the local policy context and must be determined for each specific policy intervention in order to optimize the linkages between financial inclusion and the other three objectives.

4. I-SIP linkages in practice: the case of South Africa

South Africa has a history of financial inclusion initiatives with leadership demonstrated by both the government and private sector. Government in the post-apartheid era has consistently aimed to increase access to financial services. Policies to achieve this aim were implemented through line ministries such as the Departments of Housing (now Human Settlements) and Trade and Industry (for small, medium and microenterprise finance). South Africa's history of racial exclusion continues to inform its application of policies such as Black Economic Empowerment to promote social and economic inclusion in ways that go beyond the international definitions of financial inclusion (which typically focus primarily on those denied access to financial services, and often on poor and/or remote communities).

A distinctive and important landmark in the South African financial sector occurred when all financial industry bodies (along with community, labor and government) signed the Financial Sector Charter in 2003. In this document, financial service providers made a voluntary commitment to achieve targets for Black Economic Empowerment and specifically, effective access to first order, or basic, financial services (as defined and measured in the Charter). The 5-year timeframe for initial targets ended in 2008 with most targets for effective access met or surpassed. The Charter was then subject to a lengthy renegotiation process, resulting in the publication of an updated Financial Sector Code. The Code was officially published for comment in March 2012, but as at 30 September 2012 has yet to be adopted. The scorecard contained in the draft Code sets new targets for geographic access, product related access, affordable housing origination, and consumer education. The Code acknowledges "financial stability and soundness of the financial sector and its capacity to facilitate domestic and international commerce is central to the successful implementation of broad based black economic empowerment."[13]

South African financial authorities' interaction with the SSBs and their standards was the subject of a 2011 AFI case study which concluded inter alia, that South Africa's financial authorities acknowledged that "the standards themselves are flexible and leave room to pursue financial inclusion."[14] SANT, the lead South African financial policy maker, adopted a set of four policy priorities in 2011 that correspond directly to the four I-SIP objectives.[15] Table 3 lists the South African financial authorities and indicates (i) how their mandates correspond to the I-SIP objectives and (ii) for each of the five SSBs and the Financial Stability Board, which authority is the primary South African representative. Appendix B explains the definitions of each of the I-SIP objectives applied by South African policy makers and regulators.

Table 3: Local financial policy making & regulatory agencies and their mandates

Local agency	SSB represent-ative	Financial inclusion	Consumer protection	Financial integrity	Financial stability	Other mandates
South African National Treasury (SANT)	FSB , IADI*	√	√	√	√	
Bank Supervision Department, South African Reserve Bank (SARB)	BCBS			√	√	
National Payment Systems Department, SARB	CPSS				√	Efficiency
Financial Intelligence Center (FIC)	FATF			√		Combatting financial crime
Financial Services Board	IAIS**	√	√	√	√	
National Credit Regulator		√	√			Promoting effective access to the credit market

Note: *IADI: SANT represents South Africa as an associate member of IADI.
** The Financial Services Board acts as representative in respect of its role as supervisor of insurance. The Financial Services Board has other functions as well.

[13] The draft Financial Sector Code is available via: http://www.fscharter.co.za/page.php?p_id=186
[14] *South Africa's engagement with the standard setting bodies and the implications for financial inclusion*, available via http://gpfi.org/knowledge-bank/case-studies/south-africa-s-engagement-standard-setting-bodies-and-implications-financial-inclusion, page 13.
[15] See Box 1 for more details.

In its "Red Book" policy document, SANT explicitly mentions the likelihood, even the expectation, that there will be tradeoffs among these objectives. This report cannot undertake a comprehensive review of all inclusion interventions in South Africa, nor does it need to. Its objective is more limited: to look at evidence of whether, and if so how, I-SIP linkages were understood and considered. To that end, we have selected a portfolio of five interventions that cover a number of dimensions:

- Together, they cover all the pair-wise linkages of inclusion to other I-SIP objectives (stability, integrity, protection);
- They demonstrate a range of anticipated and actual outcomes in terms of each linkage;
- They exemplify each of the categories of financial intervention listed in Table 2 above;
- Four of the five are *ex post*, so that it is possible to assess the outcomes at some level. One *ex ante* example is discussed as a more recent example of considering linkages in practice.

Together, this group of examples summarized in Table 4 below illustrates linkages in practice, and enables us to draw certain conclusions about how to optimize them. These initiatives have not been subject of exhaustive regulatory impact assessments, and in the development of the methodology, we have relied on a pragmatic but systematic "light-touch" approach for assessing impact. Full regulatory impact assessment is usually highly resource-intensive and not practical in all cases; our approach here was rather to consider evidence of linkages in the chosen cases through structured analysis of available information and engagement with policy makers and local experts.

Table 4: The specific intervention cases considered from South Africa

Category	Intervention	Objectives and linkages expected at the time	Observed outcomes
1. New product tiers	Change in KYC regulations to allow Mzansi basic bank account (2004)	Mzansi accounts were intended to advance financial inclusion; usage limitations were imposed on the accounts to address financial integrity concerns	Positive for inclusion and probably positive for integrity
2. New tier of institutions	a. Cooperative Banks Act (2007); b. Microinsurance framework (2011)	a. Intended primarily to advance financial inclusion b. Intended primarily to advance financial inclusion and consumer protection	a. Very limited effect so far b. Not yet in force
3. Social lending	Affordable housing lending under the Financial Sector Charter (2003→)	Intended to advance financial inclusion; but could introduce stability risk	Positive for inclusion and early indications of possible positives for stability
4. Innovations in payment & distribution methods	Payment methods for small value loans (1993-2006)	Intended to advance financial inclusion; no original anticipation of increased stability or consumer protection risk	Negative for systemic stability and consumer protection; payment innovation corrected the negative outcomes

In each case, we have sought to describe the context, intentions and nature of each particular intervention; and then to understand how the I-SIP linkages were understood and considered (to the extent that they were) in the design of the policy or intervention in question at the time by the relevant authorities. Finally, in the case of the four ex-post policy interventions, we have sought to assess the extent to which the anticipated linkages have in fact been realized based on our interviews and existing data. In Appendix A, we provide a detailed summary of the I-SIP methodology applied to the Mzansi bank account, as a representative case.

4.1 Amendment to KYC regulations to allow the basic ("Mzansi") bank accounts

What was the intervention?
In 2004, the Banking Association approached the Financial Intelligence Center (FIC) and Ministry of Finance to seek an amendment to the KYC regulations in order to enable the launch of a new class of basic bank accounts targeted at unbanked people.

What was the context?
In the Financial Sector Charter, the South African banking sector set itself the target of providing 80% of adults in lower income groups[16] with effective access to basic transactions and savings accounts by 2008. Research indicated that a majority of individuals in these segments were unbanked and had never been banked. 'Effective access' was comprehensively defined in the Charter in terms of geographic access, product features and affordability.

The country's big four retail banks (subsequently joined by the state-owned Postbank) established a working group under the auspices of the Banking Association to meet this target by collaborating to design and to launch a basic bank account with common product standards. These standards included no monthly fee, very low minimum balances, and an initially uniform set of product features thought to match the needs and affordability of the targeted segments. The new account type was branded "Mzansi" so that it could be marketed collaboratively by participating banks.

In this targeted segment, research at the time indicated that a majority of people did not have a formal verifiable address. An already existing exemption to KYC (known as Exemption 17) waived address *verification* requirements on low-risk accounts with balance and transaction limits. However, the exemption did not accommodate the debit cards (which were not restricted to domestic use but rather permitted cash withdrawal and usage in the Common Monetary Area (CMA)) and an address was still required. If the exemption were not changed, the product – which involved the issuance of a debit card with each Mzansi account to allow access to ATMs and use at point of sale devices – could not launch as a modern, mass banking product as intended and needed to reach scale.

Which linkages were identified?

[16] Defined as LSMs 1-5, which are the lowest five tiers of the conventionally-used market segmentation measure—the Living Standard Measure -- which uses observable features as a household wealth proxy.

The Mzansi initiative envisaged achieving financial inclusion on a large scale, targeting 2.2 million active new bank accounts within four years at a time when there were only 12 million banked people in the country, an increase of almost 20%. However, the requirements of card-based mass bank accounts were not contemplated in South Africa's recently passed main AML-CFT legislation, the Financial Intelligence Center Act (FICA, 2001). In addition, South Africa had joined FATF in 2003, and was as a result subject to increased scrutiny for its enforcement of AML-CFT laws. Specifically, while Exemption 17 exempted low risk accounts from the need for address verification as part of KYC procedures, it did not cater for debit card-linked products (due to their possible use outside of South Africa) and clients were still required to provide an address. Changing or widening any exemption was therefore to be carefully considered.

How were linkages optimized?
A series of meetings between the Banking Association and the FIC, mediated by SANT, highlighted the specific integrity risk concerns arising from the use of debit cards — including their ability to be used outside the country and the possibility of one client using multiple cards beneath the maximum value thresholds to avoid scrutiny. To address these concerns, banks agreed to put in place measures to restrict usage of the cards to the Rand Common Monetary Area and to ensure that an individual could open only one account of this type at any one bank (since it was impossible to enforce across banks). The FIC accepted that these measures would mitigate the risk that the accounts were used for money laundering or terrorist financing. The Minister of Finance then promulgated a revision to Exemption 17 to accommodate Mzansi (and similar products as well as Mzansi-type single transactions to allow for remittances and other payments and transfers).

What have been the outcomes since?
A formal evaluation of Mzansi accounts was undertaken in 2009 by BFA. The review process included extensive interviews with and surveys of Mzansi users and non-users, as well as gathering data from all issuing banks. The review judged Mzansi successful as a financial inclusion intervention: 72% of Mzansi accounts were opened by people who had never been banked before; and 61% of Mzansi account holders were from the targeted low income groups.[17] Though uptake in Mzansi accounts has dwindled since then and the Mzansi brand is no longer promoted, the accounts have also had a demonstration effect: banks, including Mzansi issuers, have launched their own low value accounts that take advantage of the revised Exemption 17 to meet the needs of low-income customers demonstrated in their rapid takeup of Mzansi.

The 2009 evaluation did not consider the effects on financial integrity. However, de Koker (2009) concluded (based on a study of the experience of banks, law enforcement and regulators) that, while there was some evidence that accounts opened under the exemption accounts had been abused for criminal purposes, the levels and incidence were low. Neither banks nor the FIC have gathered

[17] BFA (2009).

systematic data which would enable comparison of whether Mzansi accounts as a category have been used for money laundering or terrorist financing in ways which compromise financial integrity more than any other bank account type. However, the Banking Association said that its member banks (which are required to report suspicious transactions) had no grounds for special concern with Mzansi accounts. FIC staff indicated similarly. In fact, the Mzansi account is now cited in the 2011 FATF Guidance Paper on AML-CFT measures and financial inclusion as an example of a proportionate approach to KYC enabling a financially inclusive approach. De Koker's review concludes that the appropriately designed controls can facilitate financial inclusion while limiting the risk of criminal abuse.

It is important to note that usage levels were low:[18] 42% of Mzansi accounts at private banks had no client-initiated financial transaction within the prior twelve-month period (dormant) or had been closed. Despite a decline in active client numbers since the peak, there were 3.2 million Mzansi users in 2011. This represents one in six of the total number of adults with bank accounts (which had increased substantially overall since the launch of Mzansi in 2004). Since most of these account holders had become part of the formal banking sector for the first time, reducing the informal flows of funds, this outcome can be considered positive for the overall climate of financial integrity in the country.[19]

In the Mzansi case, a proportionate financial inclusion policy intervention, driven by identifying and mitigating possible risks of relevance to other I-SIP objectives led to a likely 'positive-positive' outcome in practice. This is not to say, however, that the inclusion-integrity linkage was fully optimized. For example, the opportunity to analyze reported suspicious transactions so as to monitor the risk to integrity of a new account class has not yet been taken as the FATF Recommendations encourage.[20]

[18] The distinction between *access* and *usage* of financial services is often material when calibrating the impact of inclusion on the I-SIP objectives (or vice versa). For example, a simple increase in access to accounts (the number of accounts opened) will have a limited effect on transparency and integrity. The majority of the gains arise from the *use* of those accounts and the ability to monitor suspicious *activity*. However, usage is difficult to measure, and often requires appropriate demand-side data that is not readily available.

[19] FATF, in its guidance on "Anti-money laundering and terrorist financing measures and Financial Inclusion" (June 2011) recognizes that "Informal, unregulated and undocumented financial services and a pervasive cash economy can generate significant money laundering and terrorist financing risks and negatively affect AML/CFT preventive, detection and investigation/prosecution efforts." Furthermore, "Promoting formal financial systems and services is therefore central to any effective and comprehensive AML/CFT regime. Financial inclusion and an effective AML/CFT regime can and should be complementary national policy objectives with mutually supportive policy goals." (p-15-16) Available via: http://www.fatf-gafi.org/media/fatf/content/images/AML%20CFT%20measures%20and%20financial%20inclusion.pdf

[20] See for example Recommendation 33; by including an account-type indicator on suspicious transaction reports or obtaining a lookup table from each bank which would enabled reported accounts to be mapped to account types so that statistics could be analyzed.

4.2 New tier of institution: Cooperative Banks Act

What was the intervention?

The Cooperative Banks Act of 2007 created a legal and regulatory framework to formalize existing member-owned financial institutions operating pursuant to various exemptions to the Banking Act and to encourage the formation of new cooperative banks. These Cooperative Financial Institutions (CFIs) included financial services cooperatives, saving and credit cooperatives (SACCOs), community banks, credit unions and village banks.

What was the context?

A 2003 study of member-based financial institutions counted 800,000 'stokvels' (informal rotating savings groups), 62 financial services cooperatives and 28 SACCOs, all of which pooled funds and used them to benefit their members.[21] These CFIs operated under a variety of exemptions to the Bank Act and were also subject to other regulatory authorities: the Registrar of Cooperatives for registration as a legal entity and the Microfinance Regulatory Council (the precursor of the National Credit Regulator) for activities as a lender.[22] CFIs were all meant to be supervised by self-regulatory bodies; however, by 2003, many of these bodies had failed or become defunct. In this context, the purpose of the Cooperative Banks Act was to:

a) "promote and advance the social and economic welfare of all South Africans by enhancing access to banking services under sustainable conditions;
b) promote the development of sustainable and responsible co-operative banks; and
c) establish an appropriate regulatory framework and regulatory institutions for co-operative banks that protect members of co-operative banks."[23]

Which linkages were identified?

As per the purposes of the Cooperative Banks Act, the policy intervention identified the soundness of financial sector cooperatives and protection of their members as objectives concurrent with financial inclusion. Stability risks to the wider financial sector were considered unlikely, although on a few occasions, the rapid growth and sudden collapse of pyramid lending schemes masquerading as CFIs had brought local unrest and social instability.

How were linkages optimized?

Formalizing a sector with hitherto largely informal oversight raises tension over the appropriate standards to set in various areas of prudential regulation. The 2010 BCBS Guidance Paper on "Microfinance Activities and the Core Principles for Effective Banking Supervision" recognized the need

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[21] ECI Africa, Third Tier Banking Report: A review of the capacity, lessons learned and way forward for member-based financial institutions in South Africa, 25 July 2003.

[22] ECI Africa, Third Tier Banking Report: A review of the capacity, lessons learned and way forward for member-based financial institutions in South Africa, 25 July 2003, p.32.

[23] Cooperative Banks Act, No.40 of 2007.

to apply a proportionate approach to the regulation and supervision of new types of depository institutions designed to address microfinance,[24] including among others: initial capital requirements,[25] capital adequacy requirements, and tailored provisioning and reserve requirements for microloans (applicable to banks with microloan portfolios as well).[26]

The new Cooperative Banks Act set the minimum capital requirement at 6 per cent of total assets whereas the sector had previously had an average well below this (2 percent over the four year period to 2008).[27] This requirement alone would make it hard for most existing institutions to be licensed under the new Act.

In addition, the Joint Supervisors Report noted that "CFIs that failed to meet the registration requirements exhibited significant weaknesses and pose risk to the restoration of confidence in member based banking." The Report identified numerous shortcomings that are being brought to the attention of the self-regulatory bodies and a capacity building unit established by SANT. CFIs that do not meet registration requirements are given time in which to make progress. To date, no CFI has been asked to wind-down.

What have been the outcomes since?
By August 2012, of the 18 eligible CFIs (with a total of 28,034 members and approximately $20 million[28] in deposits), only two (with combined deposits of around $6.15 million) had registered as cooperative banks.[29] The low number of people in newly registered entities suggests that the framework has in the four years since implementation so far had a limited effect on financial inclusion. Equally, since those eligible CFIs unable to meet registration requirements continue to operate for now, the objective of consumer protection has not yet been achieved either, though there has been some progress with regard to governance and an awareness of shortcomings.

In this case, while there was considerable research and planning in the design of the new dispensation for CFIs, the translation of objectives into regulatory standards does not yet appear to have achieved the purposes intended. A clear feedback loop that would monitor and review regulations would mitigate the risk that this case ends in the 'grey zone' of Figure 1, neither advancing inclusion nor improving consumer protection.

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[24] "Microfinance" is defined in the BCBS Guidance Paper as "the provision of financial services in limited amounts to low-income persons and small, informal businesses."
[25] The BCBS Guidance Paper notes that, taking into consideration "the limited complexity, scope and size of their operations," the initial capital requirement should be lower than for commercial banks but "high enough to discourage unviable candidates and yield a manageable number of institutions to supervise."
[26] In recognition of the need for further guidance on regulating and supervising cooperative banks and other deposit-taking institutions engaged in microfinance, the BCBS intends to issue a revised guidance paper in 2013.
[27] Combined Annual Report of the Supervisors of the Co-operative Development Agency and the South African Reserve Bank, April 1st 2010 – March 31st 2011 ("Joint Supervisors Report"), p.12.
[28] Exchange rate at date of writing: 1US$=approximately 8 ZAR.
[29] Of the 11 applications received in 2010-2011, 9 were unable to meet registration requirements.

4.3 Social lending: Affordable housing finance

What was the intervention?
Under threat of imposition of directed lending for housing, South African banks set substantial targets in the 2003 Financial Sector Charter for new affordable housing lending. These targets were accepted by government.

What was the context?
During much of the apartheid period, black South Africans were not legally permitted to own houses in urban areas. The first post-apartheid National Housing Policy set out a multi-faceted approach to reverse this legacy, including improving access to credit for housing for people who could afford it.

With housing finance still lagging in 2000, the Department of Human Settlements enacted a Home Loan and Mortgage Disclosure Act, and drafted, but then shelved, a Community Reinvestment Bill. (Both pieces of legislation were modeled on similar US laws.) The first aimed to increase pressure on banks through transparency about lending patterns; and the second to require forms of affordable home lending. Banks accepted the first, but in part to avoid the compulsion, they proposed their own targets for housing lending in the Financial Sector Charter: new affordable housing loans totaling US$5.25 billion. This target comprised less than approximately 12% of mortgage loans outstanding at the time and 3% of total banking assets of $183 billion at the end of 2003.[30]

These loans would be made for housing purposes to a specified target group: those earning monthly household income between $187 and $875 (which comprised around 4 million households, about 44% of the population at the time).[31] The income bands would be adjusted using the rate of consumer price inflation annually. This definition of this so called ‘Charter target market’ followed long discussions between banks and government preceding the Charter to define the potentially ‘bankable’ based on affordability to repay credit and other reasonable credit criteria. In particular, there was an acceptance that banks could not be held responsible for making loans to households beneath the lower income threshold: this large group of people would be assisted through government social housing subsidy schemes.

[30] Data obtained from SARB website, accessed October 2012.
[31] FinMark Trust (2010).

Mortgage lending is about more than sufficient borrower income: it also requires that the borrower meets mortgage lending criteria (in terms of age of borrower and credit record, for example) and that the home to be mortgaged is suitably valued as security. South Africa-based research institute FinMark Trust produced analysis in 2006 which applied the banks' mortgage lending criteria and information about the availability of housing stock to national survey data to establish how many households in the Charter target market would in fact qualify for mortgage loans. The access frontier[32] resulting from their analysis is shown in Figure 2 below. This showed that, while 95% of households in the defined income segment did not have mortgage loans at the time, only 21% could qualify for access to mortgage loans, and of those, only 12% (or 480,000) could be expected to be potential borrowers under the Charter program.

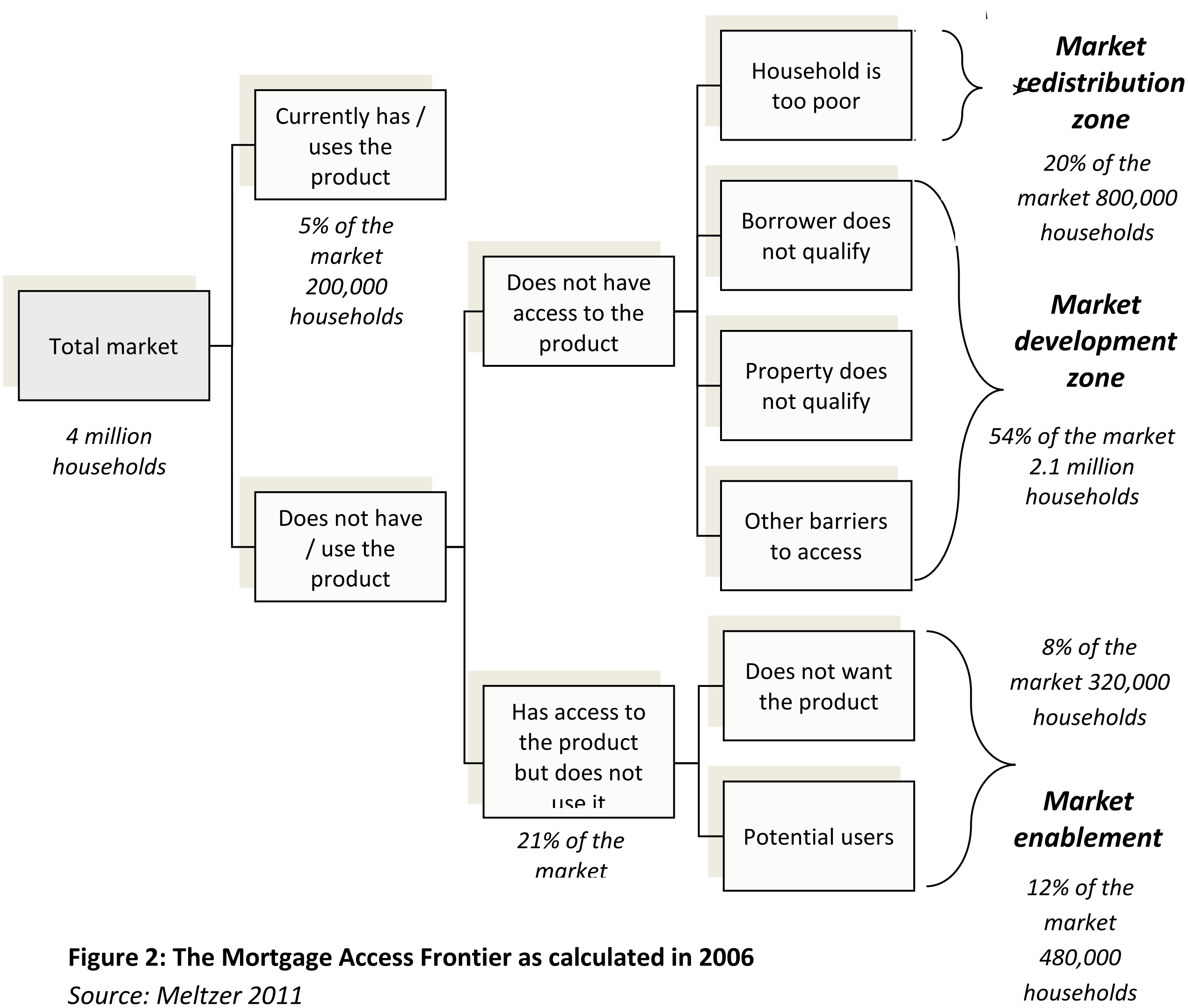

Figure 2: The Mortgage Access Frontier as calculated in 2006
Source: Meltzer 2011

[32] The more general concept of the use of access frontiers for the purpose of segmenting the population will be discussed in the next section.

Which linkages were identified?

Though risks to financial stability as the result of affordable housing exposure had been a concern for financial regulators in earlier deliberations between government and banks, this concern did not arise in the Financial Sector Charter deliberations.

How were linkages optimized?

Stability was not identified as a significant concern in the Charter deliberations mainly because banks themselves had proposed the target, which allowed the banks to align the target with their perception of the risk involved. Furthermore, this volume of lending was very small relative to total bank assets or of residential real estate loans, hence not considered systemically significant at the time. Even though there were limited stability concerns at the time, banks did express concerns about the potential higher risk profile of loans to this new market.

What have been the outcomes since?

In the five-year period to December 2008, the banks originated $3.5 billion in mortgage loans (234,638 loans).[33] The remainder of the $5.25 billion target for new lending was met through making other types of housing-related loans including loans backed by retirement fund guarantee, unsecured housing micro loans, and wholesale loans to residential developers and social housing institutions. By this time, 2.7% of all mortgage credit by value and 9.8% by volume was granted to qualifying borrowers in the Charter target market.[34] Between 2009 and 2011, a further $2.5 billion in mortgage finance was extended to the target market. This outcome was undoubtedly positive for financial inclusion. However, debates took place over the type of lending and in particular, the causes of the shortage in the supply of affordable home stock to finance, which had the effect of leading some banks to enter the residential development market to finance the building of more houses.

The outcomes from the point of view of stability are more complex. During 2009, largely as a result of the global crisis, interest rates decreased sharply in South Africa, growth declined, and job retrenchments peaked, bringing stress to the financial system as a whole. Non-performing loans peaked at 5.9% of GDP in 2009, from a five-year average of around 2% before that year.[35] Against the background of general credit stress, the relevant question here is whether the affordable home loans extended in order to meet Charter lending targets performed worse than mortgages in general, thereby exposing the financial system to more stress than could have been the case without them.

Though segmented data to perform this analysis has not yet been gathered by banks nor yet required by regulators, researchers have recently assembled a comprehensive data set that identifies Charter loans

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[33] Center for Affordable Housing Finance (2011) *Housing Finance: FSC mortgage loan performance*: Available at http://www.housingfinanceafrica.org/document/housing-finance-fsc-mortgage-loan-performance/.

[34] NCR data, Consumer Credit Market Report: Mortgages: granted – by gross monthly income of individuals

[35] World Bank World Development Indicator (WDI) data for South Africa, accessed August 2012.

and compares their credit performance to that of conventional home loans.[36] The researchers found that, after an initial period (mid-2005 to mid-2009),[37] Charter mortgage loans[38] performed on par or even slightly better than conventional loans (when measured by 90-day portfolio-in arrears) through early 2012.[39]

Even if the proportion of Charter-qualifying mortgage loans had been higher, this above-par performance suggests that affordable housing loans did not introduce additional stability risk to the South African banking sector. If the performance is sustained, it is even possible that this new market segment may have a positive (albeit small) stability outcome for the banking sector due to the increased numbers of customers served and the additional diversity in bank loan portfolios. This example also highlights how the collection of relevant data can contribute to understanding linkages and avoiding false tradeoffs. Only by collecting and analyzing data such as this is it possible to implement guidance such as 6.2 in the new FSB Principles for Sound Residential Mortgage Underwriting Practices, which encourages jurisdictions to ensure that lenders apply more conservative underwriting criteria to compensate for higher risk.[40] Presumably the converse applies — which is to remove unduly onerous requirements (and also risk premia contained in loan pricing) if expected risks are not in fact realized.

In particular, the use of segmentation approaches can help to define realistic expectations of what can be achieved through social lending targets — unrealistically high targets may lead to stability risks whether achieved (because fulfillment of the target comes with compromise of credit standards) or not achieved (because unmet expectations of politicians or public may generate unpredictable backlashes against financial institutions).

4.4 Innovations in payment methods for small value loans

What was the intervention?

The South African government as an employer took the decision to allow the deduction of unsecured small value loan repayments directly from civil servant salaries; and then withdrew the deduction facilities suddenly in 2000 following evidence of widespread over-indebtedness of borrowers. Specialized forms of electronic debit orders that provided more security to creditors than conventional

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[36] Housing Finance, FSC mortgage loan performance (Centre for Affordable Housing Finance in Africa) available via http://www.housingfinanceafrica.org/wp-content/uploads/2011/08/HF_FSC_NPLs_Aug11.pdf

[37] During this initial period, which began shortly after South Africa's microlending crisis, the main provisions of the 2005 National Credit Act came into effect (in June 2007) and home loan and mortgage disclosure regulations were adopted (in 2008).

[38] Due to lack of segmented data, it is not possible to assess if Charter housing microloans, pension-backed loans, and wholesale loans also compared as well to non-Charter loans in each category.

[39] The reasons for this higher performance (relative to non-Charter loans) during the global financial crisis may be attributable to less volatility in the affordable housing market than in higher priced property markets. It is also plausible that banks' risk management of the affordable market portfolio had improved.

[40] FSB (2012) 6.2

direct debits evolved subsequently as an alternative collection mechanism for credit and other financial services such as insurance.

What was the context?

Small value loans in South Africa were enabled by an amendment to the Usury Act exempting small value loans from interest rate caps. The policy intention at the time was to promote access to microcredit for business purposes as a means of promoting self-employment — one aspect of what would today be called a financial inclusion measure directed at an excluded group.

In fact, most of the lending under the exemption was to lower income formal sector workers who had a reliable income flow and a strong demand for credit, having been limited in their access to general formal credit under the apartheid dispensation. Various collection practices with questionable features soon evolved. Employers responded to pressure both from their employees and from lenders to accept employees' instructions to deduct loan installments from their wages or salaries. The state payroll management system, Persal, also allowed deductions for the large public service workforce. Qualified loans that could be repaid via direct salary deduction were meant to be used only for housing purposes such as home improvements. The intent of this move was again to facilitate financially inclusive credit to an excluded group. However, it soon proved impossible to enforce the policy to limit usage of the loans to housing purposes. Since the salary deduction order removed the risk of non-payment as long as the borrower remained employed (with no associated reduction in interest for this lower risk), these loans proved highly profitable. As a result, several smaller banks entered the business (which had initially been dominated by smaller non-bank lenders specializing in small value loans) and the volume of payroll deducted small value loans grew rapidly. By the end of the 1990's, there was increasing evidence of a widespread problem of over-indebtedness, especially among state employees.

Which linkages were identified?

At the time of granting salary deduction facilities, government officials did not envisage how the combination of powerful commercial incentives to lenders (created by the combination of the removal of the usury cap and with the reduction in risk through the payroll deduction) together with the pent up credit demand from an emerging middle class could lead to large scale abuse — by both lenders and borrowers.

Loans made under the exemption from the Usury Act also offered borrowers little protection.[41] Furthermore, no systemic consequences were foreseen — in large part because individual loan values were restricted (to less than $1,250) and because the early lending was led by non-deposit taking non-bank lenders specializing in small value loans. Also, there was no initial understanding of how difficult it

[41] This changed somewhat in 1999 when a revised exemption notice required that lenders register with an industry regulatory body in order to enjoy the exemption. The single industry body, the MicroFinance Regulatory Council introduced and enforced a range of rules to address bad lending practices for its members. However, it was only in 2005 that a new National Credit Act was adopted (the main provisions of which came into effect only in June 2007) introduced a new consumer protection regime applicable to credit of all types.

would be in practice to limit the use of salary-deducted loans to 'housing purposes'. In practice, this usage restriction was widely ignored by lenders and borrowers.

How were linkages optimized?

In 2000, due to concerns within the Ministry of Finance about a substantial increase in over-indebtedness of lower waged employees, Persal withdrew all salary deduction facilities for small value loans to state employees in that year, with limited warning. This sudden move was motivated by the desire to protect employees. There is no evidence that any wider consequences for the financial sector were analyzed or foreseen at the time, other than losses for non-bank lenders specializing in this business.

Lenders had to collect their outstanding loans to civil servants through more expensive and insecure traditional means. Rising bad debts eventually triggered the failure and closure of one specialized small bank early in 2002. Since this bank was the subsidiary of a large banking group, the failure did not result in loss of depositor money. However, the incident turned the market spotlight onto an independent retail bank, Saambou Bank, at the time the country's seventh largest, which also had a substantial small value loan book. After a plunge in its share price and a run on its deposits, this bank was taken into curatorship in February 2002. This was South Africa's largest single bank failure in many years, and led to the demise of the 2nd tier banking sector. Because of its relative size and extent of integration into the national payments system and wider financial markets, this failure in turn triggered a systemic banking crisis in which a run on deposits started at the fifth largest banking group. This run was stopped only when the financial authorities issued a specific guarantee of deposits in this bank.

What has been the outcome since?

Within a decade of inception, interventions with a financially inclusive intent had perverse unintended consequences: a directly negative linkage was seen in practice. However, inclusive goals were not necessarily realized either: there was certainly greater access to unsecured credit for salaried workers who had lacked it; but this was not the type of financial inclusion desired.

The Persal decision and the crisis it triggered had (as with most banking crises) numerous ramifications. First, new affordability rules were negotiated with lenders as the basis of eventually re-allowing limited salary deductions. These rules foreshadowed the broader implementation of a National Credit Act which provided consumer protection across all forms of credit (including microloans), such as requiring that lenders assess clients' ability to repay.

Secondly, the removal of salary deduction led to a scramble by lenders and technology companies to design other collection mechanisms that took advantage of the country's relatively developed payment system, including widespread use of direct debits against bank accounts instead of payroll. So-called "preferred" debit orders debited a borrower's account before any other debits were processed: a bank holding the transaction account would obviously have the advantage. This system of preference generated uncompetitive and uncertain condition for lending in which payment became a lottery. The payment regulator frowned on the practice of preference as unfair and likely to cause reputational damage to the national payment system. Finally, a revision to the National Payment Systems Act in 2006 outlawed the practice. However, before the practice became illegal, two new payment instruments were designed by the Payment Association of South Africa in consultation with a range of interested stakeholders to accommodate the underlying need for secure debit instruments: the Authorized and non-Authorized Early Debit Order.[42] These innovations allow clients to authorize debits to their accounts on a randomized, non-preferential basis inter alia for insurance premiums and loan repayments. They were first introduced in 2006 and continue to be used by financial service providers (insurers as well as banks) to collect installments and insurance premiums in a more secure manner from the borrower's bank account, regardless of the source of income. In this way, the new instruments helped to broaden the emphasis of small value credit away from its initial dependence on formal income.

In this case, the linkages were not understood or considered at the time either of allowing deductions or withdrawing them. With the benefit of hindsight, a 'test and learn' approach by Persal allowing payroll lending on restricted basis at first may have highlighted risks and demonstrated the need to enforce affordability rules (because lenders were not doing this) and to abandon the linkage to housing purposes (or else find effective means of enforcement). However, even without the testing, learning in this case did lead the payment regulator to encourage and then require the move to more a more stable, fair collection mechanism integrated into the National Payments System and under its oversight. CPSS has recently published a review of innovations in retail payments,[43] and commented on how the growing role of non-banks challenges central banks to review their own oversight frameworks and seek cooperation with other authorities to do so. The latter part of this case at least exemplifies that approach in practice.

4.5 *Ex ante* case: Proposed microinsurance legislation

What is the intervention?

In 2011, National Treasury published a policy framework for microinsurance which creates a new tier of micro-insurer. The framework is expected to lead to passage of a new law by 2014.

What is the context?

In 2003, only 11% of low-income South Africans had any formal insurance policy.[44] The most common policy type (held by most of this group) was funeral insurance. Funeral insurance provides a payout on death to cover funeral expenses that are high relative to income in poor communities. It is provided both by licensed insurers as well as by a large number of entities not licensed to offer insurance, especially funeral parlors. In addition, 30% of the population participates in informal funeral insurance

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[42] For more detail on these new innovative payment instruments, see http://www.pasa.org.za/payment_aedo.html

[43] CPSS (2012) Innovations in Retail Payments, CPSS Publication No.102, available via http://www.bis.org/publ/cpss102.htm

[44] FinScope survey 2003.

schemes called burial societies. Burial societies are an example of mutual, cooperative and other mutual community based organizations.[45]

In 2003, evidence of large scale consumer abuse in the informal funeral insurance business prompted hearings by the Parliamentary Committee on Finance, demonstrating a need for change. SANT and the Financial Services Board responded by forming a task team to propose reforms in the funeral assistance business. The Financial Sector Charter also included targets for the provision of certain insurance lines as part of first order retail financial services, including life assurance, funeral insurance, household insurance, and risk insurance. A joint SANT-Financial Services Board task team was set up in 2005 to direct the reform process. In 2006, the mandate was widened to include microinsurance more generally through aiming to create an appropriate regulatory space for insurance models that reach low-income communities.

This work of the task team led to the establishment of an inter-governmental forum to ensure alignment across government agencies; and to the publication of a discussion paper in 2008.[46] Public consultation took place in 2009/10 leading to the publication of a final policy statement in July 2011.[47] The 2011 document lists the following objectives: financial inclusion, competition and market efficiency, financial sector development, stability, consumer protection, empowerment, and SME development. At its core, the new policy framework will lead to legislation enabling the creation of stand-alone licensed microinsurers with lower capital, reporting and corporate governance and market conduct requirements than existing insurers. Other features of the proposed legislation include:

1. Allowing for composite insurance products (short term and life) but limited to risk products only (i.e. excluding savings);
2. Product regulation empowering the Financial Services Board to reject a product if it is unsuitable;
3. A cap on sums insured and one-year contract term limit.

Planned legislation would also include other consumer protection elements such as limited waiting periods, no exclusions for pre-existing conditions, enforcement of a 48-hour claim payment period and the use of plain language in contracts. Legislation to give effect to this is expected to be completed in 2012 and enacted by 2014.

Which linkages have been identified?

Linkages between the dual objectives of consumer protection and financial inclusion have been explicitly considered since deliberations started. The 2008 discussion paper identified a range of specific linkages.

[45] Porteous and Hazelhurst 2004:155.

[46] SANT (2008) The Future of MicroInsurance Regulation in South Africa, available via www.treasury.gov/za

[47] SANT (2011) The South African Microinsurance Regulatory Framework, available via http://www.fsb.co.za/insurance/Microinsurance/PolicyDocumentMicroInsurance.pdf

Although the initial concerns were about abuse in informal funeral insurance, the process has had a desire to apply proportionality by balancing inclusion on one hand and protection on the other. Policymakers have been aware that additional market conduct requirements load costs and complexity to the products, which may undermine inclusion. Specifically, market conduct regulations could shut down funeral parlors many of which are small and medium enterprises largely owned by black South Africans, a linkage to a wider policy goal of Black Economic Empowerment. In addition, the process has considered the enforceability of any new provisions, given the sheer number of new operators to which the law could apply, in considering which provisions to impose.

Given the nature of insurance operations and the relatively small scale of each expected new microinsurer, stability risk was not identified as a significant risk arising from the newly licensed entities.

How have linkages been optimized (ex ante)?

Throughout the process, there was extensive coordination across government agencies, starting with the formation of the joint SANT-Financial Services Board task team, and the establishment of the inter-government forum. A discussion paper was subject to an extensive consultation process with industry stakeholders in 2008/2009.[48] Initial readiness assessments were undertaken to assess the likely number and type of entities that would fall under the ambit of the proposed law. Although it took a considerable time (five years from formation of the task team to publication of the final policy document), this process helped to identify possible linkages and to resolve how best to address them. Further consultation will take place once the proposed legislation is introduced to the formal Parliamentary process in 2013.

Even though stability risk was not a major concern, prudential requirements have been carefully considered in order to balance keeping small insurers sound so as to protect policyholders with the objective of promoting inclusion. The lower proposed capital requirements, which can be built up over three years, support smaller players closer to the community. Still, this is balanced by the restrictions on permissible products (no long term savings products) and caps on the sum insured. It remains to be seen whether these limits prove overly restrictive on product scope. In addition, questions remain about whether market conduct and prudential regulation for microinsurance should be split, so as to allow existing insurance providers to provide microinsurance products subject to the lighter market conduct norms, but leveraging their current capital base.

In general, proportionality has been a guiding theme of the process to date. Providers will face consumer education requirements and tougher enforcement and supervision. However, certain actions have been proposed to lower costs on providers to support inclusion while the legislation is being developed (such as regulatory forbearance); and a phasing in of the regime is envisioned, with providers

[48] The Financial Services Board website lists written submissions received on the framework, as well as the attendance at 6 workshops to discuss the framework which were convened in different parts of the country. See http://www.fsb.co.za/insurance/Microinsurance/AnnexureStakeholderEngagement.pdf

closely involved through readiness assessments, capacity building, and training activities to support take-up.

What have the outcomes been?
The proposed legislation has not yet entered the Parliamentary process, nor the draft regulations published, hence no outcomes can yet be evaluated. However, the process to date has embodied intensive, if prolonged, use of evidence and consultation within government and the sector to inform the final policy. The only question is perhaps whether the process has taken too long to address the risks identified back in 2003. This observation suggests that more information or consultation is not always better either: here too, proportionality can and should guide the depth and scope.

The South African experience to date has also informed the IAIS dialog around inclusion and microinsurance, which has been summarized in recently finalized guidance on inclusive insurance markets (IAIS 2012).

4.6 Evaluating the linkages: a summary

The information available in each *ex post* case is by no means sufficient to pronounce definitive judgment on outcomes. However, it seems adequate enough to conclude that at least one, and possibly two, of the cases demonstrates evidence of *synergy* in terms of the linkages. *The Mzansi exemption revision* enabled a substantial advance in financial inclusion, and at least did not increase the risk to integrity, and may even have had positive outcomes for integrity by reducing informality and exclusion from the formal financial sector. *Affordable housing lending* which resulted in substantial credit advanced to targeted groups for a financially and socially inclusive purpose has not adversely affected stability so far and may ultimately even contribute to stability.

Certainly, no local stakeholder expressed the view that either case compromised the achievement of the linked objectives. Local debate has rather been about whether each intervention could have had even more effect on financial inclusion — what if banks had promoted Mzansi more, for example; and how to create more affordable housing stock which is mortgage-able? With hindsight, these questions suggest that optimization of linkages among I-SIP objectives could perhaps have led to even better outcomes. However, even if there was no comprehensive linkage assessment at the time, there is evidence that a proportionate approach was followed in practice.

The other two cases considered are different. The payment approaches used for small value loans in the 1990's ended in the 'lose-lose' zone of policy outcomes, at least until the reforms to the payment system law and rules from 2006 onwards addressed the risks attached to debit orders. The lending practices during the early days of the lending boom today fall outside of the currently accepted understanding of responsible lending, and indeed, responsible financial inclusion; and the severely negative stability effects, though relatively short lived, speak for themselves.

The Cooperative Banks Act raises a different issue: although it is still relatively new, it has yet to demonstrate any significant impact on financial inclusion. It has also not yet resulted in a clamp down on deposit taking activities by cooperatives previously exempt from the banking law, and this has not yet noticeably improved the protection of these consumers either. In this case, the absence of any significant outcomes suggests that initiative should be placed in the 'grey zone' of Figure 1 above, with no noticeable effect yet on either.

5 I-SIP methodology

In practice, when confronted by the issues underlying the examples presented here, South African policy makers have applied varying levels of rigor and have had different quanta of information available to be able to identify the linkages, understand them and then consider how to apply a proportionate approach to manage them. There was limited (if any) *ex ante* consideration of wider linkages for any of the examples except microinsurance, and only since 2011 has the existence of I-SIP linkages been explicitly appreciated in national policy.

With hindsight, South African policy makers' experience with the linkages and their explicit endorsement of the I-SIP objectives at the national policy level provides an opportunity to consider how linkages can be optimized methodically and consistently. What lessons can be extracted from the South African cases to help guide policy makers both in South Africa and the increasing numbers of policy makers in countries around the world who want to pursue inclusion, stability, integrity and protection goals simultaneously? We offer initial thoughts on a methodology for policy makers to use when designing and implementing financial inclusion interventions, in order to maximize the synergies and minimize the tradeoffs and other negative outcomes – in other words, *to optimize the linkages among the I-SIP policy objectives*.

The methodology stems from an acknowledgement that there are linkages between the I-SIP objectives that must be understood and considered for each new policy. Construction of a linkage framework is fundamental for policymakers to make proportional decisions about optimizing the linkages. A clear definitional framework for financial inclusion, a segmentation model, adequate policy relevant data, and private sector input are required to build a robust linkage framework that accurately assesses impact. Finally, optimization is only possible if the linkage framework is dynamic and benefits from a feedback mechanism based on new evidence as it emerges.

The following seven Guidance Statements embody our initial thinking about the I-SIP methodology for optimizing linkages. In each case, a short explanation follows the statement, together with a brief analysis of how the South African cases support the statement.

#1. A proportionate approach first requires inter-agency collaboration to identify the linkages between a proposed policy and I-SIP objectives, as well as with national objectives beyond I-SIP.

The principle of proportionality—the balancing of risks and benefits against costs of regulation and supervision—is the key to optimizing the linkages among I-SIP objectives.[49] When the objectives and the linkages go beyond the mandates of one particular agency, application of a proportionate approach requires communication and collaboration across the relevant agencies to ensure that the risks and benefits are identified and understood methodically. Identifying linkages is critical to building a robust linkage framework as suggested in Guidance Statement #2 below.

While the I-SIP objectives are the central focus of financial authorities, they do not exist for their own sake nor are they independent of wider national policy objectives and the particular domestic financial sector objectives that they support, such as increased welfare, economic development and improved efficiency. Any analysis of linkages should consider these as well. Other financial sector objectives may include promoting greater efficiency and competition in financial markets. National objectives may include empowerment for disadvantaged groups, as in South Africa, as well as job creation, poverty reduction and urban redevelopment, all of which are affected by and in turn affect the financial sector.

These linkages cannot be fully identified without collaboration across agencies, and even within departments of the same agency, which creates an understanding of discrete mandates and how they interact. Such collaboration is encouraged in Principle 6 of the G20 Principles for Innovative Financial Inclusion[50], and the identification of I-SIP and other linkages can create a practical basis for ongoing inter-agency discussion.

The cases from South Africa illustrate how pair-wise linkages were considered *ex ante* to some extent in some cases (inclusion-integrity linkages in the case of Mzansi bank accounts; inclusion-stability linkages for affordable housing lending; inclusion-consumer protection in the proposed microinsurance policy and the Cooperative Banks Act), but not at all in one (innovations in payment methods for small value loans). Some of the cases also demonstrate that *ex ante* assessment alone is not enough: rather that linkages need ongoing monitoring in practice. The need for, and extent of, coordination across agencies varied widely in these cases. The Council of Financial Regulators proposed in the 2011 Red Book is intended to help facilitate inter-agency coordination going forward.

#2. A linkage framework is a structured approach to identify and assess the potential risks and benefits of defined policy objectives that arise in the implementation of a specific measure. A linkage framework enables linkages to be optimized, helping to avoid false or unnecessary tradeoffs between objectives and to maximize synergies among them.

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[49] See G20 Principles for Innovative Financial Inclusion: “Principle 8: **Proportionality:** Build a policy and regulatory framework that is proportionate with the risks and benefits involved in such innovative products and services and is based on an understanding of the gaps and barriers in existing regulation.” http://www.gpfi.org/knowledge-bank/publications/principles-and-report-innovative-financial-inclusion

[50] G20 Principles for Innovative Financial Inclusion: “Principle 6: **Cooperation** Create an institutional environment with clear lines of accountability and coordination within government; and also encourage partnerships and direct consultation across government, business, and other stakeholders.” http://www.gpfi.org/knowledge-bank/publications/principles-and-report-innovative-financial-inclusion

A linkage framework is a structured approach to identify and assess the potential risks to the defined policy objectives that arise in the design and implementation of a proposed policy measure. The objective of using a linkage framework is to highlight the need for modifications in order to achieve the best possible outcomes for all objectives (i.e., optimization), avoiding false tradeoffs and minimizing the risk of unintended consequences. As such, a linkage framework should focus on the short and medium terms, when linkages can be actively monitored and managed, with the understanding that, when optimized, the I-SIP outcomes should be complementary in the long run. The framework should also highlight upfront the indicators needed to monitor linkages so that policy relevant data is collected as proposed in Guidance Statement #5 below.

We have sought to illustrate a linkage framework applied to one of the South African examples presented above, the Mzansi basic bank account, as a part of the application of the I-SIP methodology in Appendix A. It is not an easy process to think through all possible linkages *ex ante*, but using a framework like this does at least introduce the discipline of having to consider the key linkages—here we have used I-SIP objectives as the core set—and to calibrate the risks in terms of their likelihood and severity. The risks of financial exclusion, for example, need to be considered. Clearly, this process requires sound and seasoned judgment on the part of the policy maker applying the framework; as well as sufficient relevant information to assess the magnitude of potential impact on the I-SIP objectives. The use of a framework such as this may help policymakers by structuring the task somewhat, although ultimately, no framework can replace, but can only support, the application of sound judgment.

As mentioned before, the South African examples illustrate the need for and value of constructing a linkage framework by its absence, rather than its presence. In practice, linkages were mainly considered pair-wise, as in the tension of the inclusive intent of Mzansi accounts and the integrity concerns of KYC regulations; or the stability implications of affordable housing that were considered briefly but then dismissed. In practice, the process of designing the microinsurance policy and accompanying legislation best exemplifies this process of thorough analysis, as well as consultation with the private sector (see Guidance Statement #6 below). It has gone through many stages, and taken a considerable period of time.

#3: A clear definitional framework for financial inclusion that includes definitions at the national, policy and product levels is needed to establish priorities, to avoid both irresponsible and misguided inclusion, and to measure progress.

To be applied meaningfully in the context of identifying and assessing I-SIP linkages, financial inclusion requires more than one simple national definition: to be sure, a clear official definition is a good starting point, and should be a cornerstone of financial inclusion policy, but it is seldom sufficient.[51] Most national definitions create an overall vision but are too general to guide applied decision making which

[51]As mentioned in footnote 5, the GPFI White Paper, GPFI (2011), includes a working definition of "financial inclusion" for the purposes of that paper. As with many general definitions that governments adopt as a vision for financial sector development, this working definition is not a substitute for the type of detailed, country- and product-specific definitions that would be contained in the type of definitional framework called for here. .

needs to distinguish responsible inclusion from irresponsible or misguided inclusion;[52] and also to know which of the many potential dimensions of inclusion to prioritize at particular times. A good definitional framework will build on a national definition, setting out a clear articulation of priority areas and methods for measuring performance in them. The framework should also extend to defining product standards which qualify as inclusive, although this need not be done by policymakers—it may best be done by industry bodies within a national framework. Creating such a comprehensive national definitional framework for inclusion can be a useful outcome of broad-based government commitment to financial inclusion, which includes the necessary leadership to align diverse views.[53]

South Africa currently lacks a complete formal definition of financial inclusion, although the Red Book describes certain desired attributes of inclusion, including multiple product categories and linking inclusion to other policy goals such as poverty alleviation. The absence of an applied definition of financially inclusive credit products in the early days may have made it easier for the accumulation of over-indebtedness through small value payroll loans to be accepted in the guise of financial inclusion.

In 2003, even in the absence of a full framework, industry led the Financial Sector Charter process, that developed very detailed definitions through to the product standard level for a range of products geared towards financial inclusion. Establishing these granular definitions enables a common understanding across the public and private sectors and enables clear measurement: this was shown, for example, in the detailed monitoring of active accounts which qualified under the Mzansi initiative. Similarly, the affordable housing loan was defined by income range of the borrower (the Charter target market), although as the example points out, the particular inclusion concern in housing went beyond income of borrower alone to include the geographic areas which had been historically excluded from access to housing credit.

#4: Segmenting the market according to whether clients are currently served with formal financial services, within reach of but not using formal financial services, outside the current reach of formal financial services, or 'self-excluded' improves the understanding and calibration of the I-SIP linkages.

Financial inclusion policies rest ultimately on a clear segmentation of the population into different segments reachable through different approaches. The policy relevance of each segment will vary based on a country's definitional framework for financial inclusion. However, in a financial system in which private providers play an important role, the "access frontier approach" yields one type of policy-

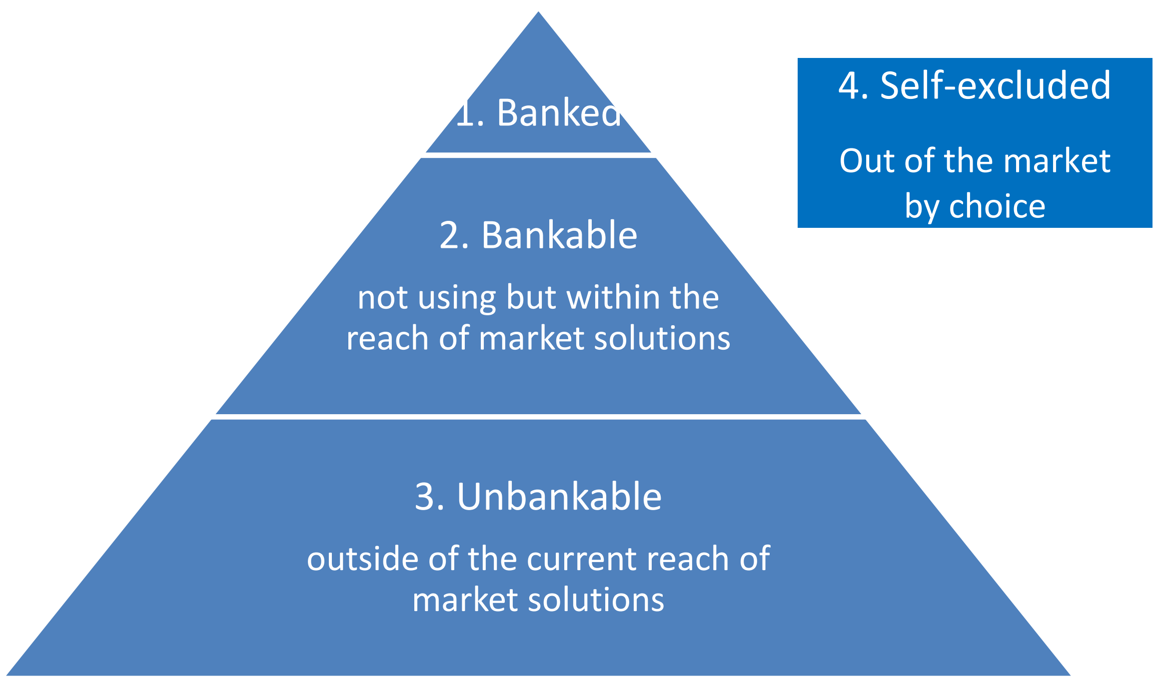
[52] For example, describing products or product features which are not considered inclusive — such as loans which do not adequately consider the affordability of borrowers which may lead to their over-indebtedness, default and exclusion from formal credit. Or adopting an excessively broad definition in terms of which products and services that are not specifically aimed at reaching the excluded inappropriately benefit from special treatment.

[53] The need for this type of role is expressed in the G20 Principles for Innovative Financial Inclusion: "Principle 1: **Leadership**: Cultivate a broad-based government commitment to financial inclusion to help alleviate poverty." http://www.gpfi.org/knowledge-bank/publications/principles-and-report-innovative-financial-inclusion

relevant segmentation. As described by Porteous (2007) and also in Beck & de la Torre (2007),[54] this approach essentially divides the population into four main segments for a given product market,[55] depicted in Figure 3 below using the market for bank accounts. The access frontier itself is the line separating the group that can be reached by *currently* available services from the group that can be reached by *potentially* available services. This line is a vector defined by the dimensions of inclusion—such as geographical access, eligibility requirements and affordability given product-pricing structure. Making a clear distinction between these segments, and understanding the characteristics of each segment, helps to map out an understanding of where a policy is calculated to have effect; and also, how large the affected group may be. Mapping the access frontier enables modeling of how much a proposed move may shift the frontier.

Even the self-excluded group, which is typically not large,[56] is important to understand, since it may contain people who were previously reached by private providers but have dropped out of the financial system for reasons which are important to understand.

Figure 3: the core access frontier segments — in the market for bank accounts



[54] Note that Beck and de la Torre use the term 'access possibility frontier' for a similar concept, which has been widely applied outside South Africa in World Bank policy documents, including most recently *Financing Africa* (2011)

[55] As now widely recognized, financial inclusion efforts should reflect the particular needs of the population being addressed. For some, this may mean that priority should be given to savings products and services; for others, the priority may be for insurance or payments and transfers or credit products.

[56] The size varies on the market in question, but this group was estimated to be around 5% of adults for transactional banking in South Africa based on survey responses (Porteous 2007).

A number of studies have calculated access frontiers for different markets in South Africa (see, for example, Figure 2 above). Of the other cases discussed here, similar exercises have been undertaken for insurance (Eighty20 2006) and for bank accounts (Porteous 2005 and 2008). For example, Porteous (2008) concluded that the Mzansi initiative had shifted the access frontier outwards, bringing a further 17% of the adult population within the reach of transaction banking; and that the application of new technology such as mobile banking could be expected to shift the frontier further in future. Measures like these can help to calibrate the potential scale of an intervention. The subsequent take-up of a product can then be monitored against its calculated potential—for example, at its height, Mzansi users made up 10% of the population, which is around two thirds of the calculated possible additional segment identified.

#5. Policy relevant data should be collected on a regular basis to calibrate linkages ex ante and then monitor them in practice.

Enabling meaningful segmentation and assembling a linkage framework requires the collation of data sets that monitor policy relevant indicators over time. Both policy-specific and nationally representative data sets should be collected. Determining which data are relevant for purposes of shaping a policy and correcting (as necessary) is a fundamental challenge for policy makers as data collection is costly and unnecessary data can be distracting. Data collection itself requires a proportionate approach that recognizes that for each policy at hand, more data is not always better. Involvement of private providers (see Guidance Statement #6 below) can be critical in identifying what data will be most useful to optimize relevant linkages.

Policy-specific data enables observation of expected short-term outcomes or the issues where potential tradeoffs of synergies were identified. Data should be appropriately segmented to observe inter alia the target client segment, product class and institution. The relevance of the distinction between access and usage of financial services should be carefully considered when assembling a policy-specific data set. For example, researchers' ability to distinguish between the performance of Charter and non-Charter mortgage loans has provided no evidence of a tradeoff to date with stability. But this research required a one-off special effort to collect the data. Measurements like these could and perhaps should become standard going forward. Similarly, the revision of Exemption 17 to enable the use of debit cards on Mzansi accounts would have benefitted from the collection and monitoring of suspicious transaction reports specifically for these accounts relative to other bank account types, and by monitoring of money laundering and terror financing convictions for Mzansi accounts, to determine whether they in fact posed a greater risk. Other outcome data collected by supervisors such as the number of cooperatives formed, the number registered and rejected help to assess the traction of the Cooperative Banks Act.

Assembling *nationally representative datasets* to monitor inclusion is time consuming and costly. However, this information is necessary to segment the market as discussed above (see Guidance Statement #4); or to calibrate the size and nature of groups affected by identified linkages as in the second guidance statement. GPFI[57] and AFI data[58] initiatives are seeking to design frameworks of relevant information for countries to collect; and more countries are now embarking on this path. In the midst of the gathering of much new data, it is important that surveys are designed to be policy relevant. However: this requires that policy makers be able to set out their requirements in terms of segmentation and linkage, and update these over time.

Databases arising from nationally representative surveys are not only important for inclusion purposes but can enrich substantially the understanding of indicators collected for other purposes — the understanding of stability for example, which is tracked in part through aggregate measures on household debt and debt service,[59] would be enriched if it were possible to identify and track these measures at significant sub-segment level over time.

For its level of income, South Africa is a relatively data-rich country. For example, credit bureaus are well established and track the individual credit records of 19.3m credit-active individuals (57% of the total adult population). The National Credit Regulator consolidates and analyzes all credit bureau data to monitor credit trends across the economy and across affected groups. This level of data availability cannot be expected in all markets. However, the task of collecting and analyzing data need not rest with regulators alone.

For example, The Bureau of Market Research at the University of South Africa now produces a quarterly Consumer Financial Vulnerability Index that combines measures of consumer vulnerability to cash flow pressure, which is also a useful indicator of credit-stress. While the country has long had established living standard-based segmentation driven by the needs of marketers and media (such as the Living Standard Measures produced from the All Media Product Survey), an independent research institute, FinMark Trust, has since 2003 managed an annual nationally representative survey of all aspects of financial inclusion, known as FinScope.[60]

Despite the relative abundance of data, South African policy makers have faced the challenge of putting these data to effective use. Whatever the level of data availability, policy makers can prioritize their data needs on the basis at least of understanding linkages within the envelope of limited resources. Creating a linkage framework is instrumental in determining and prioritizing data requirements to support a light-touch approach that draws on new and existing sources of data.

#6: Structured consultation with providers in proportion to the scale of the proposed changes helps to identify and understand linkages.

[57] See the G20's Basic Set of Financial Inclusion Indicators, which includes indicators of access to, and usage of, financial services.
http://www.gpfi.org/sites/default/files/G20%20Basic%20Set%20of%20Financial%20Inclusion%20Indicators.pdf

[58] See the work of AFI's Financial Inclusion Data Working Group in designing a Core Set of Financial Inclusion Indicators at http://www.afi-global.org/about-us/how-we-work/about-working-groups/financial-inclusion-data-working-group-fidwg

[59] The set of 40 Financial Soundness Indicators has these two indicators, I33 and I34, for households, but only at the national level.

[60] FinScope is managed by local research institute FinMark Trust. See www.finscope.co.za

Motivated and engaged providers are essential if policy interventions are to result in financial inclusion in practice. In the face of uncertainty about the nature and extent of linkages among the I-SIP objectives, consultation with providers – and in particular, those who would be critical in the implementation of a measure – helps to surface new perspectives and reduce the risk of unintended consequences. Such stakeholders can be prompted specifically to give their views on whether and if so how a proposed policy or regulation would affect the achievement of other specified objectives. To be effective, consultation has to be structured in ways which are appropriate to reach the affected group: for example, inviting only written submissions from a previously informal sector is unlikely to be adequate to give policy makers a good sense of how proposals will affect those providers.

However, as with other inputs like data above, more consultation between policy makers and the private sector is not always better: consultation carries costs in time and resources for both policy makers and providers. Effective consultation balances the cost and benefit of the appropriate level of consultation at different stages in the design cycle of a new policy.

South Africa has a strong history of multilateral consultation through formal bodies such as the National Economic Development and Labour Council (NEDLAC), established to ensure that the voices of organized labor and the more vaguely defined community constituency are heard on economic and development issues, alongside those of government and business. NEDLAC was consulted during the Financial Sector Charter process, for example, and over various housing policies. The Financial Sector Charter has its own Council comprised of directors nominated from each constituency to oversee the monitoring and achievement of Charter targets. As discussed, the proposed microinsurance framework has undergone extensive multi-phase consultation, including readiness assessments on a sample of entities that would be required to be licensed under the proposed law.

While in the past, most major pieces of financial legislation also required the appointment of an advisory committee (for example, a Standing Committee on the Banks Act or on Insurance) which included representatives from the private sector, SANT now plans to change the basis of consultation in the sector going forward and empower a Council of Regulators. It has yet to be seen whether how the absence of advisory committees will affect ongoing consultation with the private sector.

#7: Optimization of I-SIP linkages requires a commitment by policy makers to adapt policy and regulation over time in light of the evidence collected and outcomes observed.

Principle 7 of the G20 Principles for Innovative Financial Inclusion[61] encourages a 'test and learn' approach to innovation in which regulators create space by exemption or waiver or forbearance to allow experimentation on a limited scale. The 'test and learn' principle can itself be seen as an expression of

[61] G20 Principles for Innovative Financial Inclusion: "Principle 7: **Knowledge:** Utilize improved data to make evidence-based policy, measure progress, and consider an incremental "test and learn" approach by both regulators and service providers." http://www.gpfi.org/knowledge-bank/publications/principles-and-report-innovative-financial-inclusion

proportionality: on limited scale, and especially where linkages and effects are hard to foresee, there is often a good case to allow controlled experimentation.

However, this guidance statement goes further than 'test and learn' alone—not so much in widening specific windows for experimentation, but rather by expressing the notion that optimization requires an ongoing process of testing and learning, well beyond a pilot phase alone. Evidence collected through data monitoring (as per Guidance Statement #5 above) and through ongoing consultation (Guidance Statement #6) should inform a structured policy-review process whereby the changing nature of linkages can be assessed and *action taken where necessary to adapt policies*. This statement therefore recognizes the realities of the policy making world in which information may be inadequate when needed or inaccurate in practice, and in which unintended consequences may result. The practice of proportionality requires this commitment to review and ongoing adaptation. Without this adaptation, even the most carefully designed policy, which has identified and calibrated all relevant linkages *ex ante*, may over time result in unnecessary tradeoffs or the underachievement of objectives.

The South African cases considered in this report show limited application of *ex post* adaptation, although this absence highlights the cost of deferring adaption, and therefore the need for adaptation. For example, adaptation regarding electronic collection mechanisms eventually followed the collapse of payroll-based lending, but it came at a high price, after a systemic banking crisis. In the case of cooperative banks, it may be argued that the current limited experience of licensing only two banks in four-year period provides a *de facto* testing of the thresholds and requirements set. Since the expectation was that many more entities would benefit from the new legislation, the learning about the impediments in the light of changing circumstances could generate a review of which modifications are required to reach appropriate scale using this approach; or else, a reassignment of supervisory and developmental support resources elsewhere.

6 Conclusions

The South African examples demonstrate that tradeoffs among the I-SIP objectives are not inevitable. Indeed, some of the examples show that synergies *are* achievable between financial inclusion and the other three I-SIP policy objectives: stability, integrity and consumer protection. This does not mean that tradeoffs are always avoidable. However, synergies are more likely to result when the approach taken focuses consciously on the potential to optimize linkages in the pursuit of all four I-SIP objectives, as well as the other broader policy objectives to which they contribute such as economic development, increased welfare, and increased efficiency.

The South African examples also suggest that optimizing I-SIP linkages is not an easy process, and is not likely to occur without explicit attention. An approach based on the Guidance Statements comprising the I-SIP methodology may help both national level policy makers and the SSBs to translate the principle of proportionality into practice and increase the chances of maximizing synergies and minimizing tradeoffs and other negative outcomes in the pursuit of a financial inclusion agenda.

While financial inclusion policies may bring additional complexity to policy making, they also bring the benefit of introducing new lenses through which to see an economy and society, which are relevant for the achievement of other I-SIP objectives. Inclusion brings with it the recognition that policies can have different effects on different segments, and that these differential effects must be considered. In this sense, pursuing inclusion in a responsible manner (that is, by considering all the linkages) should contribute at least towards better understanding the other objectives.

For *national financial policy makers and regulators* introducing financial inclusion as a policy objective, the South African cases demonstrate that I-SIP linkages can be complementary in practice. The cases also challenge the common mindset which considers each I-SIP objective as a goal to be maximized in isolation, rather than as part of a larger whole which can be optimized: more of each objective is not necessarily better for the society as whole. Given the challenges of optimizing these linkages, the Guidance Statements above aim to provide a means of understanding this process at a more practical level.

For *international standard-setting bodies* , the I-SIP methodology illustrates how in practice the independent objectives advanced by each SSB interact in a wider whole in the context of a particular domestic policy agenda in which I-SIP objective are a subset of wider national imperatives. By introducing this wider policy perspective, the introduction of inclusion to the framework may also enhance the understanding and the achievement of each of the I-SIP objectives.

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Appendix A: Application of the I-SIP Methodology to the Mzansi case

1. Intervention proposed/ requested	**FIC was approached by the Banking Association to amend Exemption 17 of FIC Act to accommodate a new proposed basic bank account category (Mzansi)**
2. Proximate objectives proposed	The big four banks sought to achieve access targets set under the Financial Sector Charter through opening 2.2 million new basic bank accounts for transactions and savings by 2009.
3. Definitional framework	Mzansi qualifies as a first order transactional bank account under the Financial Sector Charter definition. Specifically, affordability is addressed through no balance requirement and no regular fee; and fee for use only after basic bundle of transactions.
4. **Segmentation framework**	
What are the relevant groupings?	
--Banked *(currently served with formal financial services)*	Although the banked are not the intended users of the basic bank account, they may open such accounts anyway because of lower fees; this cannibalization is a concern of the banks.
--Bankable *(within reach but not using formal financial services)*	Intended users of account type (features include low fees and core functionality to address the needs of this group); however, many in this group lack addresses that can be verified as required for debit card-linked bank accounts.
--Unbankable (i.e. outside access frontier / current reach of formal service)	May ultimately use the account since no fixed fee is charged (in which case, this product would result in a shift in the access frontier and in the definition of who is bankable; many of this group also lack addresses that can be verified)
--Self excluded	No likely effect unless the new category changes the value proposition for basic banking
5. Consultation process	
--Existing providers in the same market	Big four banks were part of the working group which designed the product; other banks were invited to join although only state-owned Postbank did.
--Potential future providers in the same market	The low fee basis may discourage other entrants from offering basic accounts, unless they are able to make money elsewhere.
6. Linkages	

I-SIP objective	**6.1 Identify potential linkages**	**6.2 Likelihood of linkage**	**6.3 Materiality if realized**	**6.4 Mitigating strategies**	**6.5 What indicators would show that the existence of a linkage**
Inclusion	The target group falls clearly in definition of financial inclusion so is linked to this objective	High	High (targets increasing % banked by 20%)	Not necessary	The number of accounts open and active

Stability	Offering this account may not be profitable and may undermine solvency of big banks More banked people may improve image of banking sector and legitimacy of banks	Low Medium	Low Medium	Not necessary	Monitoring product profit and loss from banks
Integrity	Widening the exemption to allow debit cards may encourage smurfing and undermine integrity	Medium	Low (transaction limits already set)	Only one card per person which can only be used in CMA; transaction limits	% of STRs on Mzansi accounts versus other categories of bank account # of ML /TF convictions by different categories of bank accounts
Protection	The account is targeted at formerly unbanked people who may not understand its usage Formerly unbanked people benefit from being served by institutions which are subject to banking code of practice and ombudsman	Low High	Low—simple, standard product Medium	 Ensure support for financial literacy e.g. new clients know how to contact ombudsman	% complaints or queries received by Bank Ombudsman on this category of account vs. others
How linkages were optimized: Exemption 17 was revised but with restrictions: (i) one account per customer at same bank, (ii) balance and transaction value limits imposed (if exceeded, account frozen until full KYC completed), and (iii) only usable in Common Monetary Area.					

Linkage framework: (i) *ex ante*

		Effect on inclusion		
		Negative	Neutral	Positive
Effect on integrity	Positive			
	Neutral			**X**
	Negative			

(ii) *ex post*

		Negative	Neutral	Positive
Effect on integrity	Positive			**X**
	Neutral			
	Negative			

	Effect on inclusion

Appendix B: Definitions of I-SIP objectives as applied in South Africa

Financial Inclusion

In SANT's Red Book, the National Treasury states: "Financial inclusion is about ensuring that all South Africans have access to financial services that encourage them to manage their money, save for the future, obtain credit and insure against unforeseen events." There is no further definition although financial inclusion is described as having the following desired attributes:

- "access" to individuals, households and micro, small and medium (MSMEs);
- a focus on the poor or near poor: those who are vulnerable in times of financial emergency;
- multiple financial services: savings, credit, insurance; and
- a broader welfare/impact dimension: where inclusion is linked to the benefits for the economy, including job creation, boosting economic growth, alleviating poverty, improving income distribution, and empowering women.

This general framework is further expanded by one regulator in particular: The National Credit Act of 2005 requires the National Credit Regulator to promote and monitor the development of an accessible credit market "to serve the needs of: (i) historically disadvantaged persons; (ii) low income persons and communities; and (iii) remote, isolated or low density populations and communities."[62]

Financial stability

SANT identifies financial stability as its first policy priority in the Red Book. The issue of stability is framed in the context of the recent global financial crisis, but no clear definition of stability is given. As the lead agency responsible for financial stability, the South African Reserve Bank defines financial stability as "the smooth operation of the system of financial intermediation between households, firms and the government through a range of financial institutions. Stability in the financial system would be evidenced by, first, an efficient regulatory infrastructure, second, efficient and well-developed financial markets and, third, efficient and sound financial institutions."[63]

"Financial instability, conversely, could manifest through banking failures, intense asset-price volatility or a collapse of market liquidity and, ultimately, in a disruption in the payment and settlement system. Financial instability affects the real sector due to its links to the financial sector. It has the potential to cause significant macroeconomic costs, as it interferes with production, consumption and investment and, therefore, defeats national goals of broader economic growth and development."[64]

Financial integrity

SANT defines financial integrity as combating financial crime in order to promote integrity so as to maintain (a) a sound international macroeconomic environment (b) financial stability (c) foreign investment. The aim is *"to bring transparency to the financial sector by requiring financial institutions to conduct proper due diligence with respect to their customers, and maintain customer and transaction information in records that are accessible by supervisory and investigating authorities."* The FIC and the

[62]South African National Credit Act 2005 http://www.ncr.org.za/pdfs/NATIONAL_CREDIT_ACT.pdf

[63] South African Reserve Bank Financial Stability Review (March 2012) Available via: http://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/5025/FSR%20March%202012.pdf

[64] South African Reserve Bank Financial Stability Review (March 2012) Available via: http://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/5025/FSR%20March%202012.pdf

National Treasury seem to define financial integrity as the absence of financial crime which includes, but is not limited to money laundering and terrorist financing.

Consumer financial protection
South Africa adopted a comprehensive Consumer Protection Act in 2011, outlining nine fundamental rights and providing a legal mandate for pursuing consumer protection goals, including in the realm of financial services. Previously, consumer protection in the financial sector was addressed through sectoral legislation, where for example, the responsibility for overseeing market conduct in the area of selling investment and insurance products was assigned to the Financial Services Board. In the Red Book, SANT recognizes financial consumer protection as a priority and identifies shortcomings in the retail financial sector such as "high and opaque fees and the provision of inappropriate services driven only by commissions."[65] Under the new "twin peaks" regulatory system which will be implemented in 2013, the mandate of the Financial Services Board will expand to cover market conduct regulation of banking, alongside the role of the National Credit Regulator as market conduct regulator for credit markets. The Financial Services Board's current "Treating Customers Fairly" initiative is a framework for tougher market conduct standards[66] with 6 specific desired outcomes:

1. Customers can be confident they are dealing with firms where Treating Customers Fairly is central to the corporate culture
2. Products and services marketed and sold in the retail market are designed to meet the needs of identified customer groups and are targeted accordingly
3. Customers are provided with clear information and kept appropriately informed before, during and after point of sale
4. Where advice is given, it is suitable and takes account of customer circumstances
5. Products perform as firms have led customers to expect, and service is of an acceptable standard and as they have been led to expect
6. Customers do not face unreasonable post-sale barriers imposed by firms to change product, switch providers, submit a claim or make a complaint.

Many of the Financial Services Board's "Treating Customer's Fairly" outcomes are in line with the rights enshrined in the Consumer Protection Act, making them legally enforceable.

[65] SANT (2011) *A Safer Financial Sector to Serve South Africa Better* (p.39)
[66] Financial Services Board Roadmap for Treating Customers Fairly (TCF) available via: http://www.fsb.co.za/