2022

FINANCIAL SECTOR OUTLOOK STUDY

This study reviews the South African financial landscape and describes the financial industries regulated by the Financial Sector Conduct Authority. It details developments within the different industries, the associated risks and trends observed. In addition to analysing individual industries, the report looks at macroeconomic developments and drivers of change, including the impact of the COVID-19 pandemic on the financial sector.

This report was compiled by Genesis Analytics in partnership with the Financial Sector Conduct Authority.

FSCA
Financial Sector
Conduct Authority

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List of acronyms

Acronym	Definition
AI	Artificial Intelligence
API	Application Programming Interfaces
ASISA	Association for Savings Investment South Africa
CAGR	Compound Annual Growth Rate
CBI	Contingent Business Interruption
CBR	Conduct of Business Returns
CIS	Collective Investment Schemes
COFI Bill	Conduct of Financial Institutions Bill
COP	Conference of Parties
CSD	Central Security Depository
EESE	Equity Express Securities Exchange
EFT	Electronic Fund Transfer
ESG	Environmental, Social and Governance
FAIS	Financial Advisory and Intermediary Services
FSCA	Financial Sector Conduct Authority
FSP	Financial Service Provider
FSR Act	Financial Sector Regulation Act

GEPF	Government Employment Pension Fund
GDP	Gross Domestic Product
IMF	International Monetary Fund
IFWG	Intergovernmental Fintech Working Group
IoT	Internet of Things
JSE	Johannesburg Stock Exchange
KYC	Know-Your-Customer
LTIA	Long-term Insurance Act
LSM	Living Standard Measure
MNO	Money Network operators
MSME	Micro, Small and Medium Enterprise
NAEDO	Non-Authenticated Early Debit Orders
NASDAQ	National Association of Securities Dealers Automated Quotations
NASASA	National Stokvel Association of South Africa
NDP	National Development Plan
NCA	National Credit Act
NCR	National Credit Regulator
NFC	Near Field Communications
NPLs	Non-Performing Loans
NPS	National Payment System
OSTI	Ombudsman for Short-term Insurance
OTC	Over the counter
ODPs	Over-the-counter Derivative Providers
PASA	Payment Association of South Africa
PA	Prudential Authority
PCH	Payment Clearing House
POPIA	Protection of Personal Information Act
PPRs	Policyholder Protection Rules
POS	Point of Sale
PSO	Payment System Operator
QR	Quick Response
RTP	Request to Pay
SAPO	South African Post Office
SARB	South African Reserve Bank
SASSA	South African Social Security Agency
SASRIA	South African Special Risks Insurance Association
SMEs	Small and Medium Enterprises
Strate	Share Trading Transactions Totally Electronic
TCF	Treating Customers Fairly
TCFD	Task Force on Climate-related Financial Disclosure
TPPPs	Third Party Payment Providers
USSD	Unstructured Supplementary Service Data
ZAR	South African Rand

1. Executive Summary

South Africa has a sophisticated and large financial sector with an asset to GDP ratio well above that of most emerging markets. The bulk of these assets sit in the banking sector, with pension funds and insurers holding significant assets as well. Domestic credit to the private sector as a percentage of GDP in South Africa stood at 129%, exceeding other African countries such as Egypt (27%), Nigeria (12%), Kenya (33%) and Morocco (89%). In the IMF's Article IV Staff Consultations conducted in 2019, South Africa was commended for having a highly developed and resilient financial sector.

Key highlights in this report are:

South Africa has made significant progress in expanding access to financial services, as a significant number of individuals own bank accounts, however, active usage remains low. In 2021, over 81% of South Africa's population above the age of 16 had access to a bank account. However real access to financial services remains low, demonstrated by low levels of account usage. The 2021 Finscope survey found that 40% of dormant accounts were held by individuals from low-income households and that within this segment, another 19% withdrew all funds as soon as it was deposited.

Despite the increase in new entrants in the banking sector, the market remains highly concentrated, with the largest banks holding over 85% of the industry's deposits in 2020. The banking landscape is changing as banks face increasing competition from newly-established banks, technology-enabled start-ups, and a growing number of retailers offering financial services including credit products. Three newcomers over the last four years, namely: Tyme Bank, Discovery Bank and Bank Zero have played a significant role in reducing banking fees, as well as introducing different distribution models (for example leveraging retail stores) and launching innovative value propositions for customers.

Digital adoption has been on the rise, with more customers using banking apps and online banking platforms to perform transactions. Banks have introduced banking apps and improved digital payment options and implemented next-generation ATMs that allow customers to do a wider range of transactions, with the aim to reduce the dependency on bank branches. The COVID-19 pandemic further accelerated the rate at which businesses and consumers adopted technology for transactions, particularly in the payments space where many customers preferred to transact with card over cash; and tap-and-go card transactions increased significantly.

Heightened by the increased adoption of digital platforms is the increase in risk related to digital banking fraud. The South African banking industry has seen the emergence of cybercrime at an alarming rate over the past few years. The pandemic saw large-scale move to remote working, accompanied by a rise in technical vulnerabilities related to network security and the uptake of digital banking channels by individuals as they were limited in their ability to visit a physical branch. As a result, 2020 saw a sharp increase in digital fraud incidents relative to previous years.

In July 2021, the country experienced civil unrest which resulted in significant damage to infrastructure. The banking industry incurred massive damage to infrastructure such as ATMs leading to cash shortages for consumers. Emergency measures were put in place to safeguard access, these include temporary removal of the Saswitch fees, allowing customers to withdraw cash at any ATM at no additional cost.

On average, the insurance industry has seen positive growth with a 3% CAGR in gross written premiums between 2015 and 2020. The sector caters to millions of South Africans, with nearly three in five South Africans reporting to have some type of insurance. Funeral cover is the most commonly held insurance product and inflates the number of South Africans who are insured. 42% of adults claim to have a funeral product; when excluding funeral cover, the share of South Africans with an insurance product drops to 19%.

Due to the pandemic the number of claims in long-term insurance industry increased, and the short-term insurance industry saw a rise in business interruption claims. The payments of claims have been reported to be inefficient, with a large number of individual customers and businesses reporting their insurers for failure to pay claims. Further, a number of life insurers have increased premiums on policies to cater for the increase in the risk of death, arising from the pandemic. Disclosure of changes made to a customer's policy remains an issue of concern in the industry.

With assets in excess of ZAR4,6 trillion, South Africa's retirement industry has one of the highest assets to GDP ratios in the world. Of the 5,154 funds, only about 1,580 funds, approximately 31%, are currently active. Many of the inactive funds are in the process of liquidation or cancellation, or in the process of being transferred. 927 are self-standing occupational funds and 445 are umbrella funds. Applications for liquidation increased as member contributions fell in 2020 due to the pandemic.

Coverage remains an issue in the retirement industry, given that only approximately 7 to 10 million individuals have retirement savings products out of an employed labour force of about 15 million. In the public sector, 92% of workers have a retirement product, whereas less than 50% have a retirement product in the private sector. Coverage is particularly low for individuals earning a monthly income of less than ZAR 14 000.

The industry continues to experience a huge amount of unclaimed pension fund benefits, with an estimate of over ZAR42 billion in 2020, owing to approximately five million members. The FSCA has implemented a Know-Your-Customer (KYC) directive to address the large amount of unclaimed benefits. The unclaimed benefits search engine implemented under KYC has helped over 14,000 individuals receive payments worth approximately ZAR1,2 billion.

The South African investment and asset management industry serves several million consumers and has seen steady growth in consumer numbers, investment activity and assets under management. As at 30 September 2021, the investment industry held an estimated ZAR4.26 trillion in total assets under management; 79% of the total assets under management were held by local CIS, 18% by foreign CIS, while CIS in hedge funds held 2%. While growth of the private equity sector over the last 20 years has been significant, year on year growth has been more volatile. Venture capital investment is still nascent but growing, with the majority of the funds channelled into late-stage investments

The financial advisory and intermediaries' industry stands out as the largest sector - with FSPs who render financial advice on a non-discretionary basis constituting the largest category of FAIS. A noticeable consequence of the COVID-19 pandemic was the increase in the number of lapsed FAIS licences as a number of FSPs closed down their operations in 2020. Many sole traders had to shut down due to slow business activity, and a relatively large number of smaller businesses resorted to merging as a way to share operational costs and improve their customer proposition.

Like many other sectors, investment in technology has improved efficiency in the sector. Remote working has forced advisors to adopt digital channels to connect with their customers and there has been an increase in trading platforms, which have allowed for more accessible and affordable products and services.

The financial market infrastructure sector remains largely concentrated. However, there has been an increase in competition in the last few years with four new exchanges being registered. An increase in competition is believed to enhance market efficiency by fostering innovation, improving the performance of competing firms, and lowering prices. Currently the JSE faces competition in trading costs, with A2X being reported to have trading fees that are around 50% lower than those charged on the JSE. Increase in the number of exchanges has allowed companies to adopt the dual listing option, improving their prospects of raising capital and promoting access to capital markets to a wider range of investors.

Similarly, the sector has also experienced an increase in investment in technology. Over the years the JSE has been known to allocate a significant proportion of funds in the investment in technological infrastructure. This played an important role in 2020 as it allowed the JSE to continue operating when lockdown restrictions were imposed. Likewise, Strate has been investing in blockchain technology via its partnership Nasdaq.

South Africa's credit market is highly developed and formally provides credit to almost half of the South African population, however the informal credit market remains endemic. Unregistered lenders have long been operating in South Africa and are considered to be socially embedded in lower-income communities.

Over-indebtedness remains an issue, with more than 50% of South Africa's credit-active consumers being regarded as over-indebted. Since 2009, the value of consumer credit has increased steadily as more individuals acquire credit. The number of individuals with an active credit account saw a peak in 2020 as heightened financial distress due to the COVID-19 pandemic drove an increasing number of consumers to acquire credit.

The payments sector in South Africa is well developed and compares favourably with more developed economies. The sector facilitates interoperable payment transactions between registered banks and FSPs, allowing 91% of South Africans to participate in the formal financial system. Over the past few years, the sector has experienced a rise in innovative digital payment products, such as 'scan-to-pay', 3D Secure and Chip and Pin cards.

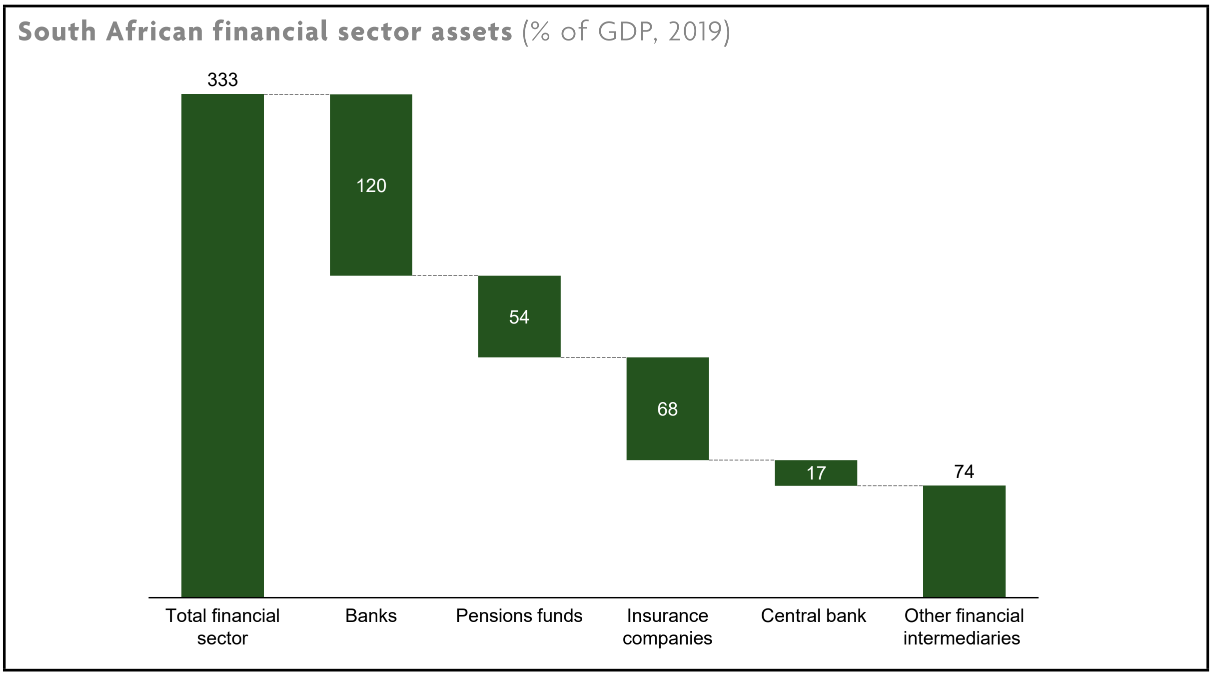
Financial institutions across the world are playing an increasingly critical role in environmental, social and governance (ESG) initiatives. In November 2021 world leaders gathered in Glasgow, for a global climate summit known as COP26 - significant outcomes from this summit included climate financing for developing countries and financing initiatives to build climate resilience of vulnerable nations. With the growing interest in sustainable financing, regulatory bodies in South Africa have been adapting the regulatory landscape to include the ESG standards in the financial sector. The National Treasury recently published the Draft Green Finance Taxonomy and based on the recommendations of stakeholders, the paper will establish technical guidance for Climate-related Financial Disclosures.

Crypto-trading has become an increasingly popular asset class in South Africa, with daily crypto asset trading in South Africa exceeding USD145 million in January 2021. Many South African investors have been attracted to the high publicised returns, however crypto assets remain highly volatile and inherently risky given their decentralised and disintermediate nature. To date, cryptocurrency platforms have been operating outside the purview of regulators, but have been considered a taxable asset. In June 2021, The Intergovernmental Fintech Working Group (IFWG), a collaboration of regulators including the FSCA, published a position paper on crypto assets and made the decision to regulate crypto assets to promote responsible innovation.

2. Introduction

South Africa has a sophisticated and large financial sector with an asset to growth domestic product (GDP) ratio well above that of most emerging markets.[1] The bulk of these assets sit in the banking industry, with pension funds and insurers holding significant assets as well (figure below). Domestic credit to the private sector as a percentage of GDP in South Africa stood at 129%, exceeding other African countries such as Egypt (27%), Nigeria (12%), Kenya (33%) and Morocco (89%).[2] In the International Monetary Fund's (IMF) Article IV Staff Consultations conducted in 2019, South Africa was commended for having a highly developed and resilient financial sector.[3]

Figure 2a: South African Financial Sector Total Assets[4]



The sector is concentrated and interconnected with the largest banks, insurers and fund managers controlling the majority of assets.[5] At the beginning of 2020 the five largest banks

1 IMF Article IV Consultation Press Release, 2019. Available here. Note: Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

2 World Bank Database, 2020. Available here.

3 IMF Article IV Consultation Press Release, 2019. Available here.

4 Statistica, 2021, Total assets of financial institutions in South Africa from 2002 to 2019, by institution type. Available here.

5 Genesis Analytics, 2017, The Impact of the Fourth Industrial Revolution on Financial Services in South Africa, Centre for Excellence in Financial Services Research Report.

held more than 85% of total banking industry assets,[6] increasing from an average of about 80% between 1994 and 2002.[7] However, the sector remains stable and the South African Reserve Bank (SARB) actively monitors the degree of interconnectedness from a financial stability perspective.[8]

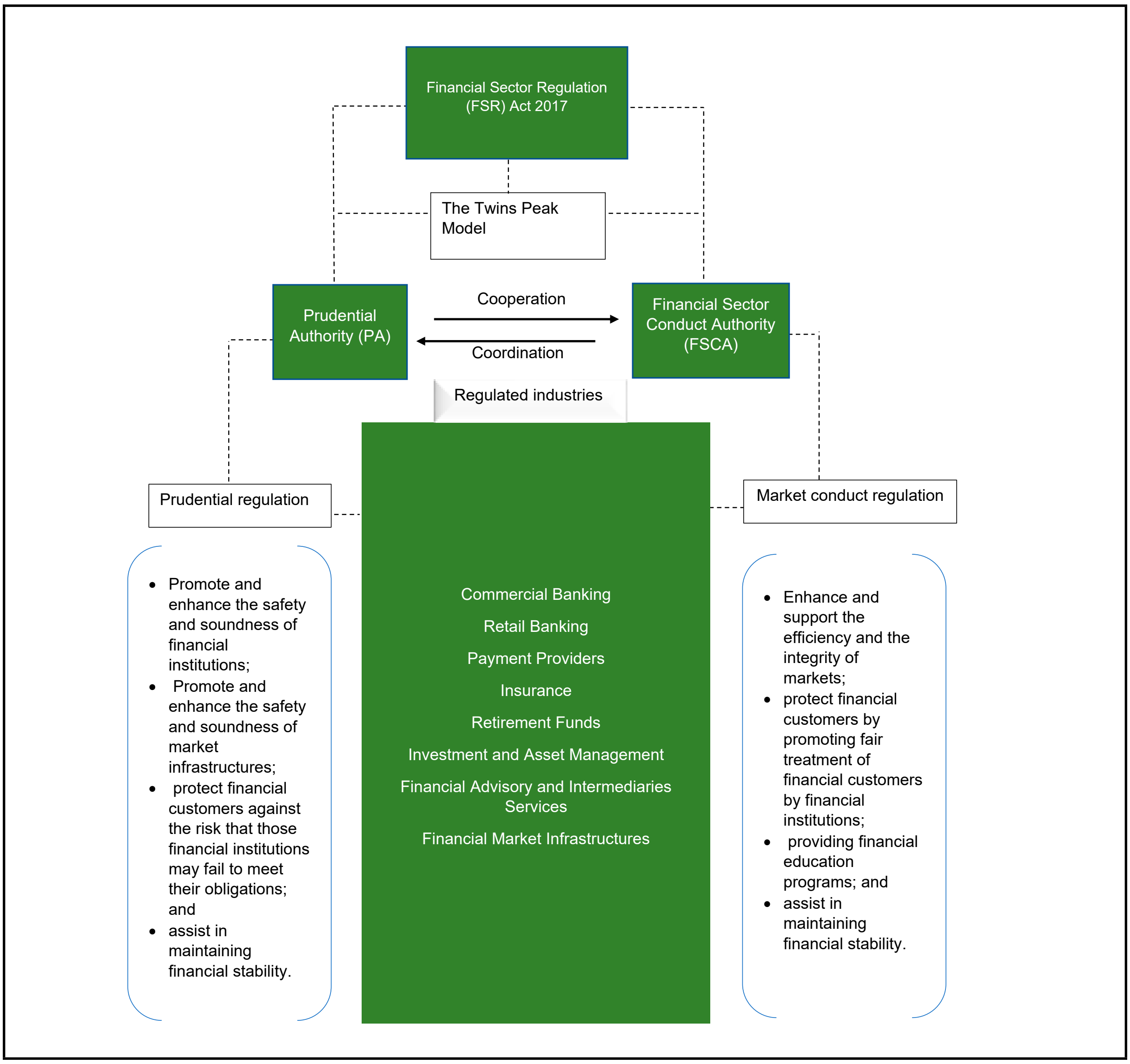
The Financial Sector Conduct Authority (FSCA) became operational in 2018, with a mandate to enhance the efficiency and integrity of financial markets; promote fair customer treatment by financial institutions; provide financial education and promote financial literacy; and in collaboration with other regulatory bodies assist in maintaining financial stability. The Treating Customers Fairly (TCF) framework underpins the regulatory and supervisory approach for market conduct in South Africa. The framework sets out the principles to be adhered to by financial institutions to ensure that financial customers are treated fairly and protected during financial interactions.

6 SARB, BA900. Available here.

7 South African Reserve Bank, 2017, Financial Stability Review First Edition 2017. Available here.

8 Genesis Analytics, 2017, The Impact of the Fourth Industrial Revolution on Financial Services in South Africa, Centre for Excellence in Financial Services Research Report.

Figure 2b: The South African financial system regulatory landscape



The FSCA carries out its supervisory and regulatory functions guided by the Financial Sector Regulation Act (FSR Act) and in alignment with the policy direction set by the National Treasury. This requires the FSCA to be *pre-emptive and proactive;* to take a *risked based approach* and to respond to risks appropriately and *proportionally*; to ensure that supervision and regulation is *intensive and intrusive;* to be *transparent and open to consultation; to* monitor the extent to which the financial system is delivering fair *outcomes for financial customers;* and to be *comprehensive and consistent* in promoting compliance with legislation.[9]

To support this effort, the FSCA draws on a broad spectrum of information sources, extending beyond financial institutions. Sources of information includes interactions with consumer bodies and industry associations; alternative dispute resolution structures, (for

9 FSCA, 2018, Regulatory Strategy of the Financial Sector Conduct Authority: October 2018 - September 2021. Available here.

example ombud structures); other regulatory bodies, government departments and state agencies; consumers and other media, including social media platforms; whistle-blowers; publicly available or privately commissioned studies relating to general or specific consumer and industry trends; and targeted mystery shopping exercises to obtain consumer experience insights.[10]

The FSCA is also advancing the tools used to monitor financial institutions, standardising and improving data collection across the sector. The omni - Conduct of Business Return (CBR) under development, will facilitate a more efficient and uniform way for financial institutions to submit data to the regulator.

This report provides a holistic view of the financial sector in South Africa; how the industry may be changing in response to innovation and the macroeconomic landscape; and the impact of these changes on consumers and the efficiency of the market. A sound understanding of the sector is an important input as the FSCA undertakes its regulatory and supervisory priorities and market interventions relating to the fair and inclusive treatment of consumers and ensuring market integrity.

The jurisdiction of the FSCA is set out in the FSR Act and includes all institutions that provide a financial product or financial service. Some of these (e.g. services provided in relation to credit; payment services; debt collection; etc) have not yet been brought fully into the jurisdiction of the FSCA. The Conduct of Financial Institutions (COFI) Bill proposes a licensing schedule for all persons that are regulated by the FSCA and will be licensed by the FSCA in future. The licensing categories are in line with the FSR Act, but may be subject to change with the finalisation of the COFI Bill and other policy developments.

In the next chapter, the report provides an overview of the South African economy and in particular looks at macroeconomic developments including the COVID-19 pandemic. The chapter examines the ripple effects of the dampened economic situation on business activity in the financial sector and consumer behaviour alike.

The following chapters describe in more detail each of the sub-industries regulated by the FSCA. Each chapter includes an overview of the industry and the key players and drivers of change, the developments within each industry and their impact on consumers, and the observed trends. As well as assessing these factors, the chapters look at the emerging risks in some of the industries and the implications for the FSCA.

10 ***Ibid***.

3. Overview of the South African economy

South Africa has a relatively young population; however, the challenge of unemployment means that a demographic dividend is not realised. Adults (15 years and above) make up around 71% of the population with the median age being 27.6.[11] While this presents a high ratio of working age people, this has not translated into a demographic dividend for the country due to the labour market's inability to make use of the additional labour resources.[12] As at the fourth quarter of 2020, unemployment levels were at 32.5%, rising from 29.1% in the previous year.[13] By the end of 2020 the economy recovered 876,000 jobs of the 2.24 million jobs lost during lockdowns in the second quarter of 2020. However, the country again lost 742,000 jobs during the first three quarters of 2021.[14] As unemployment was recorded at 34.9% in the third of 2021.[15]

South Africa suffers from one of the highest levels of inequality globally with 18.9% of the population living on less than ZAR28 (USD 1.90) per day.[16] The 2022 World Inequality Report estimates that the top 10% earn more than 65% of the national income and the bottom 50% only 5.3%.[17]

11 Statistics South Africa, Country projection by population group, sex and age. Available here.

12 *Ibid.*

13 Statistics South Africa, 2021, Quarterly labour force survey trends. Available here.

14 *Ibid.*

15 *Ibid.*

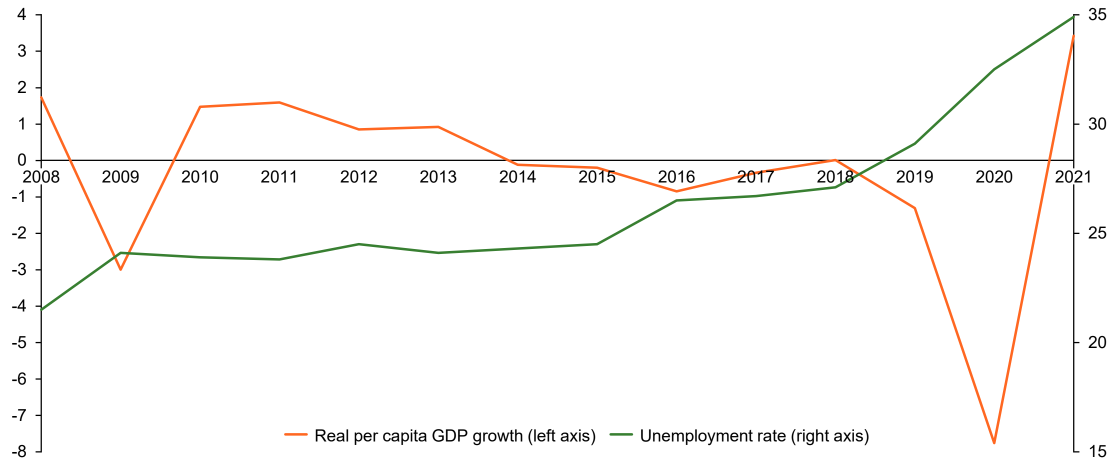
16 United Nations Development Programme, 2021, Human Development Report 2020. Available here.

17 World Inequality Report 2022, Available here

The challenging macroeconomic environment has exacerbated income inequality and unemployment. The South African economy has seen slow growth in recent years. Alongside a growing population, this has resulted in declining GDP per capita[18] and growing unemployment[19] (see figure below).

Figure 3a: South Africa's per Capita GDP[20] and unemployment rate[21]

Annual per Capita GDP growth and unemployment in South Africa
(%, unemployment as at Q4, 2008 - Q32021)



After several years of slow growth, the South African economy entered a recession in 2019[22], which extended into 2020 as a result of the COVID-19 pandemic. Economic activity came to a halt in early 2020 because of the nationwide lockdowns that were imposed to contain the spread of COVID-19. GDP growth fell drastically to a record low in five years, as the annual growth rate fell to -6% in 2020.[23] Although the country has exited its longest recession since 1992, growth in GDP remains low, and the country is only expected to recapture pre-COVID-19 levels in 2025[24]. The South African Reserve Bank has forecast GDP growth at 1.7% in 2022, growing to 2% in 2024.

18 IMF database, 2021, Real Per Capita GDP Growth. Available here.

19 Statistics South Africa, 2021, Quarterly labour force survey trends. Available here.

20 IMF database, 2021, Real Per Capita GDP Growth. Available here.

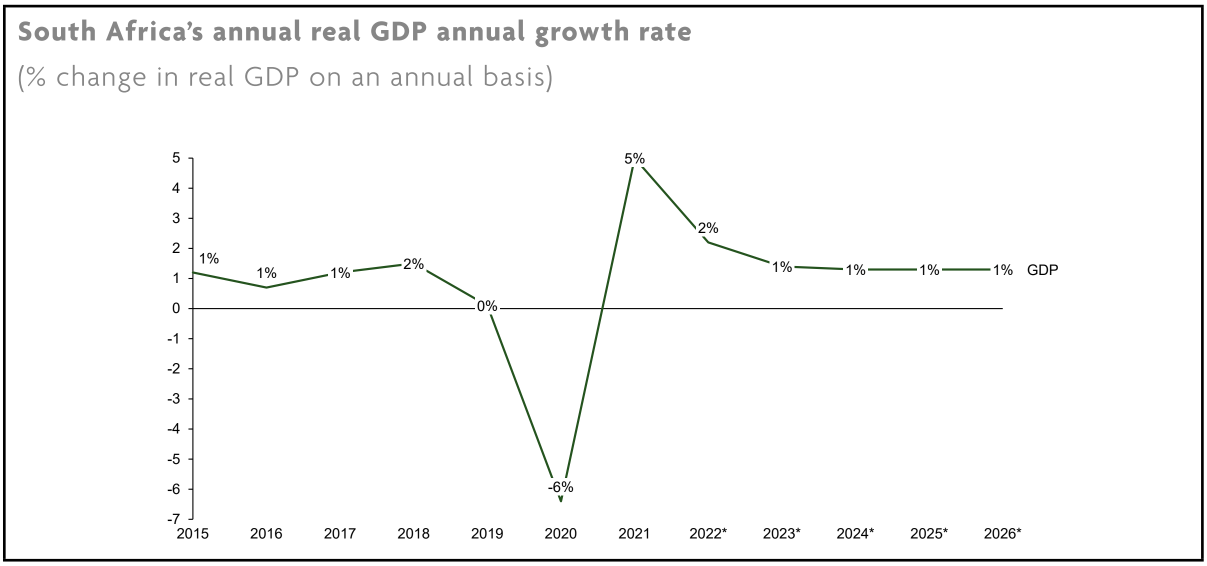
21 Statistics South Africa, 2021, Quarterly labour force survey trends. Available here.

22 Statistics South Africa, 2019, Economy slips into recession. Available here.

23 IMF World Economic Outlook (October 2021). Available here.

24 Bloomberg, 2020, S. Africa GDP Far From Pre-COVID-19 Levels Even as Recession Ends. Available here.

Figure 3b : Annual growth rate in real GDP[25]



The weakened economy has adversely affected the bottom lines of financial institutions. The major banks reported large profit declines in their 2020 financial results, with the highest decline at 57% compared to 2019.[26] Earnings declines were attributed to higher impairments; lower transaction volumes; and the cancellation of investment and insurance products. Despite poor earnings, banks remained profitable in 2020. Analysis of the first six months of 2021 showed that the big four traditional banks generated a combined increase in headline earnings of 177%[27], driven by significantly lower impairments and expense discipline. The outlook for the banking sector in 2021 is positive, however analysts do not expect an immediate return to pre-COVID profitability levels.

Both the consumer and business confidence indices fell to record lows in the second quarter of 2020. At the height of the national lockdown in April to June 2020, the business index fell drastically to five index points,[28] an all-time low. This demonstrated the lack of optimism among institutions over the future performance of businesses, industries, and the overall economy. The second quarter of 2020 saw the largest dip in consumer confidence in over 20 years to -33 points,[29] reflecting the negative sentiments held by households regarding their expected financial situation, the impact of high unemployment rates and the ability of consumers to save.

25 IMF, 2021, World Economic Outlook (October 2021). Available here.

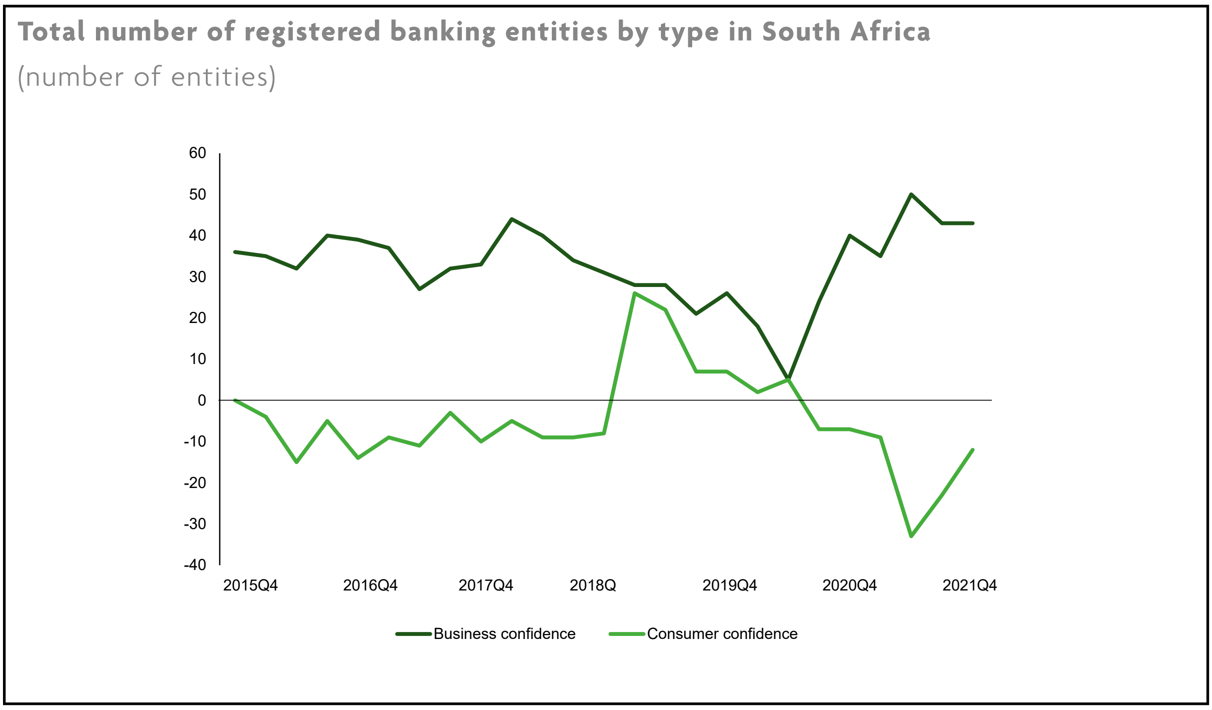
26 SARB, 2021, Selected SA Banking Sector Trends. Available here. *Note: Nedbank reported a 57% decline in headline earnings in 2020.*

27 PWC, 2021, Major Banks Analysis. Available here.

28 Bureau of Economic Research, 2021, FNB/BER Business Confidence Index. Available here.

29 Bureau of Economic Research, 2021, FNB/BER Consumer Confidence Index. Available here.

Figure 3c: Business and consumer composite indices[30]



Business and consumer indices have, however, continued to recover into 2021 on the back of a number of regulatory relief measures that were put in place to alleviate the economic downturn. Measures such as the COVID-19 social relief grant introduced by the government improved household confidence somewhat in 2021; however issues such as rising fuel prices, load-shedding, further job losses and further covid infection "waves" saw consumer confidence dip and then recover slightly over the course of 2021.

The financial sector introduced various relief measures for customers, with the SARB's liquidity injection playing an important role. The injection of liquidity into the economy by the SARB also played a vital role in encouraging commercial banks to extend credit to the private sector, stimulating economic activity. Total loans and advances to households increased from R1.740 billion in April 2020 to R1.864 billion in October 2021.[31] Commercial banks provided their customers with relief measures such as loan repayment holidays and eased credit extension to businesses. Insurance companies provided money back on certain products and paid out business claims to a number of businesses particularly affected by the lockdown.

The FSCA also implemented regulatory measures to relieve financial distress; for example, retirement funds were permitted to provide contribution relief to members as a way of reducing the financial strain on consumers.

30 Bureau of Economic Research, 2021, FNB/BER Consumer Confidence Index. Available here; FNB/BER Business Confidence Index. Available here.

31 South African Reserve, 2021, Bank Monthly Release of Selected Data No 375 May 2020 and No 393. Available here

As activity rates start to normalise and the global economy improves, the South African economy is also expected to grow by to 4.8% (revised down from 5.1% in 2021).[32] At the end of the second quarter of 2021 the economy had expanded by 1.2%; this was the fourth consecutive quarter of growth[33]. However, as shown by the 1.5% decline in economic growth in the third quarter of 2021[34], the momentum has started to wane following public violence in July; port and rail disruptions; electricity interruptions; and the third and fourth wave of COVID-19 infections.

32 National Treasury, 2021, Medium Term Budget Policy Statement 2021. Available here

33 Statistics South Africa, 2021, The economy grows by 1,2% in Q2:2021. Available here

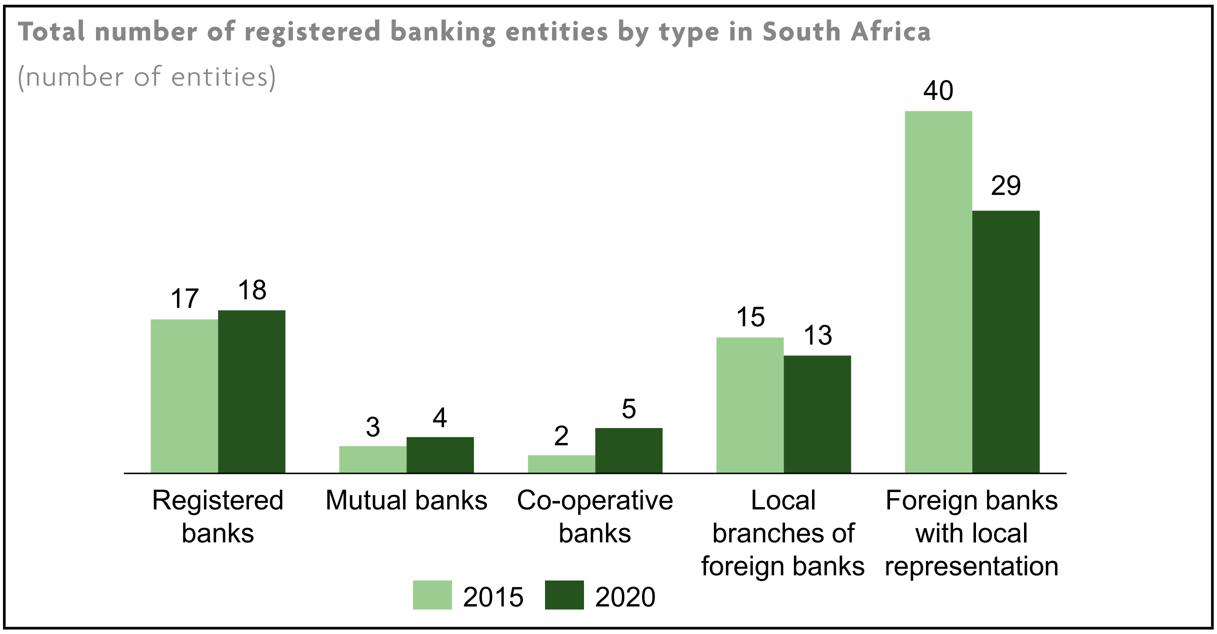
34 Statistics South Africa, 2021, GDP decreased by 1,5%1 in the third quarter of 2021. Available here

4. Commercial Banking Industry

4.1 Overview of the commercial banking landscape

There are 36 registered banking entities in South Africa, supervised jointly by the FSCA and the Prudential Authority (PA). Of the 40 registered entities, 18 are commercial retail banks and 4 are mutual banks, 5 are C-operative Banks and 13 are local branches of foreign banks. There are also 29 offices of foreign banks with local representation in the South African banking industry.[35]

Figure 4a: The number of banking entities in South Africa[36]



The banking industry is highly concentrated, with 83% of the industry's deposits being held by the largest four banks.[37] However, the banking landscape is changing as banks face increasing competition from newly-established banks, technology-enabled start-ups, and a growing number of retailers offering financial services including credit products.

35 SARB, 2021, Selected South African banking sector trends. Available here.

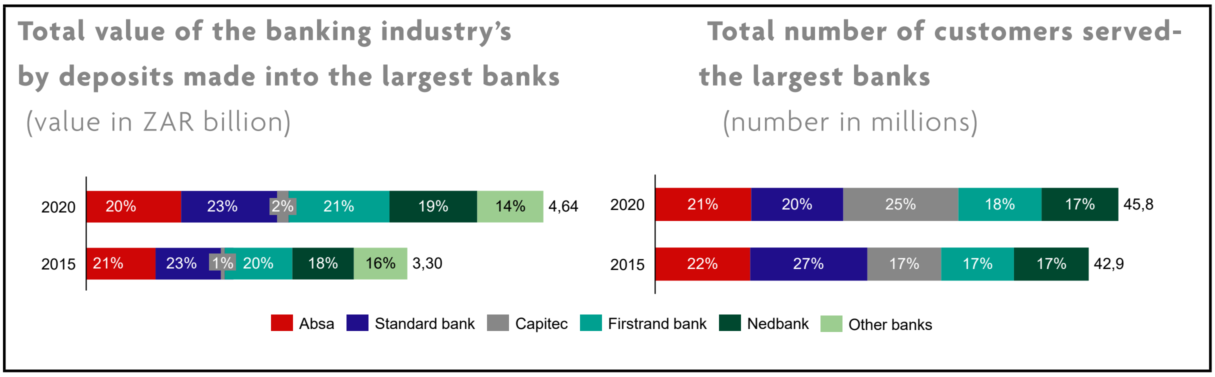
36 *Ibid.*

37 SARB, 2021, BA900 Economic Returns. Available here.

This is forcing incumbent banks to place increasing emphasis on growing customer numbers by offering more innovative products to attract lower-income earners.[38]

Many are also exploring opportunities for collaboration with new tech offerings.

Figure 4b: Deposits and customers split across the largest banking institutions[39]



While Capitec Bank held only 2% of total deposits in 2020, it had the largest market share of customers at 25% of the market. The introduction of Capitec's single account in 2001, focused on simplicity and lower fixed fees, changed the South African retail banking landscape. By leveraging digital technology, Capitec developed a low-cost banking offering that, while targeted at the low-income segment of the mass market, held broad appeal to South African consumers. In terms of customer numbers, Capitec in 2020 surpassed what was known as the 'Big Four' - Absa, First National Bank (FNB), Standard Bank and Nedbank – and cemented its place as a key player in the South African retail banking space.[40]

A new bank with a focus on simplicity and lower fees led to incumbent banks developing similar, low priced value propositions for customers. Incumbent banks responded through the introduction of entry-level bank accounts with either a small or zero monthly fee.

Competition in the industry has been increasing, with three newcomers in the last three years. New entrants were Tyme Bank in 2018, Discovery Bank in 2019, and Bank Zero which recently launched in 2021. All three new entrants have digitally driven business models, with limited physical infrastructure, reflecting a growing trend in the provision of banking services globally.

38 National Treasury, 2020, An Inclusive Financial Sector for All, Available here

39 ABSA; Standard Bank Group; Nedbank; Firstrand; Capitec bank, 2020. Financial reports.

40 Business Tech, 2020, South Africa's 5 biggest banks compared: earnings vs customers vs market cap vs reach. Available here.

New entrants are reducing fees further, as well as introducing different distribution models and launching innovative value propositions for customers. Physical infrastructure, legacy systems and high staff numbers account for the biggest costs for traditional banks. New entrants are supported by new banking technology, often cloud-based, which can substantially reduce the operating costs of financial institutions. Bank Zero, which launched fully in the second half of 2021, built proprietary banking systems that have allowed the bank to limit reliance on third party system providers and in turn keep costs low.[41] The entry of these players has also introduced different distribution models (for example partnerships with retailers to give customers more convenient access points for basic services like cash in and cash out). Leveraging existing infrastructure has allowed these banks to avoid expensive branch infrastructure costs. Innovations such as Discovery Bank's 'behavioural banking' approach to encourage good financial discipline, and Tyme Bank's 'buy now and pay later' services in partnership with selected retailers also offer customers new types of products and services.

While new entrants to the banking industry may be contributing to increased bank account penetration, there is more evidence that they are incentivising switching from incumbent banks. While the total banked population has steadily increased since 2010, the number of customers served by the largest five banks decreased between 2019 and 2020.[42] This shows that the new entrants likely incentivised existing customers to switch from the largest banks. Tyme Bank was reported to have on boarded three million customers as of 31 March 2021 since its launch in February 2019[43]. The bank indicated that many of its customers were individuals that already had a bank account with one of the larger banks in the country, and chose to either open an additional account with Tyme Bank, or leave their previous bank. Discovery Bank's customers are predominantly higher income earners; and since its launch the bank has captured nearly 300,000 customers.[44]

41 News24, 2021, Bank Zero's customers have already moved 'tens of millions' from other banks. Available here

42 ABSA; Standard Bank Group; Nedbank; Firstrand; Capitec bank (2020). Financial reports.

43 News24, 2021, Loyalty to one bank is gone' - TymeBank CEO as it reaches 3 million customers. Available here.

44 Businesslive, 2021. Discovery Bank is finding 'familiar' new clients. Available here.

4. 2 Customer banking activity and behaviour

Bank account access has expanded significantly in South Africa over the past decade. For most South Africans, retail banking is the first point of access to the financial sector, often due to the ability of bank accounts to facilitate payments. Access has expanded significantly in the country, with over 81% of the population above the age of 16 having a bank account in 2021, a notable increase from 63% in 2010.[45]

Factors that have contributed to this improvement include the introduction of affordable products by financial institutions; improved distribution services and banking infrastructure; an increase in innovation and the provision of digital financial services; a focus on consumer education and financial literacy; and the distribution of social grants to beneficiaries through bank accounts.[46]

While account ownership has increased, real access to financial services remains low, demonstrated by low levels of account usage. Of those South Africans who are considered to be financially included, 83% use non-bank channels and as much as 68% still use informal channels. If social grant beneficiaries are excluded, then only 69% of adults would be considered as being formally banked.[47]

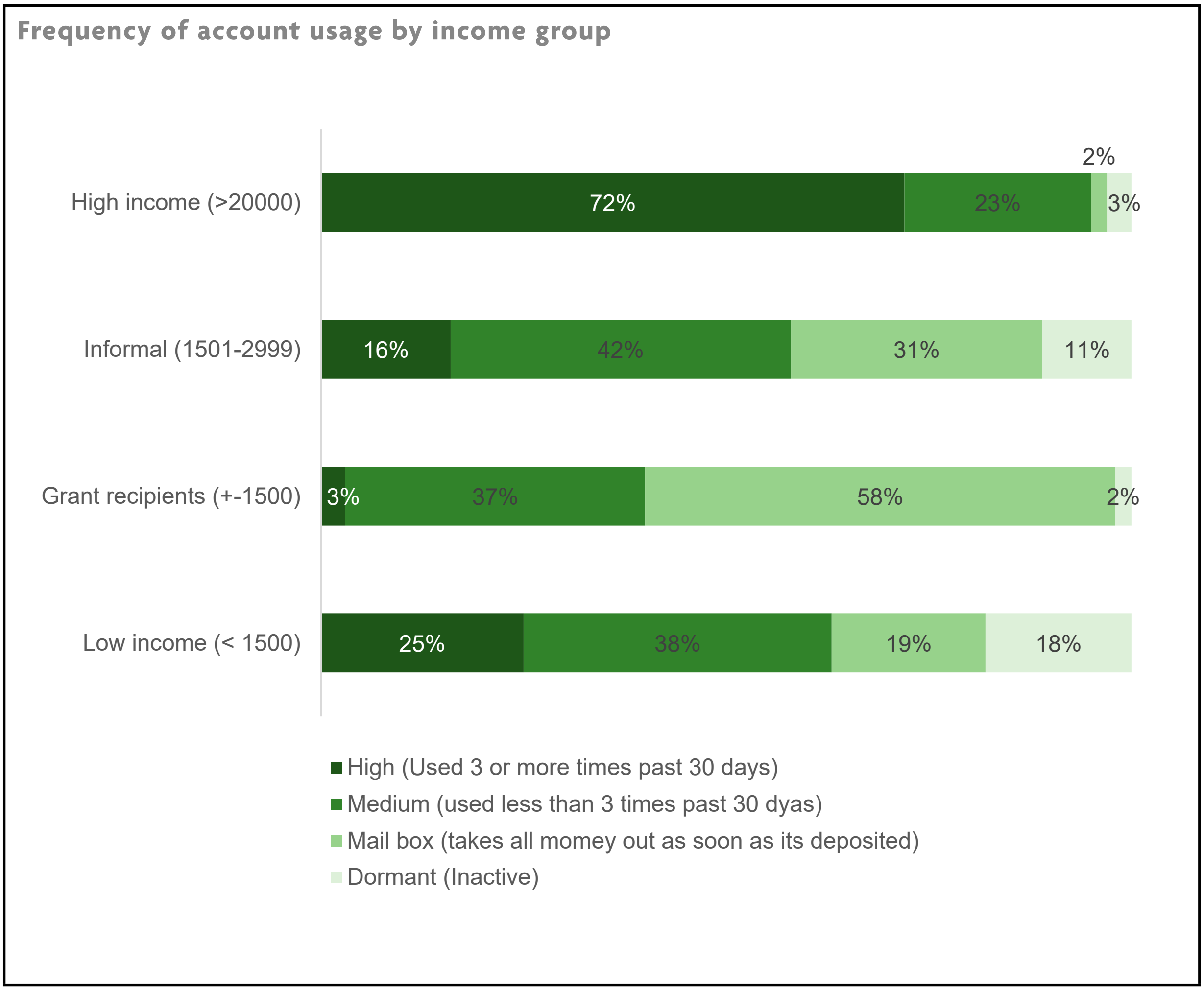
Usage is mainly an issue at the lower end of the income spectrum. The results from the 2021 Finscope survey found that 40% of dormant accounts were held by individuals from low-income households and that within this segment another 19% withdrew all funds as soon as it was deposited; these accounts are known as “mailbox accounts”. In the high-income segment, only 3% of individuals had not used their bank account in the last month with 72% indicating that they had used their bank account at least three times over this period.

45 FinMark, 2010 - 2022, Finscope National Surveys. Available here.

46 National Treasury, 2020, An Inclusive Financial Sector for All. Available here

47 FinMark, 2020, Finscope South Africa Overall Databook. Available here. *Note:The survey conducted by FinMark trust provides a representation of the usage of, and access to financial services by 4,969 individuals interviewed between 27 August and 5 November 2019 in South Africa, that interact with the financial sector as a whole.* ***The survey provides a nationally representative sample,*** *weighted/benchmarked to Statistics South Africa's (Stats SA) 2018 mid-year population estimates. Therefore, the survey can be extrapolated to show the behaviour of South Africa's financial consumers.*

Figure 4c: Bank account usage by income group[48]

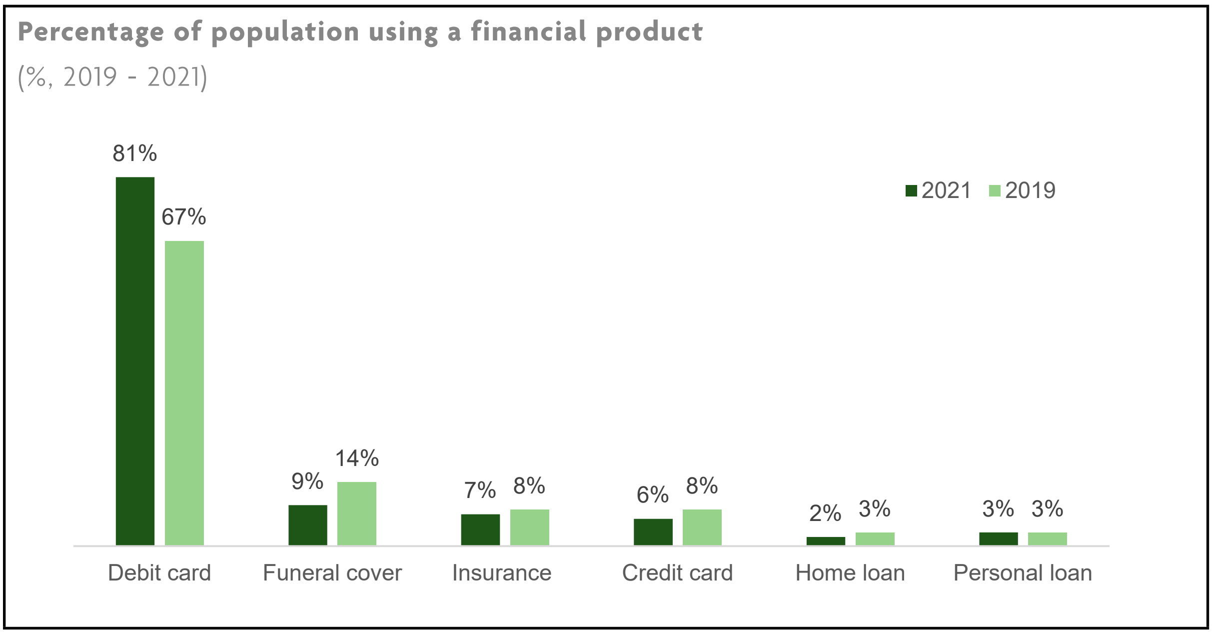


Many low-income individuals do not have the resources to engage with the financial sector in a meaningful way. This is evidenced by the low usage rate of products as shown in the figure below. In South Africa the entry point to formal financial institutions is typically a transaction account for the purposes of receiving, transacting and saving. While there has been a steady increase in the use of debit cards linked to transactional or savings accounts, take-up of more sophisticated products such as credit cards, insurance and home loans remains very limited.[49]

48 *Ibid.*

49 *Ibid.*

Figure 4d: Penetration of banking products[50]



Lack of resources is another contributing factor to the poor savings culture that exists amongst South African households through formal channels. Indebtedness and limited savings is a concern in the South African market as evidenced by the aggregate household savings rate of 0.7[51] and debt to income ratio that stood at 75.3%[52] in the first quarter of 2021. There are however pockets of a strong savings culture through informal channels, such as stokvels, which are estimated to collect approximately ZAR50 million annually in the form of member contributions across South Africa.[53] In 2020 the FSCA established the #FSCAMyMoney initiative to encourage saving by providing customers with an easily accessible and comprehensive guide to manage money better.

The Stokvel market caters to 11,6 million individuals.[54] The Old Mutual's Savings and Investment monitor for 2021 found that a growing proportion of the South African population was making use of Stokvels, 'rainy-day' funds and loyalty programmes to save.[55] Stokvels are primarily used for savings; 20% of stokvels are specifically set-up for bulk grocery purchases, 25% are set-up to cover funeral or burial costs and 45% are structured as rotational savings clubs, where a different member receives the groups' accumulated savings at each meeting.

50 *Ibid.*

51 Trading Economics, 2021, South Africa Household Saving Ratio. Available here.

52 SARB, 2021, Full Quarterly Bulletin – No 300 – June 2021. Available here.

53 The National Stokvel Association of South Africa Webpage. Available here.

54 *Ibid.*

55 Old Mutual, 2021, Old Mutual's savings and investment monitor, 2021. Available here.

The National Stokvel Association of South Africa (NASASA) estimates that a quarter of stokvels are banked. There has been limited product innovation to cater for this market; for example members are not listed as owners on the bank account and therefore have limited redress in case of fraud. Members are also unable to leverage the stokvel's active banking relationship to access a broader array of products and services. Focused product design and innovation in this space could help improve the security of stokvel savings.

A strong dependence and preference for cash impacts bank account usage negatively. In the lower income market there is often a preference for cash and, for some, cash still dominates in the ecosystems used (e.g. due to informal and community trading). The costs of cash tend to be less visible – for example, the increased security risk and the cost involved in travelling to an ATM or cash point. Informal sources of funding such as stokvels could also be contributing towards the preference for using cash amongst consumers.

Table 1: SASSA case study

Over 18 million people, around a third of the population, benefit from the social grant system in South Africa. Prior to 2012, the South African Social Security Agency (SASSA) grants were paid predominantly in cash. Due to concerns around fraud and distribution costs, a biometric SASSA card linked to the individual's account was adopted. This allowed for the digital distribution of social grants.
SASSA accounts became a material driver for increased bank account access. In 2017, bank account access stood at 77% of the adult population. When excluding **SASSA** card holders, this ratio decreased to 58%.[56]
SASSA beneficiaries can receive their grant through a bank account of their choice; via a SASSA debit card provided through the South African Post Office (SAPO); or in cash from a SAPO or SASSA cash pay point. The debit card can be used at any merchant or retailer accepting Visa or Mastercard, and allows for a limited number of free cash withdrawals at retailers and unlimited point of sale (POS) purchases.[57]
About 5 in 7 social grant recipients withdraw all their funds as soon as it is deposited into their cards.[58] Among respondents who were keen to receive their grant via a SASSA account, the majority (62.5%) had a preference for visiting a post office versus a commercial bank branch
In 2018, a survey was conducted among 1205 SASSA grant beneficiaries who chose to collect their grants in cash. Respondents indicated that cash allowed them to get their money upfront. This was regularly cited in the literature as a way to plan and track their expenses more easily. Other reasons for cash preference included not being comfortable using ATMs, long distances from banks/ATMs/merchants, expensive bank fees, and avoiding deductions on their grant.[59]

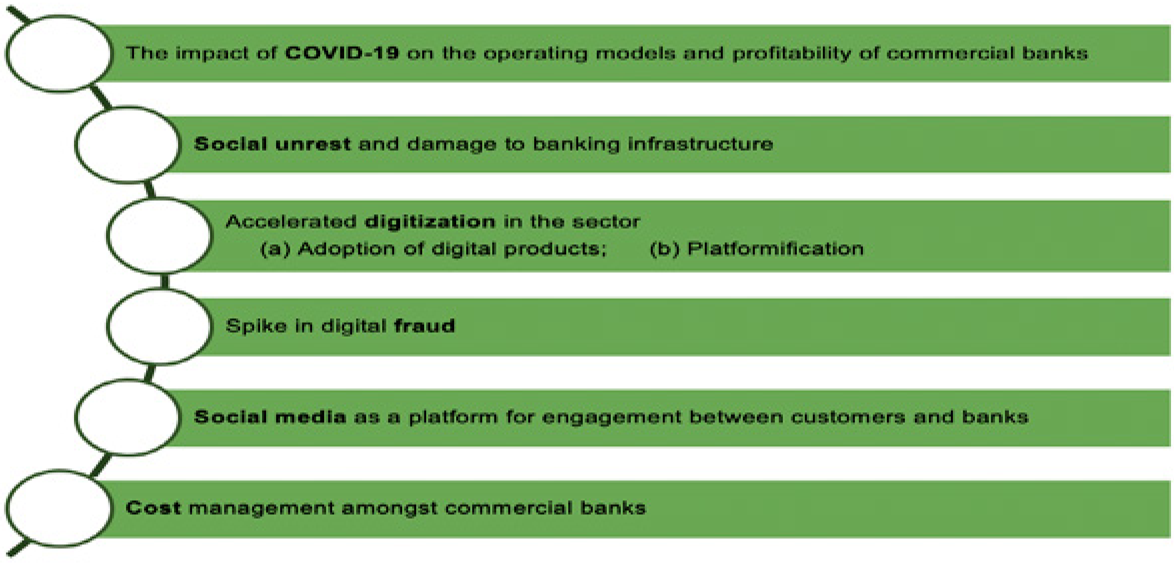
56 Genesis Analytics, 2017, The Impact of the Fourth Industrial Revolution on Financial Services in South Africa, Centre for Excellence in Financial Services Research Report

57 The South African Government, 2020, SASSA and Post Office on payment of social grants. Available here

58 FinMark Trust, 2020, Cash, cards and COVID-19. Available here.

59 CBM, 2018, SASSA Cash Preference. Available here.

4.3 Industry developments and key trends



4.3.1 COVID-19: Impact on operating models and profitability of banks

Operating model

A positive consequence of the COVID-19 pandemic has been the accelerated adoption of technology and digital financial services amongst consumers. The COVID-19 pandemic has impacted the operating models of financial institutions, notably with an accelerated increase in the adoption of technology to provide products and services, in parallel with consumers' increasing use of digital payment methods.

While the shift to a digital environment is necessary to enhance the efficiency of financial service provisioning, it creates increased opportunities for fraudsters and this poses a threat to customer protection and the integrity of the financial sector. For example, impersonation fraud (specifically online) surged by 337% in 2020.[60] Safeguarding the integrity and security of information of financial customers, and preventing data breaches in regulated industries remains high on the FSCA's agenda.

Profitability

Banks have played an active role in alleviating the financial distress faced by consumers due to the COVID-19 pandemic. As at 8 May 2021, R18,35 billion in loans had been approved by banks and taken up by small businesses under the Covid-19 Loan Guarantee Scheme. Figures reported to the South African Reserve Bank, indicate that as at February 2021, banks had provided R293 billion in financial relief to their customers and clients (corporate: R165 billion; total retail: R128 billion), which accounted for 5.8% of the total corporate and retail credit exposure.[61]

60 The Insurance Crime Bureau, 2021, Identity theft up by 337% in 2020, fraud summit hears. Available here.

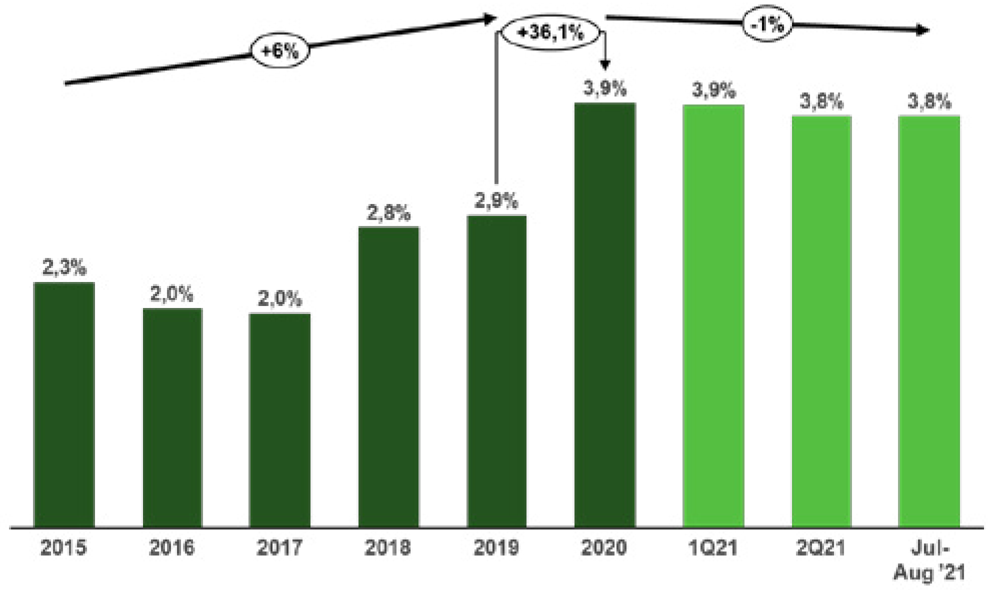
61 BASA, 2020, September Update: COVID-19 Loan Guarantee. Available here. [*to be discussed in detail*

The relief provided was backed by a liquidity injection into the economy through measures taken by the SARB, allowing banks to extend credit to their customers. [62] This had meant that the upward trend in gross loans and advances experienced in the five years prior, continued into 2020. The ratio of household debt to disposable income decreased slightly over 2021 from 67.1% in the first quarter to 66.7% in the second, as increases in nominal disposable income exceeded that in household debt.[63]

Asset quality deteriorated materially in 2020 as non-performing loans increased. The Compound Annual Growth Rate (CAGR) of non-performing loans (NPLs) for the industry from 2015 to 2019 was 6%. However, in 2020, the industry experienced a drastic rise in NPLs as a proportion of gross loans and advances relative to previous years.[64]

Figure 4e: Non-performing loans[65]

The value of non performing loans as a percentage of industry gross loans and advances
(% of value in rand billions)



The increase in provisions that went hand in hand with elevated NPLs was a primary contributor to the steep decline in profitability in the industry, from ZAR83,98 billion in 2019 to ZAR34,84 billion in 2020.[5] Provisions for non-performing loans by banks increased significantly due to the rising volumes of distressed consumers and the rise in non-performing loans. As a result, there was an increase in credit impairment charges, reflecting the scale of the crisis on loan portfolios depicted by forward-looking credit impairment models and post-model adjustments.

in the retail lending industry]

62 SARB, 2021, Our response to COVID-19. Available here.

63 SARB, 2021, Quarterly Bulletin - No 301 - September 2021. Available here

64 SARB, BA900. Available here.

65 *Ibid.*

Contributing further to a fall in profitability for banks was the lower interest and non-interest revenues. Banks faced a decline in non-interest revenues, as the volume of transactions carried out declined, particularly during the national lockdown. The low interest rate environment resulting from the regulatory relief measure by the SARB further compounded the impact on profitability as the net interest income of banks came under pressure.

Although these results are reflective of a challenging operating environment, they have also revealed the resilience of South African banks. At the onset of the COVID-19 pandemic, the Prudential Authority had announced a reduction in capital requirements and advised banks to withhold dividend payments to ensure sufficient capital buffers. Although profitability in the banking industry was materially lower for the 2020 financial year, financial institutions in South Africa remained well capitalised.

Given that the banking industry seems well placed to withstand near term challenges, the Prudential Authority relaxed its guidance on the payment of dividends by banks and proposed returning bank capital requirements to their pre-COVID-19 level by next year (2022).[66]

4.3.2 Social unrest and the damage to banking infrastructure

In July 2021, the country experienced civil unrest in the KwaZulu Natal and Gauteng provinces which resulted in significant damage to banking infrastructure. Protests began in opposition to the incarceration of former President Jacob Zuma, triggering wider rioting and looting. Unrest was further fuelled by widespread dissatisfaction with high levels of unemployment, poverty and inequality which were worsened by the national lockdowns. Shopping malls, warehouses and factories were targeted by looters with banking infrastructure being severely damaged as well. At least 1227 ATMs, 310 bank branches and 82 in-branch safes were either breached, vandalised or destroyed.[67] Of the 1227 ATMs damaged, 256 ATMs were breached and 36 ATMs physically stolen from their sites. These have not been recovered to date.

The damage to the banking infrastructure caused cash shortages for consumers and emergency measures were put in place to safeguard access. The impact of this on customers was of particular importance to the FSCA, as a number of damaged ATM facilities were unavailable for withdrawal transactions, and there were disruptions in the supply of cash to ATMs for many days. The banking industry responded by temporarily removing Saswitch fees - fees levied on customers when using the ATM of a different bank from where the account is held. This allowed customers to withdraw cash at the nearest ATM at no cost to the customers.

66 SARB, 2021, Press release on the first edition 2021 Financial Stability Review. Available here.

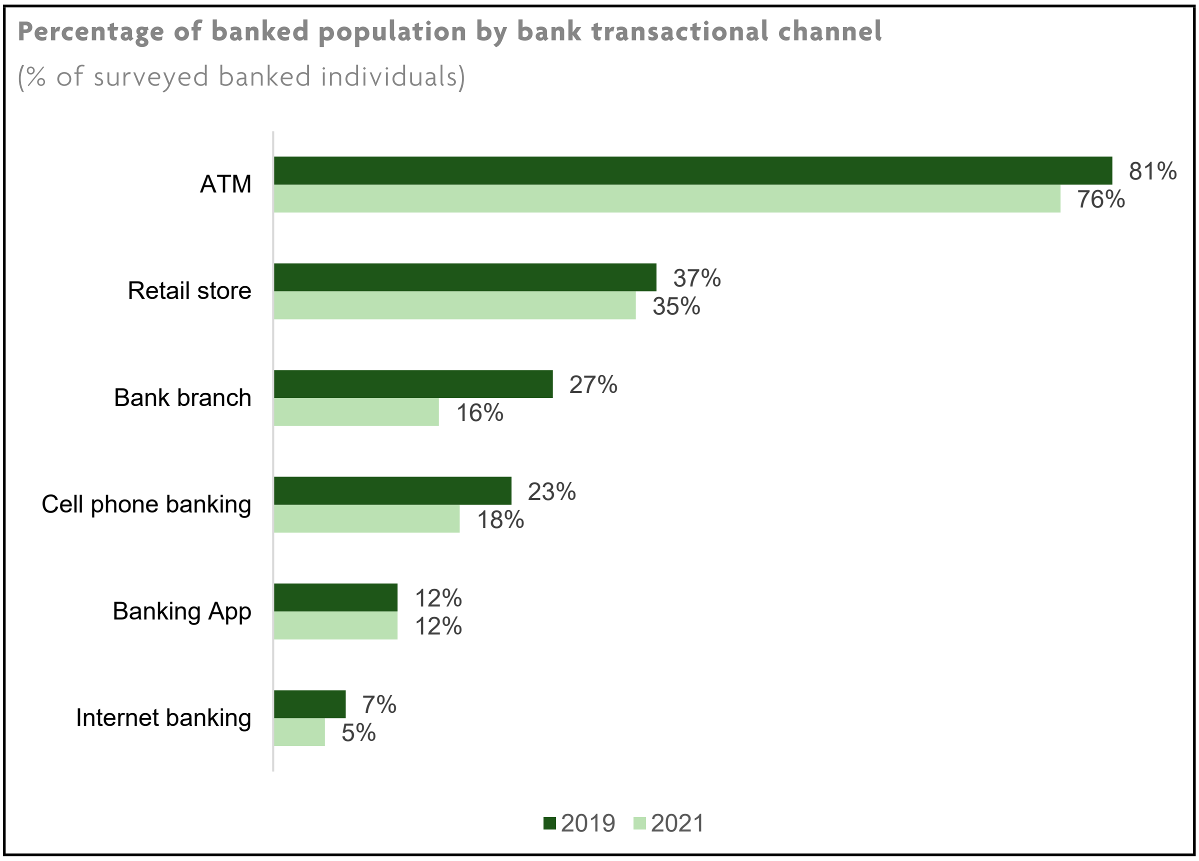
67 Sabric, 2021, Civil unrest banking infrastructure damage. Available here.

4.3.3 Accelerated digitisation in the industry

4.3.3.1 Adoption of digital products

For more than a decade, digitisation and a move to customer self-service has been a strategic focus for South Africa's largest banks. Banks have introduced banking apps and improved digital payment options and implemented next-generation ATMs that allow customers to do a wider range of transactions, with the aim to reduce the dependency on bank branches. This is demonstrated in the figure below where the usage of non-branch channels can be seen.

Figure 4f: Usage of banking channel[68]



The COVID-19 pandemic further accelerated the rate at which businesses and consumers adopted technology for transactions, particularly in the payments space where many customers[69] preferred to transact with card over cash; and tap-and-go card transactions increased significantly.[70]

68 FinMark, 2022, Finscope South Africa Overall Databook. Available here.

69 *It should be noted this segment of customers is typically already comfortable using digital channels*

70 Mastercard, 2021, Mastercard Study Shows South African Consumers Make the Move to Contactless Payments for Everyday Purchases, Seeking Touch-Free Payment Experiences. Available here.

Historically, banks' digital strategies have been focused on applications and internet banking; however, investment in USSD technology has also developed to reach lower income customers. In the past, banks have focused on the development and roll out of banking through apps accessed on smartphones and internet banking platforms accessed on computers or tablets. However, the FSCA has increasingly focused on access provision through Unstructured Supplementary Service Data (USSD) to ensure that all customers are served, particularly low-income groups that may be excluded based on smartphone or computer ownership. For low-income customers, high data costs required to access banking apps and internet banking is a further prohibiting factor.

4.3.3.2 Platformification and open finance – dynamic changes to the world of financial services

Another trend impacting banking more broadly is the creation of platform businesses, or the *platformification of financial services*. In many instances, this supports the notion of open finance (e.g. the ability to integrate third party technology businesses with the infrastructure of banks' and other financial institutions to provide customers a wider variety of products and services). In recent years, the banking industry has evolved from traditional banking capabilities that are product focused - for example, transactional services, safekeeping of deposits, credit provision and investment opportunities - to more customer-centric holistic offerings. Increasing amounts have been invested in research and development to acquire a stronger understanding of customers and their financial needs, in order to offer solutions beyond traditional financial products. In 2020 the largest proportion of spending by the Big five banks was on technology and digitisation, driven by increased competition from digital banking platforms.

In August 2021, Standard Bank publicly announced that to achieve its 2025 strategy it would need to transform to a platform business. The bank's strategy includes developing key *ecosystems*; a coordinated network of participants and devices that would allow the bank to combine its own offering with those of partners. The bank predicts that revenue growth from new business models would grow faster than revenue from banking.[71]

Open banking has emerged as a new way of offering financial services and products, disrupting the financial landscape globally. Over 22 jurisdictions across the world have developed and implemented an open banking framework in 2019.[72] Open banking presents an innovative opportunity to increase access to finance, enhance market competition, and broaden the financial services ecosystem.

71 Standard Bank Group, 2021, Standard Bank Group to reveal 2025 Ambition during virtual strategy up date for investors and analysts. Available here.

72 IFWG, 2019, IFWG 2019 Workshops Report. Available here.

It occurs when financial service providers are afforded access to consumer banking, transactional, and other financial data from banks through the use of application programming interfaces (APIs).

Open banking is regarded as a secure way to give providers access to customers by sharing financial information that paves the way for new customer-oriented products and services.

An example of open banking in South Africa, is the Fintech Spot Money.[73] Spot Money, in partnership with Bidvest Bank and other financial institutions, is leveraging technology to provide customers with the choice to transact seamlessly and acquire tailor-made financial products such as loans and insurance linked to value-added services. Other examples include the partnership between Nedbank, Mastercard, Synthesis, and iVeri to provide a tap-on-phone functionality to the bank's mobile card payment solution, PocketPOS.

Open finance is gaining further traction and takes the notion of open banking a step further: giving consumers the ability to share access to *all* their financial data online. Value to consumers is increased by extending the use of data beyond traditional payment accounts to include savings, investments, pensions, credit, insurance and mortgages.

In 2020 the FSCA conducted a survey to understand the sentiments and perspectives of over 70 FSPs in South Africa on open finance[74]. The survey revealed that most participants were open to the reality and even inevitability of innovation that would be enabled through a data-sharing framework. The areas that were identified as benefiting from an open finance framework include account aggregation, where 21% of participants' customers will most likely value seeing a consolidated view of all their financial relationships to inform their financial decisions; 18% of participants thought improved credit scoring would be another area for improvement. The main risk identified by the responders is data privacy and data misuse as a result of data exchanged and aggregated by FSPs; while 21% of respondents identified cybersecurity as the second biggest risk identified by respondents.

Respondents identified consumer adoption as the third risk, where respondents indicated that consumers may not be ready to adopt open finance owing to digital literacy and consumer education levels.[75]

The FSCA sees open finance as means of encouraging innovation, fostering competition, and developing customer-centric financial services. However, it does recognise the risks of data sharing associated with open finance. This is of particular importance given the recent passing of the Protection of Personal Information Act (POPIA) legislation passed in 2021 to protect the privacy of consumers. Banks and other financial institutions will need to consider

73 Mastercard, 2021, New fintech brand launches SA's first Open Banking offering. Available here.

74 *Open financing is a broader scope than open banking and includes industries such as insurance, retail credit, investments and pension providers.*

75 FSCA, 2020, Regulating Open Finance, Consultation and Research Paper. Available here

issues such as data ownership and customer consent for the sharing of data; for example, is consent required for each use case or could consent be applicable over an agreed time period? Also pertinent are issues of data minimality, and ensuring that data collected is necessary and used only for the original purpose for which it is collected. Partnerships between incumbents and Fintechs raise questions about shifts in liability and to what extent third party providers are responsible and accountable in the event that data breaches occur.

4.3.3.3 Non-bank distribution models

In addition to investment in technology, banks increasingly leverage existing non-bank infrastructure to broaden their customer reach in an efficient and affordable way. Retail stores have become increasingly popular as a distribution channel for banks. They typically have a wider footprint than banks', allowing banks to reach communities where it may not be viable to operate a full branch. Partnerships between banks and retailers such as Tyme Bank and Pick 'n Pay, and Absa and Pep stores have become common.

Individuals are using retail stores to perform transactions such as cash-in and cash-out. In 2021, the number of individuals using a retail store for banking transactions stood at 35%.[76] While a slight decrease from retail store usage prior to the pandemic, this trend continues to be driven by the increasing number of partnerships between banks and retailers to extend service provision beyond bank branches.

An example is Tyme bank has no bank branches but uses a partnership with the supermarket chain Pick 'n Pay and Boxer which has enabled the bank to offer a nationwide service network and expand customer access to physical banking services beyond traditional banking hours in instances where stores are open after 5pm. Customers can open an account at kiosks within the store and can execute over-the-counter (OTC) transactions at tellers and point-of-sale (POS) terminals.[77]

Distribution channels have also been enhanced through partnerships between banks and telecommunications companies, for example Ubank partnering with MTN to offer MTN mobile money services.[78]

76 FinMark, 2022, Finscope South Africa Overall Databook. Available here.

77 Consultative Group to Assist the Poor, 2020, Inclusive digital banking: Emerging markets case study. Available here.

78 Fin24, 2020, MTN, Ubank launch mobile money service. Available here.

4.4 Social media as a platform for engagement between customers and banks

Social media platforms have become a rich source of conduct-related conversation. Consumers increasingly use social media as a platform to share their banking experiences, ask questions and make recommendations to their network. The FSCA has currently adopted a data-driven strategy to understand and keep abreast of the content and sentiments shared over social media by customers; and more importantly to monitor conversation topics so that it is able to flag potential areas of concern.

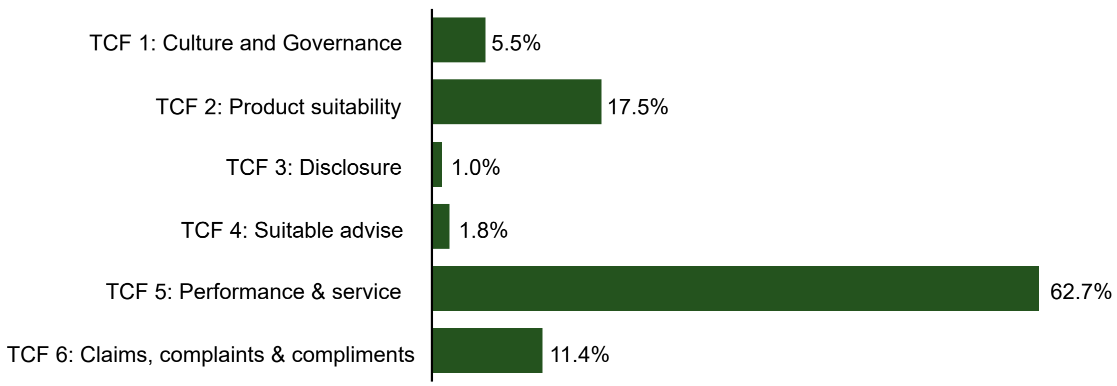
As a part of digital adoption, customers want to receive help from and lodge complaints with their banks via digital channels such as social media. There was a 61% increase in the volume of conversation around the customer banking experience during the early phases of the national lockdown, likely as customers were unable to go to a branch for help. An analysis of the social media conversations around the banking industry between June 2020 and June 2021 revealed that 42% of all monitored conversations were related to customer service, 25% to digital experience and 7% to affordability and banking fees.[79]

In the area of performance and service, the FSCA regulates and supervises the conduct of financial service providers to ensure that service is of an acceptable standard and products perform as customers have been led to expect. As illustrated in the figure below, in 63% of social media conversations customers complained about poor customer service or a poor digital experience. Conversations related to product suitability, mainly revolved around affordability and high banking fees.

Figure 4g: Consumer conversations relating to banking experience[80]

Volume of social media conversation grouped into TCF outcomes

(% of total social media conversation recorded)



79 Brandseye, 2020, Banking industry sentimental index. Available here.

80 *Ibid.*

Social media conversations, particularly around customer experience, are predominantly negative. More than 90% of the conversations were tagged as including a negative sentiment. One of the key frustrations of customers appears to be inefficiencies in responding to complaints - 71% of the complaints were related to the poor turnaround time of banks, and the inability of banks to adequately communicate with customers.

Slow turnaround times in providing support are a potential driver of account closures. Slow turnaround was particularly prevalent when customers inquired about a refund or reversal of a bank payment; or when customers were seeking assistance to understand balances on outstanding debt or bank fees levied. The conversations around turnover time have been identified as a driver for customers to cancel or close their bank account(s) with their current bank.

Some social media conversations related to banking are however positive. Conversations with positive sentiments usually include topics around credit products, and seamless account opening processes, particularly when the bank does not have onerous requirements with regards to documentation.

4.5 Cost management amongst commercial banks

With a poor economic environment putting severe pressure on banks' profitability, cost control has been front of mind for banks. As noted throughout this and the previous chapter, the South African economy has been under enormous pressure. Banks have seen decreases in transactional activity due to national lockdowns; a rise in NPLs, provisions and impairments as well as revenue pressure from cuts in the lending rate. The industry jaws ratio, which measures income versus cost growth, has been negative from January to June 2021,[81] with the exception of Capitec. This reflects the economic pressure on the banking industry. The pressure on banks' revenues has kept them focused on reducing costs as a way to limit a decline in revenues and profitability.

Cost control has been a big driver of investment in technology infrastructure. A key driver for the increased investment in technological infrastructure by banks has been the need to reduce their cost base. Digital technologies can enable financial institutions to reduce the costs of collecting, storing, processing, and exchanging information, through technology-enabled automation and "straight through" processing.[82] Digital channels reduce the need for expensive branch infrastructure and can also allow banks to offer better servicing, for example by expanding the hours of customer service. The adoption of technology lowers the banks' fixed and marginal costs of producing financial services, while improving productivity[83].

81 SARB, 2021, Selected SA Banking Sector Trends - Monthly. Available here.

82 Bank for international settlements, 2021, Fintech and the digital transformation of financial services: implications for market structure and public policy. Available here.

83 Mckinsey and Company, 2019, Transforming banks' IT productivity. Available here

Although individual banks are pursuing different physical channel strategies, overall there has been a reduction in both branches and ATMs in the industry. This is a result of cost reduction opportunities but also the increase in adoption of digital channels and self-service channels. Between 2012 and 2019, 695 branches were closed by the traditional banks; only Capitec grew their footprint over the same period. Part of FNB's and Nedbank's strategy was also to recalibrate existing branches; this includes reducing the cost of branch fittings, reducing the size of branches and opting for in-retail outlets.[84]

Although digitisation has improved access to banking services for many customers, low-income households remain largely dependent on physical facilities to perform transactions. In the supervision and regulation of banking activity, the FSCA focuses on the impact of a bank's decision to close a branch on the surrounding community and consumers. As part of consumer protection, the FSCA must ensure that customers have reasonable access to banking facilities. The Treating Customers Fairly (TCF) framework gives the FSCA discretion to direct banks to either reopen facilities or find alternative means to serve the customers that would have been adversely affected by the closure of facilities.

Banks continue to be one of the largest employers in the South African economy, however the skills and employee profile required has changed; there is a need for higher skilled technical resources to focus on technical innovation and automation. The trend in recruiting higher skilled technical resources continues to be a priority. There has been an increased number of incentives being implemented by banks to attract data scientists, behavioural economists and engineers to build in-house artificial intelligence capabilities as major banks continue to refine their business models, redesign distribution structures with a focus on reskilling teams, and increasing digitisation progresses.

The Treating Customer Fairly (TCF) framework is core to promoting fair treatment of customers. The outcomes based regulatory and supervisory approach aims to ensure financial institutions deliver specific, and clearly set out fairness outcomes for financial customers. This implies that interactions between the regulated entities and financial consumers must demonstrate that financial institutions were able to deliver equitable solutions to customers throughout the product life cycle, from product design and promotion, through to advice, complaints and the handling of claims. The Treating Customers Fairly (TCF) framework has six outcomes; 1) Culture and governance, 2) Product suitability, 3) Disclosure, 4) Suitable advice, 5) Performance and service and 6) Claims, complaints and compliments.

The Banking Conduct Standards that were published in July 2020 and came into effect in 2021 aims to ensure that the performance of products and services meet customer expectations, as set out in the marketing and publicly available content produced by banks. The Conduct Standards also addresses unfair practises by banks, for example the calculation of premiums for credit life insurance products sold by banks.

84 Moneyweb, 2019, Here's how many branches have shut in the last decade. Available here

Another area of conduct risk is ensuring that increases in digitisation are inclusive and do not disadvantage sectors of the population that may not have access to the internet, may not be comfortable using digital platforms, or may not be able to afford the data required to engage on digital platforms. One area of concern is the differences in transaction fees levied on physical or in-branch transactions versus digital transactions (which tend to be lower). Banks' pricing is motivated by encouraging customers to adopt digital channels; however, this unfairly penalises customers who do not have access or struggle to use these channels or platforms.

5. Insurance Industry

On average over ZAR12,3 billion is spent on insurance premium payments monthly in South Africa.[85] Insurance penetration, measured using premiums as a percentage of GDP, was 13.7% in 2020 - one of the highest penetrations in the world; ranking higher than the USA and the UK markets.[86] However, as further detailed below, most of this insurance comprises funeral insurance products. South Africa holds 70% of the African insurance industry's market premiums.[87]

In 2020, there were 150operational insurance providers and reinsurers registered with the PA. [88] Of these, 47% were insurers that provided non-life insurance (meeting insurance obligations that fully or partially indemnifies loss on the happening of an unplanned or uncertain event, other than a life event, death event or disability event not resulting from an accident). While long-term life insurers have a contractual obligation to pay the designated beneficiary of the policy a sum of money upon a life event, health event, disability event or death event; and in some instances in or from a fixed determinable date or at the request of the policyholder. Reinsurance can be described as insurance for insurers, when primary insurers purchase reinsurance for risks that may exceed their appetite and capacity.

As at March 2021, the Prudential Authority reported 60 primary life insurers, ten less than the year before. The top five life insurers by assets (Sanlam, Old Mutual Life Assurance, Liberty, Momentum Life, and Discovery Life) account for 82% of the market's total assets. Although concentrated, the overall number of life insurers is a sign of the health of the industry; where smaller niche insurers are able to cater to a variety of customer needs.

The non-life insurance market is less concentrated; in 2020 the market share of the ten largest insurers by gross written premiums (GWP) was 73.8% of the total market. The largest contributors of GWP are Sanlam, Hollard, Guardrisk, and Old Mutual. Motor and property insurance are the two most popular products, contributing 76% to the industry's gross written premiums in 2020.

On average, the insurance industry has seen positive growth with a 3% CAGR in gross written premiums between 2015 and 2020.[89] In 2020, non-life insurers reported a sharp increase in gross written premiums of 32% from 2019, amounting to approximately ZAR172 billion.[90]

85 FinMark, 2020, Finscope South Africa Overall Databook. Available here.

86 Swiss Re Institute, 2021, World insurance: the recovery gains pace. Available here.

87 Brookings, 2021, Figures of the week: African insurance market poised for growth. Available here.

88 SARB, 2021, Prudential Authority Insurance Statistics Division. Note: *The data has not accounted for double counting, as some insurers are providers of both life and non-life insurance*

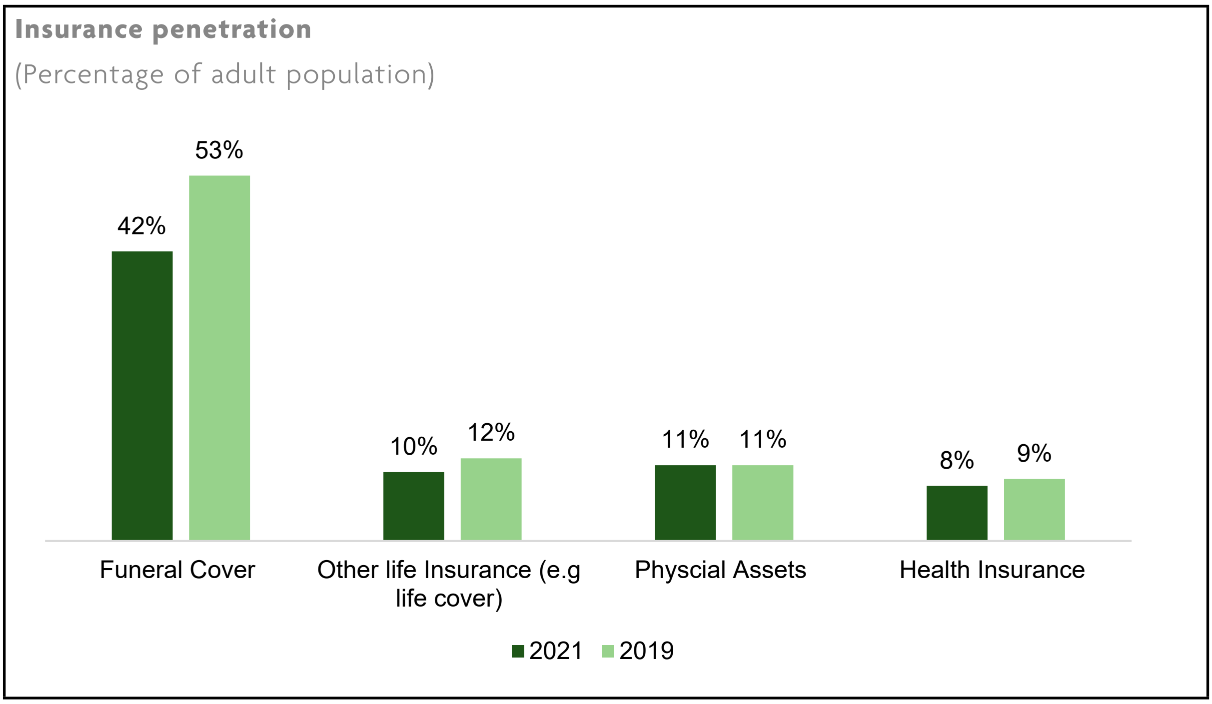
89 SARB, 2021, Prudential Authority Insurance Statistics Division.

90 *Ibid.*

The claims ratio (i.e. the percentage of claims in relation to premiums earned) for primary life insurers increased from 94.4 in December 2019 to 102.2 in December 2020, [91] reflecting the increase in the value of claims paid out in the life insurance industry, mainly driven by payouts for funeral cover policies. Similarly, primary non-life insurers experienced an increase in claims ratio from 62,5 in 2019 to 74,8 in 2020, resulting from a rise in the number of business interruption claims processed in 2020 as a result of the Covid-19 national lockdowns.[92] This ratio was also affected by loss in income affecting customer ability to pay insurance premiums.

Almost three in five South Africans report having some type of insurance. According to the 2021 FinScope survey, 17% of South African adults report having insurance through their bank, 38% from a regulated insurance company (non-bank affiliated), and 29% report having insurance (typically some form of funeral cover) through informal channels such as a funeral parlour or burial society.

Figure 5a: Insurance penetration[93]



Funeral cover is the most commonly held insurance product and inflates the number of South Africans who are insured. 42% of adults claim to have a funeral product; when excluding funeral cover, the share of South Africans with an insurance product drops to 19%, largely comprising life insurance, physical asset insurance, and health insurance[94] at 10%, 11%

91 SARB, 2021, Selected South African insurance sector trends December 2020. Available here.

92 *Ibid.*

93 *ibid.*

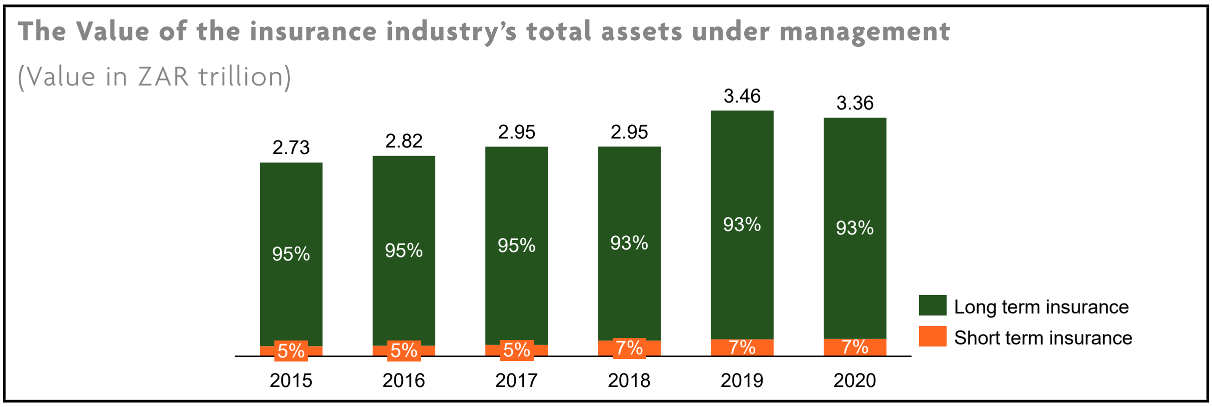
94 *The Finscope survey defines health insurance as medical aid, medical gap cover, dreaded disease insurance and a hospital cash plan*

and 9% respectively.[95] South Africans without non-funeral insurance cite affordability as the key barrier to taking up an insurance product.

Although the headline statistics are positive - much like the banking industry - the market is underserved. The life insurance gap, measured as the difference between insurance needed and actual insurance, was estimated to be ZAR15,4 billion in 2019.[96] Life insurance is strongly correlated with earnings and income, where the poorest 20% of the population have only 3% of the insurance coverage they need.[97] In the lower income segments, there is more appetite for funeral and credit life coverage than there is for life insurance. 3

Although the number of insurers is generally split evenly between providers of life and non-life insurance, 93% of the industry's assets under management are held by life insurers.[98] The industry's total assets under management (life and non-life insurance) have been increasing at 4% CAGR over the past few years (2015 - 2020), although 2020 experienced a decline of approximately ZAR101 billion.[99] The decrease was driven by the 3% decline in assets under management in the life insurance industry, which simultaneously incurred a 7% decrease in gross written premiums.

Figure 5b: Assets under management in the insurance industry[100]



Contrary to the decline in the life insurance industry, **the non-life insurance industry saw a 3% increase in assets under management in 2020.**[101]

Research commissioned by the Insurance Claims Africa (ICA), representing claimants filing for business interruption, found that **unlike the life insurance sector, the short term insurance**

95 FinMark, 2022, Finscope South Africa Overall Databook. Available here.

96 ASISA, 2019, South Africa's life and disability insurance gap widens to R34.7 trillion in 2018. Available here.

97 *Ibid.*

98 SARB, 2021, Prudential Authority Insurance Statistics Division.

99 *Ibid.*

100 *Ibid.*

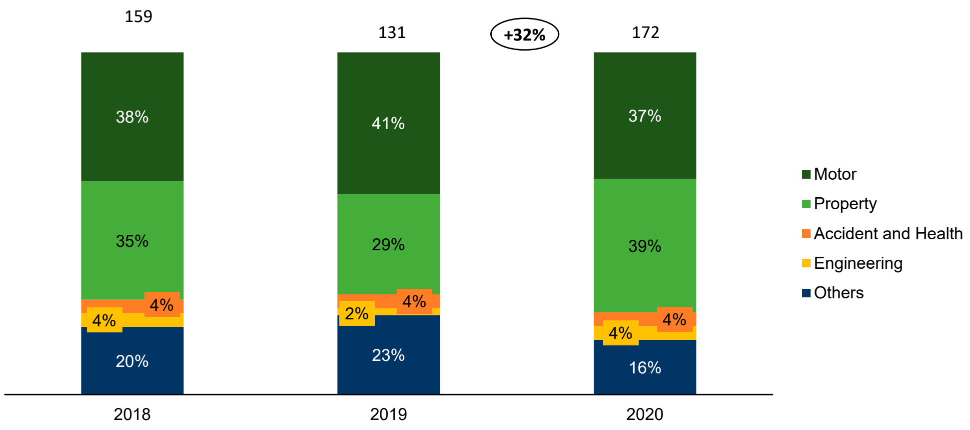
101 *Ibid.*

sector performed better than expected in 2020. The non-life insurance industry as a whole benefited from a reduction in claims due to a combination of lower alcohol consumption, curfews and the decline in road traffic leading to fewer motor vehicle accident claims. The report found that premiums increased by 2.2% in 2020 and given the lower claims in certain product lines, short term insurers' unappropriated profits increased by 20%.[102]

Figure 5c: Gross written premiums in the non-life insurance industry[103]

The Value of the non-life insurance industry's gross written premiums by policy

(Value in ZAR billion)



On the contrary, life insurers experienced a 7% decrease in gross written premiums largely due to the increase in the number and total value of claims paid out in 2020.[104]

102 News24, 2021, Insurers are making 'super-profits' while 'overcharging' on car insurance premiums. Available here

103 SARB, 2021, Prudential Authority Insurance Statistics Division.

104 *Ibid.*

5.1 Industry developments and key trends

5.1.1 Impact of the pandemic on insurance claims and premium payments

Many insurance companies approached the FSCA during the COVID-19 lockdown period regarding instituting premium relief measures for policyholders. The FSCA in 2020 issued exemptions for short-term insurers and long-term insurers from certain provisions of the Regulations under the Short-term Insurance Act, 1998 (**STIA Regulations**) and the Long-term Insurance Act, 1998 (**LTIA Regulations**) when providing premium relief. The exemptions aimed to facilitate the delivery of premium relief to policyholders, at the discretion of the insurer, without affecting the expected income of intermediaries during the period of the national state of disaster.

The FSCA also communicated expectations to industry regarding culture in general. Entities were requested to continue ensuring that all customers are treated fairly during the entire product cycle, from advertising, to sales, to claims, to renewals and complaints, and in the context of the pandemic, lockdowns, and impacts it had on customers.

The Covid-19 epidemic heightened the tempo of digital acceleration for insurers and alike. A number of insurers moved to using digital technology for distribution and sales instead of face-to-face interactions. Apart from premium relief, other initiatives undertaken included:

- Tele-underwriting services were made available through remote working arrangements in the lockdown period.
- Insurers postponed medical tests until the lockdown conditions normalised.
- Relaxation of certain claims requirements in instances where information would not be readily available due to the lockdown.
- Some insurers removed waiting periods applicable to policies, for deaths due to Covid.
- Many non-life insurers increased their grace periods.

The value of claims paid out in the non-life insurance industry has been relatively steady over the past few years, with 2020 experiencing a rise in unpaid claims, particularly business interruptions claims.[105] The value of non-life insurance claims paid out continued to increase in 2020.[106] However, the number of court cases required to resolve business claim disputes increased simultaneously. Complaints received by the Ombudsman for Short-term Insurance (OSTI) increased by 7% in 2020, the majority of which related to business interruption claims.[107] Insurers have argued that processing delays are the result of an increase in the frequency and

105 Daily Maverick, 2021, Business interruption: Insurance sector stalls on claims while making superprofits, says hospitality industry. Available here.

106 SARB, 2021, Prudential Authority Insurance Statistics Division.

107 Business Tech, 2021, The most complained-about short-term insurers in South Africa. Available here.

quantum of claims resulting from the financial pressure consumers faced in 2020, as well as challenges with having sufficient assessment capabilities to assess these technical claims.

Pandemic related covers were being rejected as insurers were trying to assert that the national lockdown was a separate event from the pandemic This narrow approach to the interpretation of policy coverage wording created risks of unfair outcomes for policyholders and can lead to a longer-term breakdown in public confidence and trust in the insurance industry. The FSCA continues to closely monitor the approach of insurers in this regard. In some instances, this has required more rigorous engagements with certain insurers, particularly those whose claims decisions may impact a large number of policyholders adversely.

Engagements with insurers have highlighted that there was uncertainty regarding insurer liability, due to varying interpretations of the wording of the policy contracts between the policyholders and the insurers. Contingent Business Interruption (CBI) claims are very technical and complex in their nature. Further, policyholders have also been uncertain about the claims' documentary requirements and at times failed to provide their documents for claims speedily. This was especially the case with smaller businesses. Adding to the crisis was a shortage of loss adjusters to assess claims submitted due to the unexpected sharp increase in demand for their skills.

Many of the concerns relating to claims have now been resolved, as the volume of complaints lobbied against insurers failing to pay out claims, have reduced significantly since December 2020. Engagements held with the non-life insurance industry concluded with the industry agreeing to interim payment relief arrangements to assist struggling policyholders. The interim relief took the form of once off payments to policyholders to enable them to continue running their businesses while waiting for the outcome of the legal process. However, some residual concerns – particularly transparency and understanding of policy terms and conditions – remain with a few insurers, and the FSCA will continue to engage with the industry until these concerns have been resolved.

Similarly, excluding the rise in claims in 2020, the value of life insurance claims has remained relatively steady since 2015, at an industry average of ZAR435 million per annum. Large insurers in the country recorded a 50% to 60% increase in life claims against fully underwritten individual life policies between March 2020 and January 2021, driven by the spike in the number of death claims in 2020.[108] Overall, the life industry recorded 434,216 death claims in 2020, a significant increase from the 317,442 claims received in 2019.[109] Death claims spiked even further with the third wave, as more than one million South African policyholders were reported to have passed away between April 2020 and 31 March 2021.[110]

108 All Africa, 2021, South Africa's Top Life Insurers Report Spike in Death Claims During COVID-19 Pandemic. Available here.

109 Daily Maverick, 2021. South Africa's top life insurers report a spike in death claims during COVID-19 pandemic. Available here.

110 ASISA, 2021, Beneficiaries receive R47.58 billion from life insurers for more than a million death claims

While the number of claims increased in 2020, the values paid out were less than the average life policy. This can be partly attributed to customers reducing the value of their cover as a result of financial pressures. The FSCA emphasised the need for insurers to ensure that claims were settled timeously, and investigated incidents where beneficiaries claims had not been settled on time by insurers. While recognising the negative impact COVID-19 has had on insurers, the FSCA still expects insurers to ensure fair outcomes for policyholders, which includes the timely payment of claims.

5.1.2 Reported Increases in Premiums

Many large insurers were reported to have raised their provisions against unprecedented COVID-19 related mortality claims, resulting in an increase in insurance premiums, particularly in the funeral policy space. It was reported that some insurers had increased premiums on the same policy more than once in a 12-month period.[111] The Policyholder Protection Rules (PPRs), state that a premium can only be reviewed if the policy provides for a review, and stipulates how often the premium can be reviewed. Engagements with the industry attempted to prevent unfair outcomes for consumers that could have resulted from policies not being priced correctly at inception of the policy, requiring exorbitant increases because of the impact of COVID-19 or subsequent underwriting losses.

The Office of the Ombudsman for Long-term Insurance (OLTI) experienced a 48% increase in the number of complaints received related to policy "lapsing" in 2021, as policyholders struggled to pay premiums under very difficult economic circumstances.[112] The FSCA has been engaging with the industry to determine whether the continued increase in premiums was substantiated. It was found that most insurers were increasing premiums on the basis of their expected claims and their experience in claims submitted from the previous two years. The FSCA believes that premium increases must be reasonable and justified by a number of factors, including among others the expense and profit margins. Supervisory efforts will continue to be directed towards ensuring that insurers adopt a fair and balanced approach towards premium approaches in future, while also taking into account the valuable role the industry has played in difficult economic circumstances – evidenced by the increase in retrenchment and loss of income claims, the surrender of policies, and in requests for premium relief extensions.

5.1.3. Civil Unrest Insurance Claims

The July 2021 civil unrest in Gauteng and KwaZulu Natal, which caused massive damage to infrastructure and disrupted business activity has resulted in approximately ZAR32 billion

in a 12-month period. Available here.

111 News24, 2021, Unlawful for insurers to push exorbitant funeral cover increases, says regulator. Available here.

112 IOL, 2021, Spike in funeral policy complaints. Available here.

in unrest related claims.[113] Social unrest is generally insured by the South African Special Risks Insurance Association (SASRIA). Out of all the received claims, R12,6 billion has been paid out, with a target of settling eighty percent of claims up to R60 million by March 2022.[114]

The FSCA has been in discussions with SASRIA on the processing of claims to affected businesses, with the intention of ensuring that all affected policyholders are paid the claims due to them timeously. The FSCA has also ensured policyholders are aware of their eligibility to claim and, through communications with insurers, has encouraged policyholders to submit their claims on time. It will continue engaging SASRIA on increases in lines of cover as a result of the civil unrest.

5.1.4 Micro Insurers and Insurtech set to expand

Micro-insurers can play an important role in addressing the low access to insurance products by low-income individuals. The Insurance Act of 2017 introduced a microinsurance regulatory framework. The difference between micro insurance and conventional insurance policies is the size of the insured amount. Micro-insurance policies are limited to ZAR100,000 for life insurance and ZAR300,000 for non-life insurance and contract terms are up to 12 months. Brokers and agents are a key feature of the delivery model; and mobile network operators (MNOs) are able to sell micro insurance using USSD technology making it accessible to low-income individuals.[115] Micro-insurers typically face regulatory requirements that are better suited to their line of businesses, for example, requiring less in the way of capital to meet prudential solvency requirements.

To date micro insurance products have typically been limited to funeral policies. The growth of insurtech, i.e. digital delivery of insurance products, especially via mobile phones, could help increase access for lower income groups. Analysts believe there will be rapid growth in this industry. [116]

Insurtechs have been emerging in the insurance industry; in 2019 there were a total of 22 insurtech firms. These entities provide part or all of the insurance value chain functions, through the use of specific technologies such as artificial intelligence, data analytics and robotics. The majority of the insurtechs (12 out of the 22 reported in 2019) are digital distributors that offer traditional insurance products through digital channels, such as mobile, web or app. Launched in 2015, *Simply,*[117] and *Click2Sure,*[118] are examples of these digital distributors.

113 SASRIA, 2021, Sasria registers over 100% of claims, as more pay-outs are made. Available.

114 *Ibid*

115 EY, 2021, Micro Insurance. Available here

116 McKinsey, 2021, Africa's insurance market is set for takeoff. Available here

117 Simply. Available here.

118 Click2sure. Available here.

5.1.5 The Emergence of New Innovative Products

Like other industries, the adoption of technology has impacted the insurance industry; insurers expanded the provision of insurance products to cover new technology and digital platforms.[119] Beyond the impact of the COVID-19 pandemic, insurers globally have adapted to insure new technologies such as drones, and offer coverage to new business models such as platform-based businesses.[120,121]

South Africa has seen a notable increase in the number of products available to cover cybersecurity losses.[122] Further, the introduction of the Protection of Personal Information Act (POPIA) has induced the development of new insurance products targeting business and consumers to cover potential risks relating to the processing of personal information.[123]

Over the past few years, the adoption of telematic devices and internet of things (IoT) has increased, particularly among non-life insurers providing vehicle tracking systems. Several South African insurance companies have started to provide vehicle insurance coupled with vehicle-tracking telemetry technology, an element of IoT. [124] Carjacking incidents have increased over the past three years (2018 - 2020), with the South African Police Services (SAPS) reporting a 10% CAGR.[125] Given the rising incidence of car-jackings, accidents and vehicle thefts reported in South Africa each year, insurers have adopted installation of tracking devices as a requirement for certain vehicles to qualify for cover.[126] Insurers are using IoT to evaluate and monitor the behaviours of their customers (drivers) to determine risk and make calculations on premiums and payouts.[127] The vehicle-tracking telemetry technology allows the monitoring and evaluation process to occur in real time, potentially improving product provision and service.

In addition to vehicle-tracking, there are also trends toward driving, lifestyle and fitness tracking to similarly inform customer risks, premiums and payouts.

119 BusinessTech, 2021, Standard Bank customers embrace digital insurance solutions. Available here.

120 Norton Rose Fulbright, 2021, What's on the horizon for the insurance industry in 2019? Available here.

121 *A platform based business model is one that owns the underlying technology platform that connects suppliers to buyers; and has relatively few assets. Examples include Airbnb and Uber.*

122 Norton Rose Fulbright, 2021, What's on the horizon for the insurance industry in 2019? Available here.

123 *Ibid.*

124 Moodley, A.,2019, Digital transformation in South Africa's short-term insurance sector: Traditional insurers' responses to the internet of things (IoT) and insurtech.The African Journal of Information and Communication. Available here.

125 SAPS, 2021, Crime statistics. Available here.

126 IOL, 2021, What you need to know about vehicle tracking devices and insurance. Available here.

127 Moodley, A., 2019, Digital transformation in South Africa's short-term insurance sector: Traditional insurers' responses to the internet of things (IoT) and insurtech.The African Journal of Information and Communication. Available here.

The risks brought about as a result of requiring such tracking – for example, accuracy of data used, informed consent by customers, and the burden of compliance for customers – will continue to be monitored by the FSCA.

The risk of financial exclusion will also be borne in mind as industries shift toward more digitally-focused solutions. While ensuring convenience and greater accessibility, digital offerings must also be evaluated in the context of differing levels of digital literacy and access to infrastructure such as smartphones, data and WiFi.

5.1.6 Social media conversation as a platform for engagement between customers and insurers

Between April 2020 and March 2021, the overall average Net Sentiment score[128] which depicts aggregate customer satisfaction, was -0.4% for the insurance industry - the lowest level of negative conversation in the industry.[129] Over this period, 450,000 public non-enterprise social media posts directed at the country's major insurers were analysed. The data collected was based on unsolicited feedback from customers and non-customers alike depicting their perception of insurance providers in the country and where they tend to fall short. Across a broad range of financial industries, the insurance industry emerged as the industry with the lowest level of negative conversation among consumers.[130]

Of all the conversations monitored within the insurance industry, 66% of the customers complained about customer experience, 36% about insurance products, and 23% about insurance claims between June 2020 and July 2021.[131] The conversations around customer experience were mainly complaints about turnaround time across all insurance products, brands, and channels; with 52.8% of the conversation being negative.[132] Customers were greatly dissatisfied by the response of insurers when they made queries about the status of their insurance claims, and monthly premiums to be paid. Often customers did not receive responses to their queries and this appears to play a significant role in driving consumers towards cancellation of insurance policies. The overall claims process across the industry was rated -64.3% in terms of net sentiment, which implies that approximately 64% of conversations regarding claims, particularly the status of the customer's claim were more negative than positive.[133]

128 *Net Sentiment Score is calculated by subtracting the percentage of negative online mentions from the percentage of positive online mentions for a brand.*

129 Brandseye, 2021, South African Insurance Sentiment Index. Available here.

130 *Ibid.*

131 Brandseye, 2021, FSCA Account with Brandseye. *Note: Some conversations were tagged in more than one category; i.e. conversation falls under customer experience and payout of insurance claims, thus the percentages are not unique to one conversation.*

132 Brandseye, 2021, FSCA Account with Brandseye.

133 Brandseye, 2021, South African Insurance Sentiment Index. Available here.

Interestingly, turnaround time was also among the top three drivers of positive conversation, indicating that turnaround time can either make or break customer experience. Analysing the conversation around take-up of insurance products, 21.5% of the conversation labelled turnaround time as a push factor to sign up for an insurance product.[134]

The relatively better response rate by insurance providers when consumers requested for an insurance quote has particularly been the reason turnaround time has induced take-up of insurance products between June 2020 and July 2021.

The FSCA is responsible for supervising and regulating the conduct of insurers through the Long-Term Insurance Act 52 of 1998, and the Short-Term Insurance Act 53 of 1998 while the PA is responsible for prudential regulation of insurance in terms of Insurance Act. Historically, the insurance industry fell under the purview of the FSB; the FSR Act introduced the PA (within the SARB) as the prudential regulator for insurers, and the FSCA became responsible for market conduct aspects such as policyholder protection. Over the years, the FSCA has engaged with the industry to amend and create new conduct reforms to afford greater protection to policyholders.

In recent years, a number of insurers have issued premium increases without fully disclosing the changes to customers, and in situations where there were disclosures, explanations of the changes were not in a manner that is easily understood by policyholders. In line with the TCF framework and set conduct standards, insurers are expected to make the necessary disclosures to policyholders in writing; disclosures should include information on the product, including the payment of premiums, in a manner that is clear and easy to understand.

To improve disclosure by insurers, the FSCA introduced additional requirements in the Regulations and Policyholder Protection Rules (PPRs), issued in terms of the Long-term Insurance Act, No. 52 of 1998 (LTIA). Among others, the additional requirements provided provisions for the manner in which insurers are expected to make disclosures, determine and review premiums, stipulate product design and performance. The rules are aimed at ensuring that insurers focus on the value the product provides a policyholder during the lifetime of the product, thereby protecting consumers from exploitation. Currently, the FSCA is considering introducing a reporting requirement that will require insurers to report premium increases that exceed a certain threshold to the FSCA in an effort to ensure that premium increases do not disadvantage policyholders and that fair and reasonable options are provided to policyholders to assist in keeping their policies.

134 Brandseye, 2021, FSCA Account with Brandseye.

6. Retirement Fund Industry

With assets in excess of ZAR4,6 trillion, South Africa's retirement industry has one of the highest assets to GDP ratios in the world.[135] The industry has over 5,000 pension funds including the South African Government Employment Pension Fund (GEPF), which is regarded as the 20th largest fund globally (when viewed with reference to assets under management), the Telkom, Transnet and the Post Office Pension Funds.

In the 1990s there were over 16,000 registered pension funds in South Africa, while in 2020, 5,158 pension funds were registered. This industry consolidation has been driven by the opportunity to find operational cost savings by merging operations. As a result, there was a move away from individual employer pension funds to umbrella funds (a fund that is open to multiple unrelated employers).

The FSCA supervises and regulates institutions registered as retirement funds under the Pension Funds Act No. 24 of 1956. As at December 2019, 5,154 funds were registered and regulated by the FSCA.[136] Although registered pension funds, some funds are not regulated by the FSCA; *inter alia* the GEPF, Transnet and the Post Office pension funds are not subjected to the Pensions Funds Act, rather they are established by separate statutes. The FSCA also has a mandate to regulate and supervise the investments undertaken by retirement funds insofar as requiring compliance with Regulation 28 of the Pension Funds Act to ensure that funds do not take unnecessary risks and that members are protected from the negative effects of poorly diversified investment portfolios.

Of the 5,154 funds, only about 1,580 funds, approximately 31%, are currently active. [137] Many of the inactive funds are in the process of liquidation or cancellation, or in the process of being transferred. 927 are self-standing occupational funds and 445 are umbrella funds. Provident and pension funds are common in both self-standing occupational and umbrella funds. The tax rules applicable to pension funds and provident funds used to be different but have now become completely aligned. Both allow tax deductions on member contributions and from 1 March 2021, members can only withdraw up to one-third of their investment as a cash lumpsum upon retirement. The remaining two-thirds must be invested in a product that pays out a retirement income or annuity.[138]

135 IFC, 2020. Sustainable Finance Practices in South African Retirement Funds. Available here.

136 FSCA, 2021, Retirement Funds division.

137 *Ibid.*

138 Allan Gray, 2021, What's the difference between retirement products. Available here

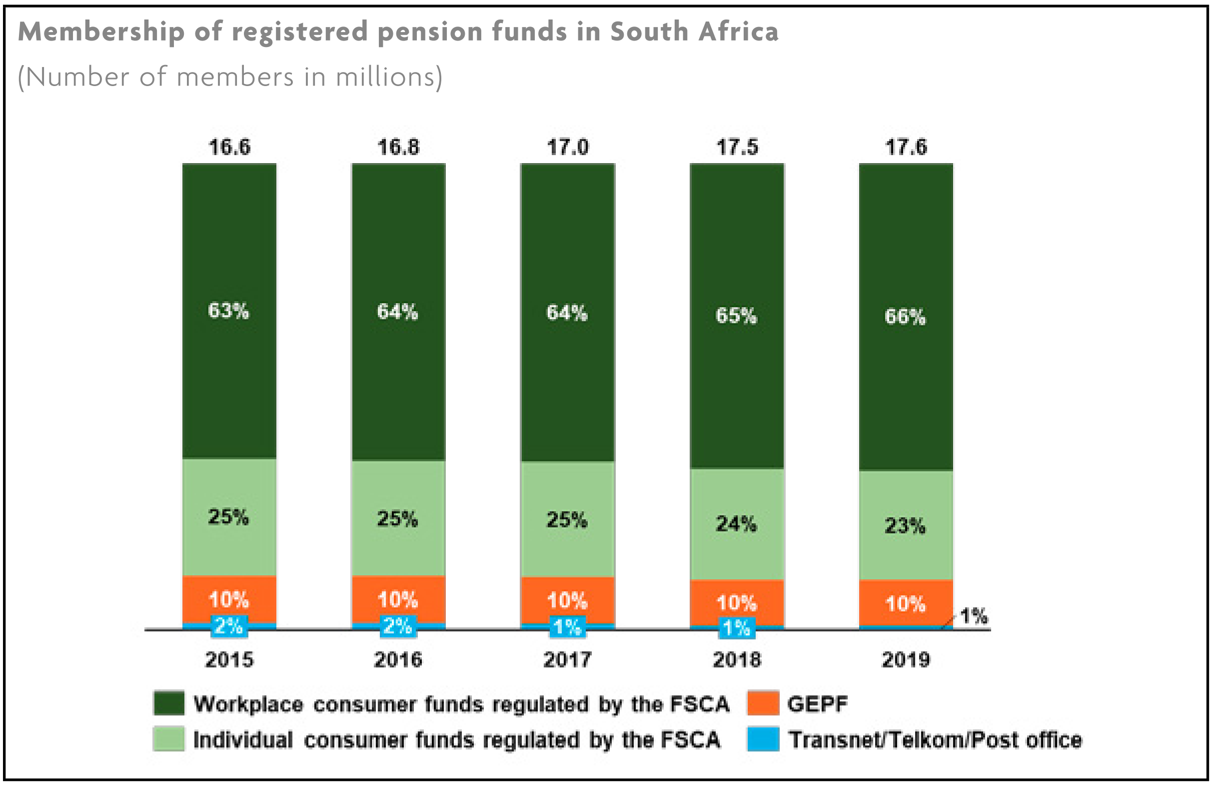
There are certain exceptions to this rule for members of provident funds; if the benefit amount is less than ZAR 274,500 the member may withdraw the funds in full; if the member had reached the age of 55 by 1 March 2021 they are entitled to withdraw a lumpsum cash benefit; and the fund credit accrued up to 28 February 2021, may be withdrawn as a lumpsum benefit.

6.1 Industry developments and key trends

6.1.1 Take-up of retirement products

Membership of regulated pension funds has been growing at 2% per annum since 2015 and there are approximately 16.4 million members in 2021.[139] These are not 16.4 million individual members as this figure double counts individuals with more than one pension product (for example, a member may belong to a pension fund, retirement annuity fund and a preservation fund). South Africa has a small and stagnant labour force, with 28.5% of the population unemployed. Youth unemployment is a particular challenge, standing at 57.5%. It is estimated that between 7 and 10 million individuals have retirement savings products out of an employed labour force of about 15 million.

Figure 6a: Members of regulated pension funds[140]



139 FSCA, 2021, Retirement Funds division.

140 *Ibid.*

Pension fund coverage looks very different in the public sector compared to the private sector. In the public sector, 92% of workers have a retirement product, whereas only 50% and sometimes less have a retirement product in the private sector. Coverage (i.e. the proportion of individuals with a retirement product) is particularly low for individuals earning below ZAR14,000 per month.[141] There is limited demand for pension products in the lowest income brackets due to government's pension support. The pensioners' government grant pays ZAR1,890 per month and therefore individuals in LSM groups 1 - 4 (between 8 - 10 million South Africans) earning approximately ZAR1,300 - ZAR3,000 per month have little incentive to contribute to a private pension fund.

Under-saving for retirement is an issue in South Africa, as only 12% of the 3.6 million individuals in the retired age group received a form of income in 2020. More than 90% of retirees are unable to maintain their standard of living prior to retirement and two thirds of members have less than ZAR50,000 in their retirement funds.[142] Since 2017, the average value of benefits paid out has slightly increased in real terms, averaging approximately ZAR39,000 per month. The average contribution to pension funds has, however, remained relatively stable at around ZAR900 per month in real terms.[143]

6.1.2 The impact of COVID-19 on retirement funds

The number of pension funds applying for liquidation increased by 21.5% in 2020.[144] Applications for liquidation were the result of financial distress experienced by funds as member contributions fell. The national lockdown saw many employers impose salary reductions, mass lay-offs, and business closures. The majority of the funds affected had smaller businesses as members, participating in umbrella fund arrangements and were predominantly in the manufacturing and services industries. Employers contributing to these funds had to request for payment relief in paying contributions. Larger employers were less affected, and continued to pay their employees' salaries and contributions towards pension funds

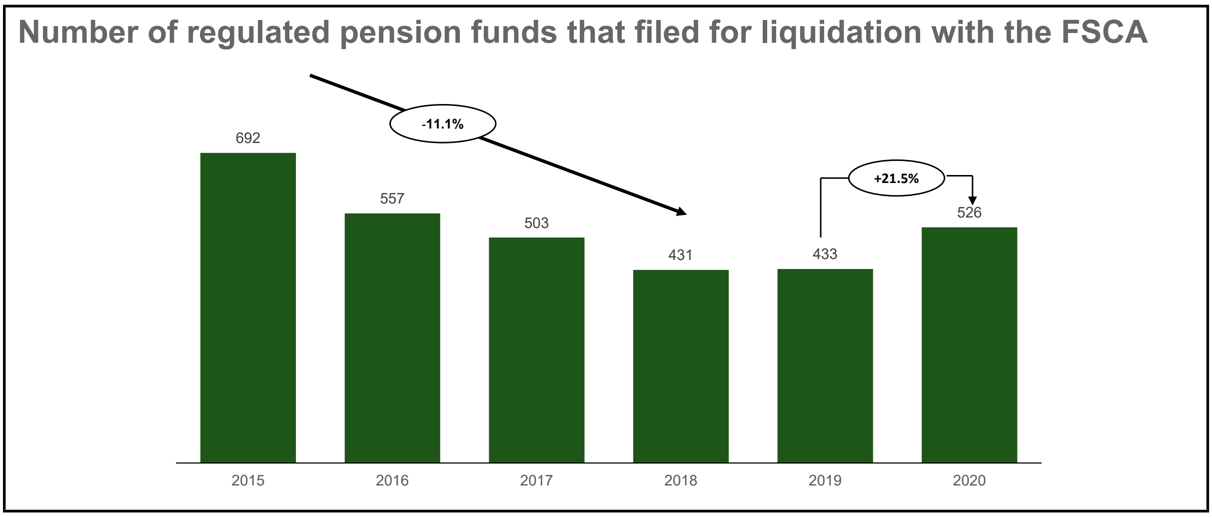
141 Old Mutual, 2019, Savings and Investment monitor. Available here.

142 Institute of Retirement Funds Africa, quoted in Shock retirement numbers for South Africa, press release. Available here.

143 FSCA, 2021, Retirement fund division.

144 *Ibid.*

Figure 6b: Liquidated pension funds[145]



To alleviate the challenges faced by employees and employers contributing to pension funds, the FSCA enabled relief measures for funds. These included reminding funds to apply or to register rules allowing for the suspension in paying contributions towards pensions funds; and a reduction of pensionable service where employees were working fewer hours. In a permanent change to the industry, the Pension Funds Amendment Bill was presented to parliament in May 2021. This amendment will allow workers with retirement funds who find themselves in financial distress (for example, due to the COVID-19 pandemic), to access a portion of their retirement savings in cash before reaching retirement.

6.2 Conduct issues under consideration

The FSCA continues to focus on enhancing trustee conduct to combat the emerging risks that are related to the lack of knowledge and experience of trustees that run pension funds. Based on the Pension Funds Act of 1956, retirement fund trustees are assigned on the basis of nomination by fund members without any prerequisites relating to the level of education and / or skill. In the past, this has created opportunities for consultants and advisers of retirement funds to take advantage of the system and push personal interests which the trustees may not notice, especially those who have no experience or knowledge of managing pension funds. The FSCA has proposed a continuous professional development toolkit for trustees, whereby trustees are equipped with the basic knowledge necessary for making informed ethical decisions to combat the issue.

The retirement industry continues to hold a huge amount of unclaimed pension fund benefits. Unclaimed benefits are estimated to be over ZAR42 billion in 2020, owing to approximately five million members. 80% of the unclaimed funds are with trade union-affiliated pension funds and the majority of these unpaid members are low-income miners. The key reason for the high level of unclaimed funds is that members change jobs without updating their personal information, and they lack the financial literacy to understand the

145 *Ibid.*

implications, and administrators also have poor records of their member base. Asset managers and fund administrators continue to earn fees from these unclaimed assets.

Table 6a: Unclaimed benefits in South Africa[146]

	Number of Funds	Aggregate amount of unclaimed benefits (ZAR Billion)	% of total UB Assets	Number of beneficiaries for whom unclaimed benefits are held
Occupational retirement funds (both stand-alone and umbrella; underwritten and not)	1,623	37,235	78.7	3,827,308
Beneficiary funds	8	118	0.2	1,916
Unclaimed benefit funds	49	9,995	21.1	977,276
Total	**1,680**	**47,348**	**100**	**4,806,500**

Progress has been made towards the repossession of unclaimed benefits, with the FSCA's unclaimed benefits search engine helping over 14,000 individuals receive payments worth approximately ZAR1,2 billion. The National Treasury announced in the 2020 Budget that legislation will be prepared to consolidate unclaimed benefits in the retirement industry and establish a single registry. The FSCA continues to prioritise the fair treatment of customers, and through the Know-Your-Customer (KYC) directive, the regulatory body hopes to further reduce unclaimed benefits in the future.

An important development is the streamlining and improvement of the 'Section 14B' process, whereby a pension fund applies to the FSCA to transfer its assets to a new administrator. This is often a solution for a situation of an inefficient or poorly run administration company, and the application will typically be filed by the transferring fund. As part of the application, the FSCA will approve transfers only where it is reasonable and equitable and where full recognition is accorded to the rights and reasonable benefit expectations of transferring members. The FSCA has clamped down on incumbents holding up the process and now enforces a strict timeline. Applications have to be lodged with the FSCA within four months after termination with the incumbent provider, and the FSCA then has 45 working days to approve the application. The incumbent administrator will have 60 days from approval by the FSCA to transfer the assets of the employer to the new administrator.

146 FSCA, 2021, Annual report. Available here.

7. Investment and Asset Management Industry

The South African investment and asset management industry is made up of Financial Advisory and Intermediary Services (FAIS) asset managers, investment administrators, and Collective Investment Schemes (CIS). The asset management industry manages and administers asset classes ranging from equities, bonds, alternative investments, and hedge funds. Collective investment schemes' (CIS) are regulated by the FSCA under the Collective Investment Schemes Control Act 45 of 2002.

The industry serves several million consumers and has seen steady growth in consumer numbers, investment activity and assets under management. Assets under management in CIS (in securities and hedge funds) increased by 5% CAGR for the period 2016 - September 2021,[147] and private equity funds by 5% CAGR between 2015 and 2020.[148] Investment activity in venture capital has been increasing over the past decade, with the last five years (2016 - 2020) seeing more than ZAR5.6 billion of investments by fund managers into early-stage opportunities.[149]

7.1 Overview of the investment management industry

The FSCA currently supervises investment activity by 49 local CIS managers, managing 1727 portfolios; 2 CIS in participation bonds and 1 CIS in property approved; 14 CIS in hedge funds; and 861 asset managers.[150]

- A collective investment scheme is a scheme (could be an open-ended investment company) to which members of the public are invited to invest money or other assets in a portfolio. CIS constitutes of two or more investors that contribute money or other assets to and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest; and the investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis determined in the deed.

- CIS held in hedge funds became subject to regulation in April 2015 when they were declared to be a collective investment scheme. These funds use various strategies (such as leveraging or short investment positions) which could potentially lead to losses greater than the aggregate market value of the fund.

147 FSCA, 2021, Investment providers division.

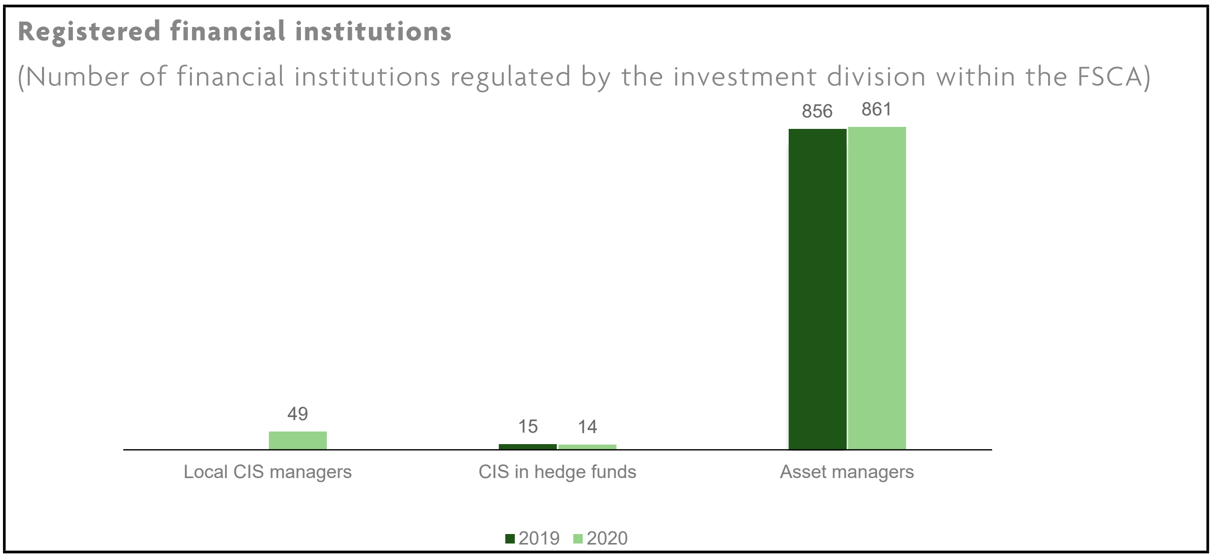
148 SAVCA, 2021, Private Equity Industry Survey Volume 2. Available here.

149 SAVCA, 2021, Venture Capital Industry Survey. Available here.

150 FSCA, 2021, Annual report. Available here.

- Asset managers are individuals that currently hold a FAIS licence and manage assets on behalf of their clients with the aim of making investment decisions that increase the value of their client's portfolio.[151]

Figure 7a: Regulated investment institutions[152]



As at 30 September 2021, the investment industry held an estimated ZAR4.26 trillion in total assets under management; 79% of the total assets under management were held by local CIS, 18% by foreign CIS, while CIS in hedge funds held 2%.[153] Relative to local and foreign CIS in securities and hedge funds, CIS in property and participatory bonds do not form a big part of the industry's assets, holding assets to the value of ZAR 1.4 billion and ZAR 4.8 billion respectively in 2021. Most of the property fund investment market sits in Real Estate Investment Trusts (REITs), noting that the market cap of publicly traded South African REITs was near ZAR 200 billion as of 30 September 2021, down from its record highs in 2017 of over ZAR 400 billion (as per information on the SA REIT website).

CIS in securities have grown by 9% CAGR, and CIS in hedge fund by 7% over the period 2016 - September 2021.

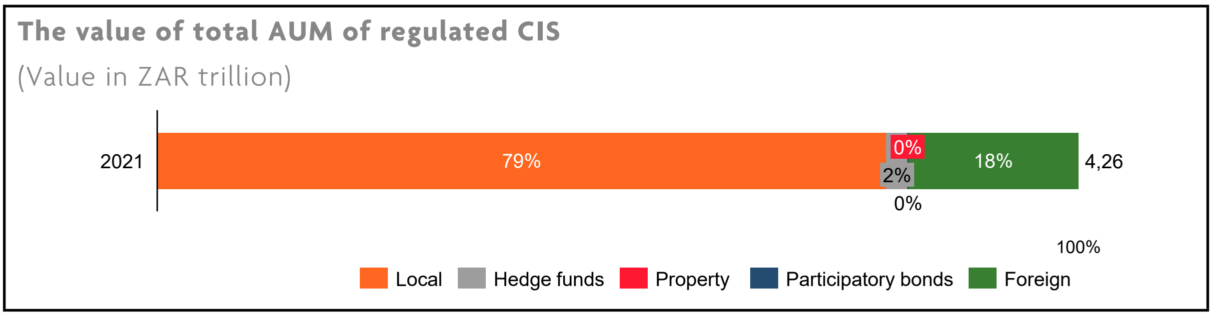
Although a relatively small proportion of the overall CIS market, there has been significant growth in exchange-traded funds (ETFs) and exchange-traded notes (ETNs). According to the ETF SA report "State of the South African Exchange Traded Product (ETP) Industry", the total market value of South Africa's 85 ETFs and 65 ETNs stood at R125.5b as of 30 September 2021. This market value has grown by 11.29% CAGR since 2016 which reflects continued interest in passive funds, which generally reflect lower costs. Main investor interest over the past year has included commodities and deriving foreign exposure.

151 *To be discussed further in Chapter 8: Financial Advisory and Intermediaries Industry.*

152 FSCA, 2021, Investment providers division.

153 *Ibid.*

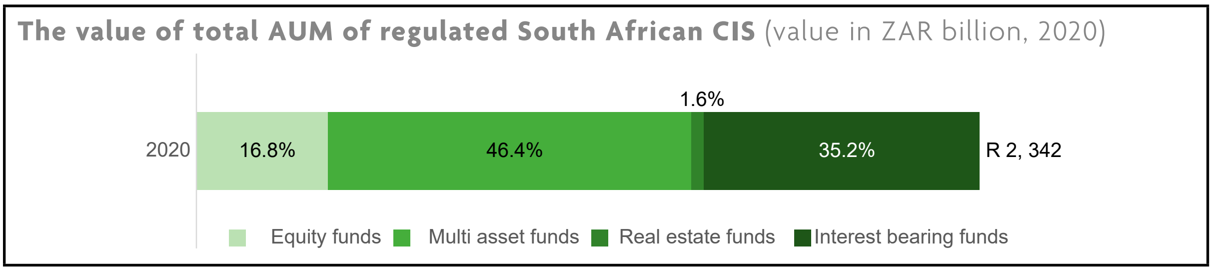
Figure 7b: Assets under management of Collective Investment Schemes[154]



Assessing investment patterns observed within the industry, **institutional investment remains popular among investors**; in 2020 the Association for Savings and Investments South Africa **(ASISA)**[155] **reported that 63% of local CIS's assets under management of its members were held by institutional investors.**[156] Institutional investors are firms that pool money from various clients and invest the funds on behalf of their client base. The remaining 37% of the assets under management in local collective investment schemes was held by members classified as retail investors, or non-professional individuals trading through brokerage firms.[157]

The majority of the assets under management held by ASISA members with local CIS are held in multi-asset funds, i.e. across various financial instruments and industries. Multi-asset funds allow financial investors to invest in a combination of asset classes, such as real estate, money market instruments, equities and bonds, affording greater diversification. Between 2015 and 2020, the total assets under management by South African CIS held in multi asset funds increased by 5% CAGR, amounting to ZAR1.1 trillion, 46% of total assets under management in 2020. This reflects the desire by investors to reduce risk as they respond to the ever changing financial and economic environment.[158]

Figure 7c: Assets under management of ASISA members by type of fund[159]



154 *Ibid.*

155 *ASISA is an industry body that represents a large proportion of CIS investors in South Africa. It is not mandatory to register with the body, therefore the data noted above is only representative of ASISA members, and not the entire industry regulated by the FSCA.*

156 ASISA, 2020, Collective Investment Schemes. Available here.

157 *Ibid.*

158 *Ibid.*

159 *Ibid.*

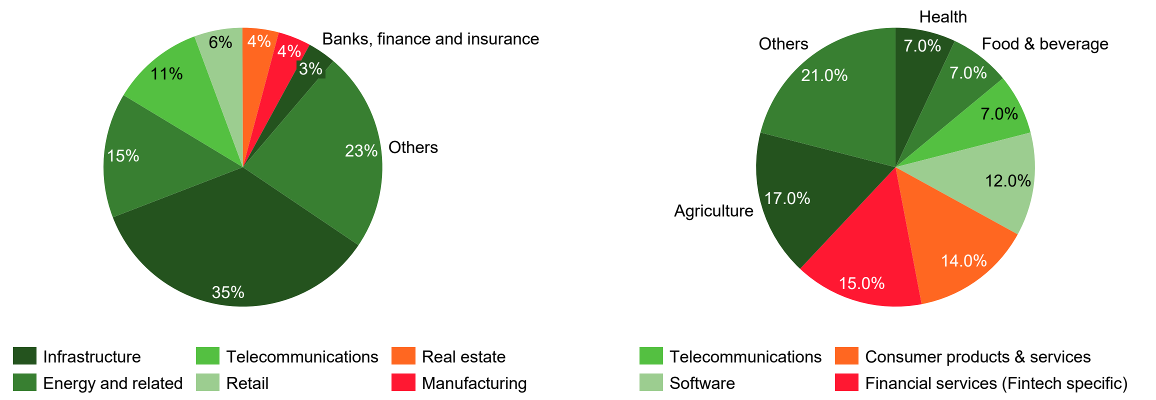
While growth of the private equity industry[160] over the last 20 years has been significant, year on year growth has been more volatile.[161] In 2009 overall investments are estimated to have totalled ZAR7.2 billion falling from almost ZAR16 billion in 2008; by 2013 the industry had recovered, and total investments had almost doubled to ZAR13.9 billion. In 2020, overall investment was estimated to be ZAR14.5 billion, a decrease from ZAR25.4 billion in 2019.[162]

The proportion of new investment deals versus follow-on investments (i.e. investments in an existing portfolio company of a private equity fund) also fluctuates year on year. Total investments in 2017 were almost double that of 2016 and 60% of those were in new deals; in 2018, 57% of investments or ZAR20.5 billion, were in follow-on investments.[163] The number of deals has been increasing since 2014 and in 2018 there were a total of 818 deals in the year, split almost equally between new deals and follow-on investments.[164]

Figure 7d: Private equity and venture capital investment activity[165]

The proportion of private equity investments **The proportion of venture**

capital deals by sector (%, 2019) **by sector (%, 2019)**



Venture capital investment is still nascent but growing, as demonstrated by the 35% CAGR in the value of new investment deals between 2015 and 2019[166]. In 2018, there were close to 180 deals concluded, up from approximately 100 deals in 2015.[167]

160 *The statistics presented on private equity and venture capital represent investment activity by SAVCA members in South Africa, which the FSCA regards as sufficient to give an industry overview.*

161 SAVCA, 2020, Private Equity Impact Survey. Available here

162 *Ibid.*

163 SAVCA, 2021, *Stakeholder meetings.*

164 *Ibid.*

165 SAVCA, 2021, *Stakeholder meetings.*

166 SAVCA, 2020, Venture capital report. Available here.

167 SAVCA, 2021, *Stakeholder meetings.*

Venture capitalists are private equity investors that specialise in investing in start-ups or companies in the early growth phase, showing high growth potential.

These businesses usually have limited access to financing and capital. In 2019, the value of deals made increased by 21% to ZAR1.3 billion; the agricultural sector was the most heavily invested in, followed by fintechs (technology enabled financial service providers).[168]

The vast majority of these funds are channelled into late-stage investments. Venture capital funds that are set-up to support early-stage businesses make up only 2% of funds that are committed to later stage investments.[169] There remains a significant need for more risk capital to fund start-ups before the proposition is a proven business. Funding more early stage business can be expected to improve innovation and competition in the sector.

A 2018 survey suggested 41% of start-ups received funding from local funds only, 45% from a combination of local and foreign investors and 14% solely from foreign investors.[170] Local and foreign co-investment is important as foreign investors provide access to international markets, while local funders are fundamental in identifying and grooming domestic start-ups to attract foreign partners.

7.2 Conduct issues in the investment industry

The investment and asset management industry can be complex for customers to navigate and interpret; a key area for improvement is the clear and transparent disclosure of fees and pricing. The FSCA requires CIS managers and FSPs to disclose all charges and fees to be levied against a financial product, including the fee amounts and their frequency, to enable the customer to determine their net investment amount.

Recently, the FSCA imposed a fine on an investment provider that failed to provide investors with clear and transparent management fees as required by the regulator.[171] The key individual was fined for charging fees it did not disclose to its customers. The fine was also related to the key individual's role in shifting funds to unregulated collective investment schemes.[172] Failure to disclose fees and/or the nature, extent and frequency of any incentive, remuneration, commission, or fees for which financial advisors may be eligible, diminishes the integrity of financial markets. Therefore, in pursuit of ensuring consumer protection, the FSCA has a legal obligation to take any necessary actions against those that infringe on the rights of customers.

168 *Ibid.*

169 IFC, 2019, The Unseen Sector: A Report on the MSME Opportunity in South Africa. Available here.

170 Intergovernmental Fintech Working Group, 2019, Fintech Scoping In South Africa. Available here.

171 City wire, 2021, FSCA fines Carrick CEO for deVere shortcomings. Available here.

172 *Ibid.*

The FSCA continues to warn members of the public to act with caution when dealing with entities claiming exaggerated or even guaranteed investment returns. It has come to the FSCA's attention that a number of investment providers are luring customers by promising 'super' returns on investment, which these entities may not be able to realise. A series of investigations by the FSCA found that most of these exaggerated offerings were by entities that were not registered with the FSCA. Members of the public are encouraged to verify the registration of financial institutions with the FSCA before engaging in any dealings. The public is able to call a toll-free number or visit the FSCA website to verify any financial service provider.

8. Financial Advisory and Intermediaries Industry

In terms of the number of entities regulated by the FSCA, the financial advisory and intermediaries industry stands out as the largest industry with a large number of financial consumers interacting with the various licenced intermediaries. Currently, there are a total of 11,283 registered financial institutions under the Financial Advisory and Intermediary Services (FAIS) Act of 2002, that provide advisory and intermediation services.[173]

The FAIS Act defines intermediaries as any person(s) who provides advice to a client (i.e. provides recommendations or guidance on the purchase, investment or termination of a financial product); or acts as an intermediary between a client and a product provider. Intermediary services include acting on behalf of a client or product provider, maintaining custody of a financial services product (e.g. a share certificate), collecting premiums, processing claims, executing discretionary or non-discretionary transactions, and the administration of a financial product.

In accordance with the FAIS Act, customers should expect to receive trusted and appropriate advice given their affordability and suitability profiles; be treated with honesty and integrity; know the details of fees, including all costs and commissions; receive an annual update on their product; and have the right to recourse, including through the FAIS Ombud. The FSCA ensures this through rigorous supervision of registered entities, conducting mystery shopping activities, and collecting and analysing data including financial statements, product offerings and uptake by customers.

As at 30 September 2021, **asset managers held approximately ZAR 11.7 trillion assets under management, an annual growth rate of 17% from 2020, and a growth rate of 33% between the period 2016 - 2021.**

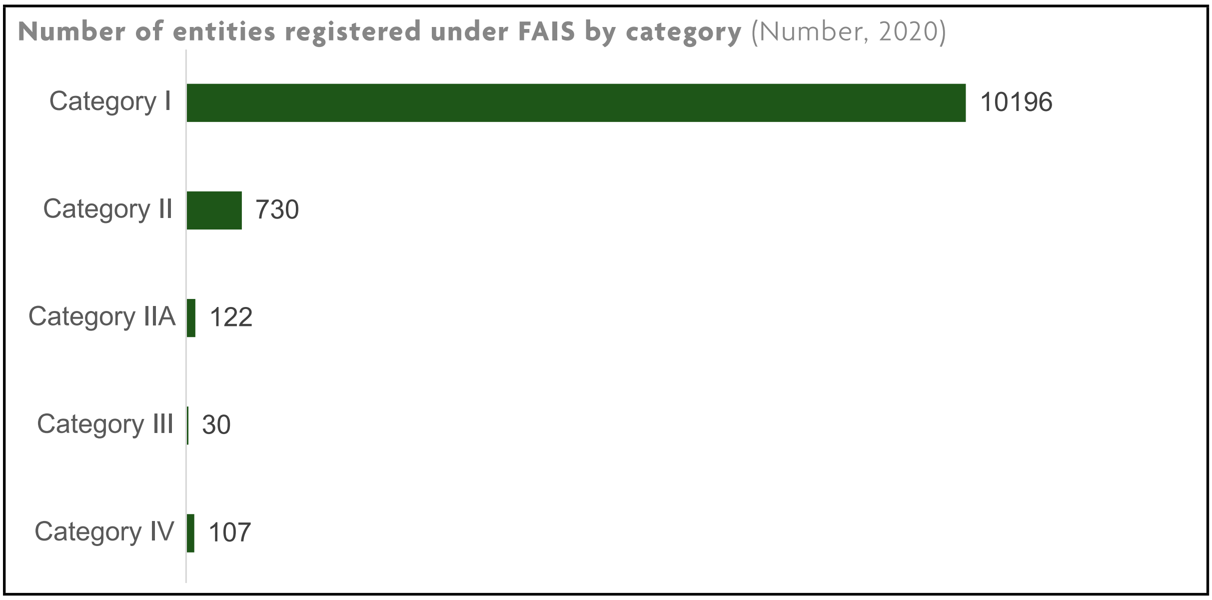
173 FSCA, 2021, Licensing department. *Note that this figure* ***includes*** *those FSPs who are licensed to provide asset management services, as discussed in Chapter 7 of this report.*

8.1 Overview of the financial advisory and intermediaries' industry

The FAIS Act authorises financial institutions providing advisory and intermediary services to be grouped into five different categories of financial institutions.

- **Category I** FPSs consist of financial advisers and intermediaries who render financial advice on a non-discretionary basis. This category makes up the largest number of service providers, with over 10,000 financial institutions.
- **Category II** FSPs (also referred to as discretionary FSPs) refer to financial services providers who render intermediary services of a discretionary nature with regards to the choice of a financial product without any bulking.
- **Category IIA** FSPs (also referred to as hedge fund FSPs) render intermediary services of a discretionary nature in relation to a particular hedge fund or fund of hedge funds in connection with a financial product. There are currently 122 financial institutions that fall within this category that are regulated by the FSCA.
- **Category III** (also referred to as administrative FSPs and linked investment service providers) render intermediary services in respect of financial products on the instructions of a client or another FSP and through the method of bulking. This makes up the smallest category, with only 30 financial institutions registered with the FSCA
- **Category IV** relates to administrative FSPs who render intermediary services in relation to the administration of assistance policies on behalf of the insurer. This category consists of 107 financial institutions rendering administrative services for product providers under the supervision of the FSCA.

Figure 8a: Registered financial advisory and intermediary service providers[174]



174 *Ibid.*

To ensure adequate standards of service and knowledge, licensed intermediaries are obligated to meet certain requirements depending on the category they fall under, and therefore, the type of engagement and advice they offer customers. Key individuals of financial institutions offering advisory and intermediary services are required to pass a regulatory exam before they can practice financial advisory or intermediary services. In addition, as a competence criterion, Category I and IV service providers are required to obtain a financial qualification within three years of employment. Category II, IIA and III service providers are required to have a financial qualification that is relevant to the type of product they provide advisory services on (including commercial and legal aspects), with the minimum qualification being a university degree.

In addition to the prerequisites stated above, the FSCA recently introduced product-specific training as a requirement to ensure high standards of service and customer protection. The intent of the training is to equip financial advisors and intermediaries with the necessary skills and practical experience to improve the service offered to customers. Training must be received through an accredited facilitator, thereby ensuring similar standards across the industry.

These requirements have been established to protect customers, and not to restrict entrants into the financial advisory landscape. Many licenced entities are small independent businesses and the FSCA recognises that a FAIS licence offers an opportunity for entrepreneurship and employment. In its role as supervisor, the FSCA acknowledges and supports the development of small business. This is achieved through regular training opportunities or forums on topics related to business management. The objective of these initiatives is to assist small businesses with other aspects of running a business, such as human resource management, financial management etc.

An area that remains concerning is the relatively large number of smaller FSPs that do not have compliance officers. Compliance officers are accredited persons who ensure regulated financial institutions adhere to the regulatory and legal requirements set out by the FSCA and other regulatory bodies. The lack of compliance officers means the accuracy and credibility of regulatory submissions within the industry may be challenged, and poses a threat to the integrity of financial markets. To bridge the gap, the FSCA has hosted webinars aimed at small FSPs to guide them through the requirements of the legislation, and to help them understand the broader landscape of financial services.

8.2 Industry developments and key trends

8.2.1 The impact of COVID-19 on FAIS licence holders

A noticeable consequence of the COVID-19 pandemic was the increase in the number of lapsed FAIS licences as a number of FSPs closed down their operations in 2020. The pandemic forced a number of sole traders to retire early due to slow business activity and resultant liquidations. Many smaller businesses merged to share operational costs and improve the customer proposition through a wider selection of financial products under one brand.

Traditionally, financial advisory services have been centred around the physical presence of an advisor to provide advice; however, remote working has forced advisors to adopt digital channels to connect with their customers. Feedback received by the industry association suggests that many sole proprietors have found that digital or online meetings have allowed them to connect with more of their customer base more regularly as they save in travel time and can schedule more meetings.[175] This is a positive development for customers that are able to participate in online meetings.

Like many other industries, technology platforms have allowed for more accessible and affordable products and services. In the past, provision of advisory services usually required a licensed professional to be physically present and provide advice to investors. However, investment platforms have allowed customers direct access to investment products at a fraction of the cost. In person consultation limited the accessibility of financial assets to wealthy individuals who could afford the management fees charged by financial advisors. In addition to lowering costs, digital investment platforms have also made investing feel less intimidating.

175 Financial intermediaries association, 2021, *Stakeholder meetings.*

9. Financial Market Infrastructures

The level of development of South Africa's financial sector infrastructure is an important contributor to the sophistication of the financial market overall. The financial sector infrastructure landscape consists of five exchanges, two central securities depositories (CSDs) and two clearing houses regulated by the FSCA. Of the five registered exchanges, four are currently active and one exchange, namely ZARX, is undergoing liquidation. Two CSDs are registered with the FSCA: Strate Limited and Granite Central Securities Depository, however, Strate is currently the only operational CSD. Alongside JSE Clear, Strate is also registered with the FSCA as a clearing house for the settlement of transactions.

Over-the-counter derivative providers (ODPs) have recently formed part of the financial market infrastructure regulated and supervised by the FSCA. During November 2019, the FSCA received over 50 ODP licence applications from financial institutions; five applications were approved and three rejected. The licensing process for ODPs is still in progress. Recently, the FSCA issued new ODP licences to financial service providers; which includes commercial banks and other non-banking institutions, both local and foreign.

Financial market infrastructure facilitates the functionality of financial markets by ensuring financial transactions occur smoothly. Exchanges, and ODPs closely interact with CSDs, which take on the responsibility to ensure the transactions performed on the four exchanges and trading platforms are implemented without complications. Strate and JSE Clear provide a guarantee to buyers of securities that they will receive the traded securities once the transaction is settled, and a guarantee to sellers of securities that they will receive the correct value after settlement. Thus, safeguarding investor trading transactions that occur in the financial sector.

9.1 Stock exchanges

For over 13 decades, the Johannesburg Stock Exchange (JSE) has dominated the South African stock exchange landscape. The JSE is the largest stock exchange in South Africa by market capitalisation, and on the basis of the number and value of the daily average transactions executed.[176] On an international basis, the JSE ranks in the top 20 of all the exchanges in the world and is the largest exchange in Africa on the basis of market capitalisation.[177]

However, a number of new exchanges have emerged in the market, providing financial institutions with a wider range of listing options, and encouraging financial consumers to participate in the investment landscape as a result of more competitive trading fees. Between 2016 and 2017, four new exchanges were registered with the FSCA. The new exchanges, namely: ZARX; 4Africa Exchange (renamed to Cape Town Stock Exchange); A2X and EESE, initially operated as share-matching platforms that connected buyers and sellers in the over-the-counter (OTC) market, before their registration as exchanges. The platforms leveraged technology to facilitate more transparent access to liquidity by publicly listing shares for trades and allowing for more efficient trading and clearing in South Africa without supervision from a regulatory body. Given the extent to which these platforms disrupted the financial market, the Financial Services Board (FSB) ruled that the platforms be registered as exchanges for regulatory purposes.

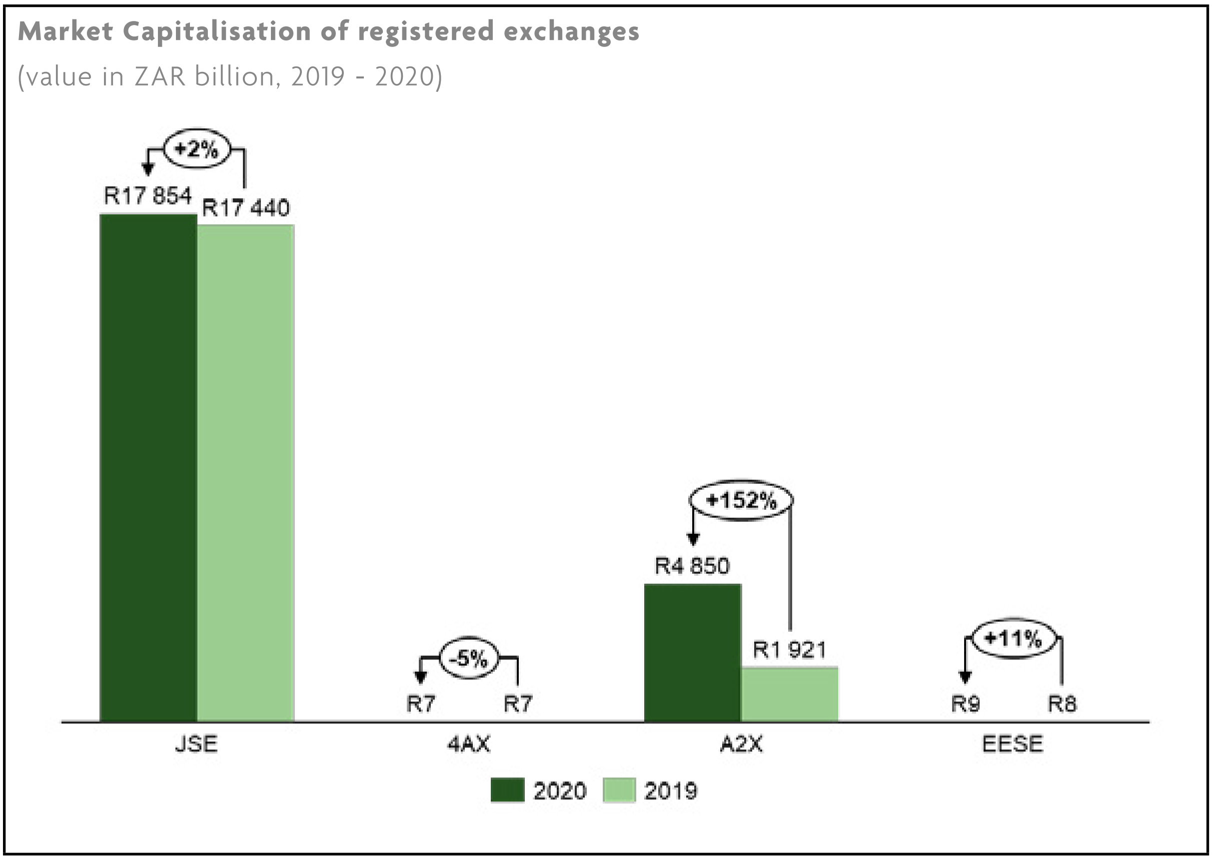
Business activity on the JSE remains high, and far exceeds that on the new exchanges in terms of the trades executed and market capitalisation. In 2020, the market capitalisation of the JSE was nearly four times the size of the second leading exchange, A2X, by capitalisation.[178] Further, the JSE had the highest daily average volume and value of transactions executed on its trading platform in comparison to the other exchanges. The volume and value of the transactions captured on the JSE far exceeded the combined total of the average number of transactions executed daily on A2X, EESE, and 4AX.

176 FSCA, 2021, Capital markets division.

177 JSE, 2021, JSE tops G20 developing countries for gender balance on boards. Available here.

178 FSCA, 2021, Capital markets division.

Figure 9a: Market capitalisation of South African exchanges[179]



Although business activity on the JSE remains high, in 2020, the combined daily value traded on A2X, EESE and 4AX equated to 60% of the value of transactions on the JSE.[180] It is noteworthy that the year-on-year market capitalisation growth rate for A2X and EESE exceeded that of the JSE in 2020. [181] The year-on-year growth in market capitalisation for EESE and A2X was 11% and 152% in 2020 respectively, indicative of the growth potential of these exchanges. [182]

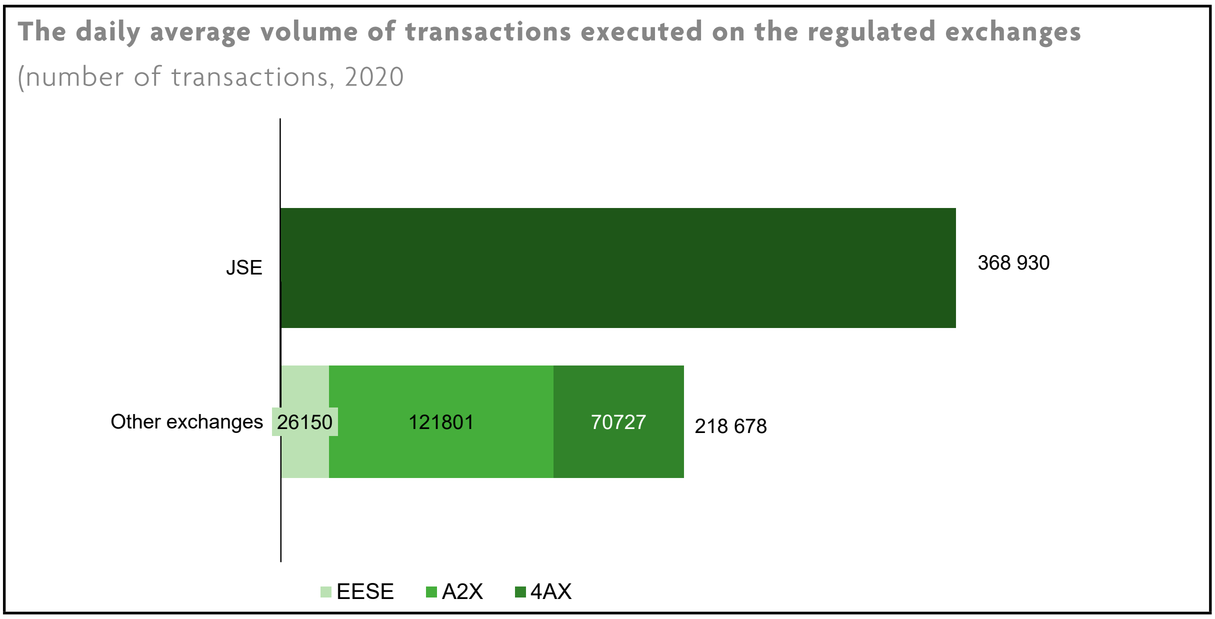
179 *Ibid.*

180 *Ibid.*

181 *Ibid.*

182 *Ibid.*

Figure 9b: Number and value of transactions on South African stock exchanges[183]



While the performance of the new exchanges has been relatively encouraging, A2X's has far outperformed its rivals, EESE and 4AX. Of the total average number of daily transactions performed on the new exchanges in 2020, 56% of the transactions were made on A2X. [184] The competitive advantage A2X has over EESE and 4AX in attracting trades can be attributed to the linkage between A2X and the JSE, as stocks traded on A2X are already in issue on the JSE. Thus, these stocks would be included in indices, and therefore be more liquid.

EESE and 4AX are important for inclusive trading. The two exchanges provide a platform on which small-cap companies may issue shares, and investors can trade a wider range of shares that are not exclusive to high-value stocks. The upward and steady trend in the number of shares issued on all of the newly registered exchanges reflects their essential role in providing a platform for listed firms to acquire liquidity for growth and expansion.

Furthermore, an increase in competition is believed to enhance market efficiency by fostering innovation, improving the performance of competing firms, and lowering prices.[185] A2X is reported to have trading fees that are around 50% lower than those charged on the JSE. [186] Lower trading costs have increased accessibility, particularly for small-cap companies, to raise capital through listing at lower costs. On the consumer side, increased competition provides investors with a choice of trading platforms and encourages participation.

183 *Ibid.*

184 *Ibid.*

185 Council of economic advisers issue brief, 2016, Benefits of competition and indicators of market power. Available here.

186 News24, 2021, Patrice Motsepe-backed A2X stock exchange expects to break even by 2023. Available here.

Companies have also adopted the dual listing option, further increasing competition and the attractiveness of the alternative exchanges. A2X provides companies with a platform for the secondary listing of stocks issued on the JSE at no cost, risk or additional regulatory burden. Listed companies that are taking advantage of the dual listing option have benefitted from increased liquidity, as their stocks are available on more than one exchange for trading.

9.2 Central security depository and the associated clearing house

Strate is currently the only operational CSD, which works with associated clearing houses to clear settled transactions. There are two clearing houses registered with the FSCA, namely: Strate and JSE Clear. While Strate is responsible for the settlement and clearing of securities in South Africa, JSE Clear is responsible for only JSE Derivatives Markets.

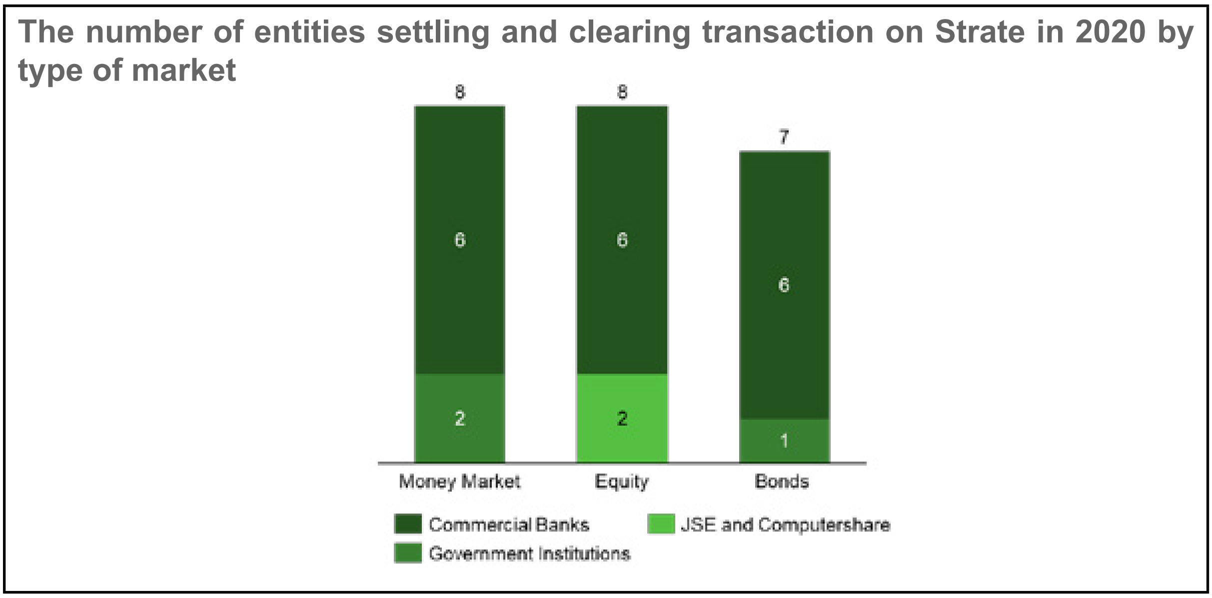
Strate provides a platform for which all financial instruments across asset classes in South Africa are cleared and settled. It is also licenced to be an independent provider of post-trade products and services for the financial markets, whereby the buyer and seller verify the details of a transaction. The process allows the two parties to compare trade details, approve the transaction, change records of ownership, and arrange for the transfer of securities and cash. The latter is particularly important for over-the-counter (OTC) markets which are not standardised.

Currently, there are ten participants on Strate that actively use the platform to clear and settle transactions.[187]

- Of the total number of financial institutions operating on Strate, six are commercial banks, which offer their customers a platform to trade securities in the bonds, equities and money market.
- Two of the participants are government owned institutions, namely Eskom and SARB. SARB participates solely on the bonds and money market to settle bond transactions when the regulator is influencing liquidity (money supply) in the economy.
- The remaining two participants are the JSE and Computershare which solely participate in the equities market.
- Computershare is a financial institution managing over two million shareholder accounts, providing share registry and custodial services, employee share plan management and investor relations for over 80% of the companies listed on the JSE, are the only financial institutions.

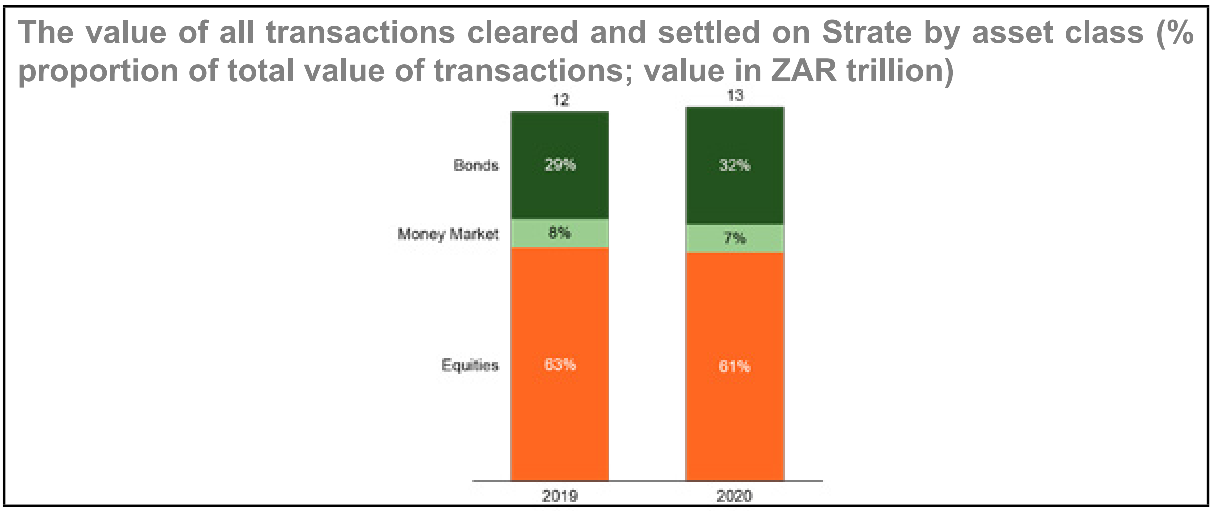
187 FSCA, 2021, Capital markets division.

Figure 9c: Participants on Strate[188]



The value of transactions cleared and settled on Strate has been increasing over the past few years, and the upward trend continued in 2020 despite the pandemic.[189] The disruption in business activity resulting from national lockdowns in 2020 affected the performance of financial market infrastructures at a relatively minimal level. The exchanges, Strate and the associated clearing houses maintained operational resilience and continued to provide uninterrupted trading, clearing and settlement services.[190]

Figure 9d: Value of transactions cleared on Strate[191]



188 *Ibid.*

189 Strate, 2021, Regulatory and Supervision report. Available here.

190 JSE, 2020, Integrated Annual Report. Available here.

191 FSCA, 2021, Capital markets division.

2020 saw a shift towards an increase in the number of transactions in bond securities, generally regarded as relatively 'safer' securities.[192] The increase in the value of transactions settled and cleared on Strate was solely driven by transactions in the bonds market, since the total value of cleared transactions in the bonds market increased, while the equities and money market transactions both decreased between 2019 and 2020. The observed change is indicative of the low-risk appetite environment in the financial market resulting from the uncertainty surrounding the economic environment in 2020.

9.3 Industry developments and key trends

9.3.1 Increased investment in technology

The resilience shown by financial market infrastructures in 2020 can be attributed to the continued investment in technology by the JSE over the past few years.[193] The JSE has increasingly been investing in technological infrastructure to improve the efficiency of their business models and their operational systems and these advanced technical systems played an important role in 2020 as it allowed the JSE to continue operating when lockdown restrictions were imposed. The system leveraged technology acquired prior to the pandemic to facilitate secure and reliable new remote working models.

Similarly, Strate has invested in blockchain technology via its partnership Nasdaq.[194] Strate has been working with Nasdaq in the US to explore the use of blockchain technology to improve corporate processes. The first use-case has been around automating shareholder meetings and voting processes. Using an app powered by blockchain technology, the application allows shareholders to log in remotely, share data securely, vote and trade shares with other shareholders in real-time. Transacting in real-time eliminates the need for inefficient reconciliation processes.

9.3.2 Issues relating to market efficiency and integrity

The entrance of new exchanges that are significantly different from the JSE in terms of size poses a threat to market integrity as regulation and supervision of the exchanges landscape must adjust. Trading of stocks has historically been concentrated on the JSE, and hence, the same has been true for the regulation governing the exchanges in South Africa. With increased competition, the existing regulation has been challenged due to the difference in the size of the new exchanges. This has raised the issue of market fragmentation whereby the exchanges are operating in silos in order to meet their regulatory requirements rather than cooperating in the shared market. This compromises the integrity of the South African financial market.

192 Strate, 2021, Regulatory and Supervision report. Available here.

193 JSE, 2020, Integrated Annual Report. Available here.

194 ConsenSys, 2019. Advancing Capital markets with Blockchain Technology.

The FSCA is currently drafting a Conduct Standard that sets the minimum standards to which all licensed exchanges must adhere to in conducting their business.

A number of FSPs continue to misuse their licences, and deliberately offer services beyond the scope of their licence. A number of investigations have found some financial institutions violating their licences, and in breach of their conduct standard. Financial consumers were being exploited as some FSPs were operating as financial market infrastructures (FMIs) without the appropriate licences. The FSCA has issued warnings to the public to deter consumers from associating with unlicensed trading platforms.

10. Retail Lending

South Africa's credit market is highly developed and formally provides credit to almost half of the South African population. South Africa's consumer credit market is highly regulated; according to the World Bank and conforms with several "good practices" for financial consumer protection. The market is large and developed and formally provides credit to more than 27 million people, equivalent to 67% of the adult population.[195]

There are 7837 registered credit providers registered with the National Credit Regulator (NCR), ranging from banking institutions to non-banking lenders such as microfinance institutions, vehicle financiers, and retailers offering store credit.

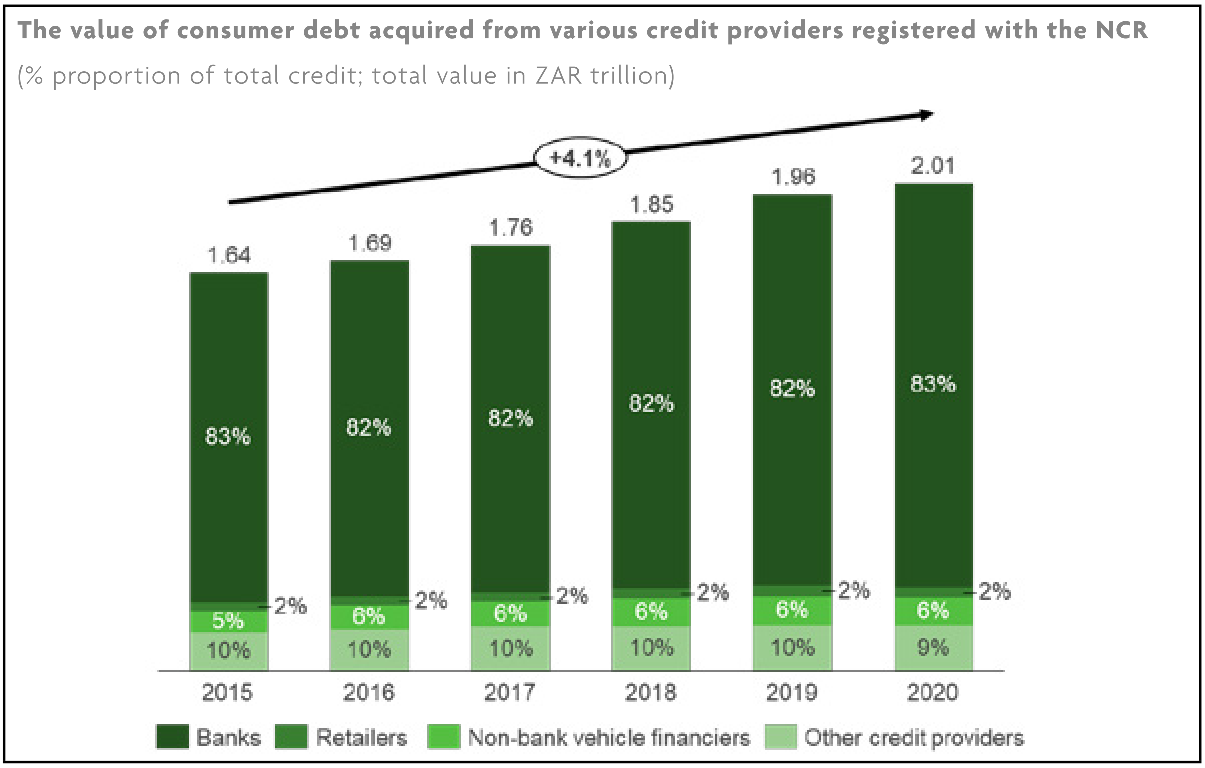
The value of consumer credit has increased steadily since 2009. Consumer credit volumes accelerated between 2009 and 2012 with an average annual growth rate of 24%. The figure below shows that between 2015 and 2020 the average annual growth rate has been 4%. As of 2020, mortgages and secured credit comprise 41% and 31% of the total loan value respectively while unsecured credit represents 15% of loan values. However, when measuring by number of loan agreements, credit facilities and short-term loans represent 55% and 21% of the market.

Banks are the largest providers of credit by value of lending and number of loans. Banks hold 82.6% of the ZAR2.01 trillion consumer debt in 2020 and 44% of the number of loan accounts; this proportion has stayed fairly consistent over the past five years.[196] Retailers account for the second largest share of lending - 38% - by number of accounts. Consumer indebtedness is a concern in South Africa and is discussed in more detail below.

195 The World Bank Group, 2021, South Africa, Financial Sector Assessment Program, Financial Inclusion

196 NCR, 2021, Consumer Credit Market Report. Available here.

Figure 10a: Consumer debt levels in South Africa[197]



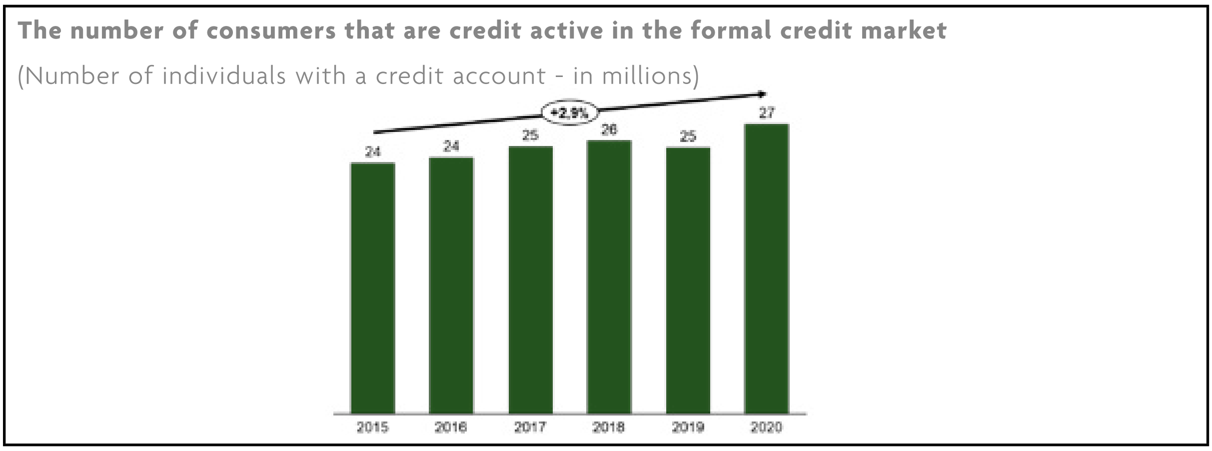
The number of individuals with an active credit account saw a peak in 2020 as heightened financial distress due to the COVID-19 pandemic drove an increasing number of consumers to acquire credit. The number of credit active consumers rose from 17,12 million customers in 2017 to a peak of 27,4 million; with an additional 2,2 million customers becoming active in 2020.[198] The increase is likely the result of an increase in access to formal credit as well as improvements in data sharing between lenders and credit bureaus. The increase in access to consumer credit is a meaningful step in financial inclusion and in improving the wellbeing of low-income South Africans.

Credit active consumers have an average of 3,3 credit accounts. NCR data in 2020 shows 90,47 million consumer credit accounts - an average of 3,3 credit accounts per credit active consumer. Finscope data reports borrowers in higher LSM groups being more likely to have four or more credit accounts.

197 *Ibid.*

198 NCR, 2021, Credit Bureau Monitor. Available here.

Figure 10b: Credit active consumers in South Africa[199]



10.1 Industry developments and key trends

10.1.1 Over-indebtedness remains a challenge in South Africa

Currently, more than 50% of South Africa's credit-active consumers are over-indebted.[200] Between 2015 and 2020 the percentage of credit active consumers with an impairment record fluctuated between 38 and 48%. Over-indebtedness is linked to national economic conditions and exacerbated by the COVID-19 pandemic. Slow economic growth and high unemployment, coupled with rising prices for food, petrol and other basic goods have had a significant impact on the credit needs of South Africans and their ability to repay debt. Financial distress is associated with missed credit repayments.

Household debt to disposable income decreased between 2008 and 2017 but began to rise between 2017 and 2020. In 2008 debt to disposable income was at 86% but decreased to 72% in 2017; it rose significantly in 2020 to approximately 77%.[201]

The majority of the credit active consumers spend borrowings on financing necessities: 43% of the surveyed population spent the borrowed funds on food, 11% on clothing, and on bills and monthly fees, repectively.[202] In essence, 95% of the surveyed low-income individuals engaged in debt financing to afford basic needs such as food, clothing, transport and bills. The fact that credit is used to cover basic consumptive expenditure or to cope with financial shocks, is indicative of the high levels of over-indebtedness of lower income segments in particular, and low levels of financial resilience.

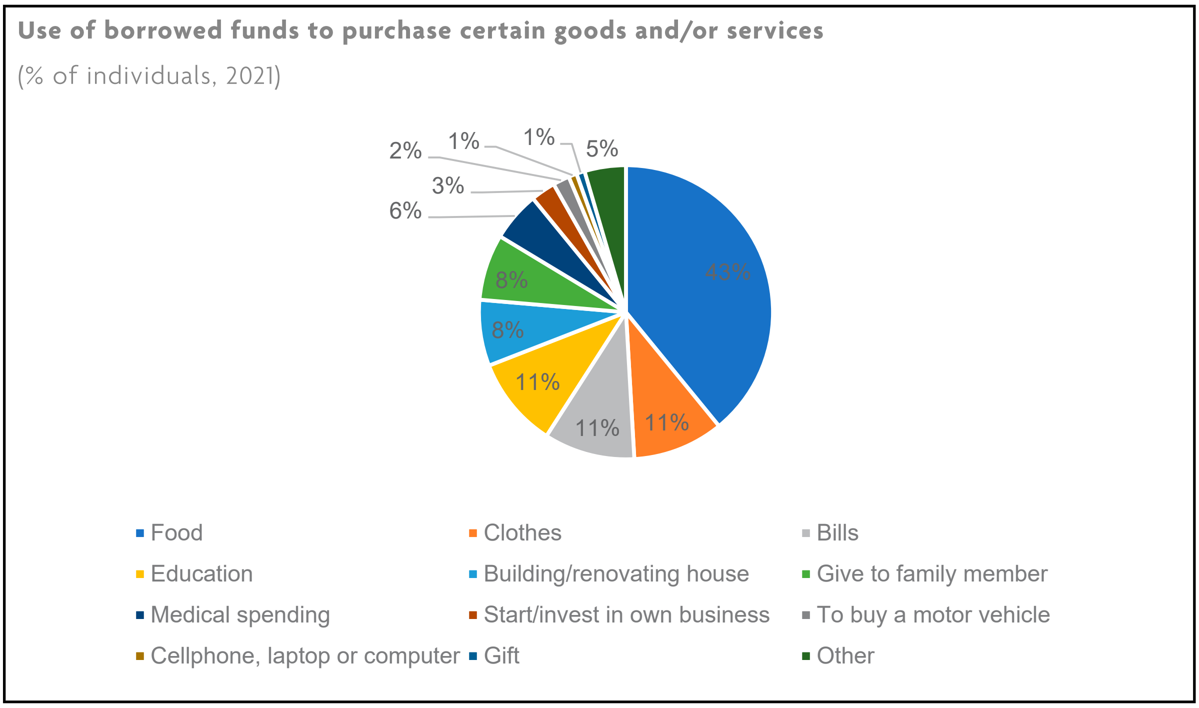
199 *Ibid.*

200 News24, 2021, COVID-19: One year on, South Africans are heavily indebted but are looking at relief options. Available here.

201 Trading Economics (2021). South Africa Households Debt To Income. Available here.

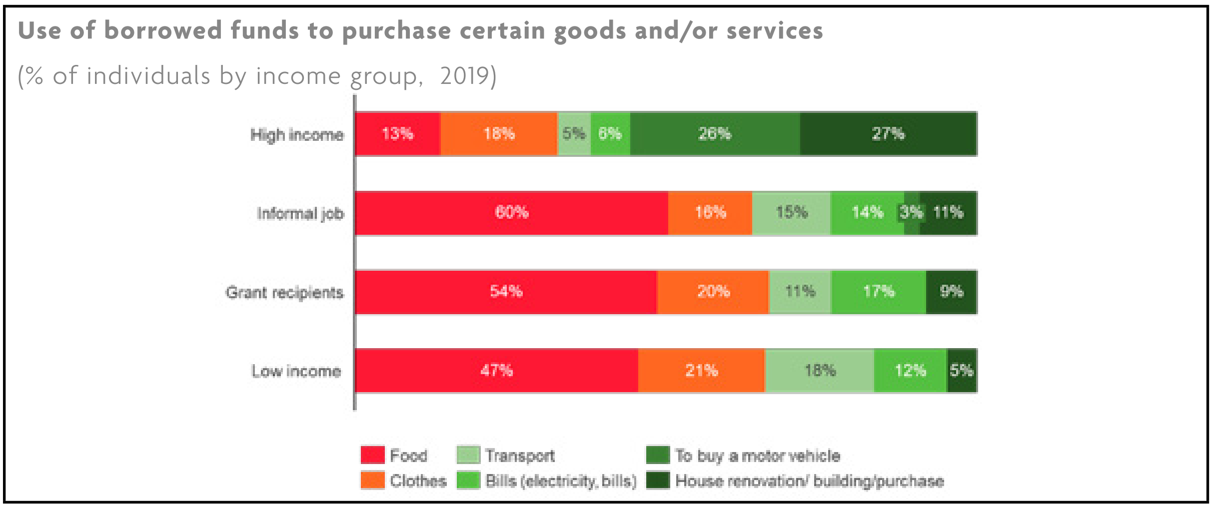
202 FinMark, 2020, Finscope South Africa Overall Databook. Available here.

Figure 10c: Household expenditure of borrowed funds[203]



As expected, this trend is dominant amongst low-income individuals (earning less than ZAR1500 per month), grant recipients (earning +/- ZAR1500 per month), and individuals with informal jobs (earning more than ZAR1500, but less than ZAR3000). Borrowers in the high-income group acquire credit to finance the acquisition of assets such as motor vehicle(s) or to build, purchase or renovate a house; while only 5% of the low-income individuals could invest in the same way.

Figure 10d: Household expenditure of borrowed funds[204]



203 *Ibid.*

204 *Ibid.*

The large number of people facing over-indebtedness is of concern for the FSCA, particularly because of the societal risk that arises when consumers are overburdened by debt in perpetuity, leading to disproportionate social and personal harm.

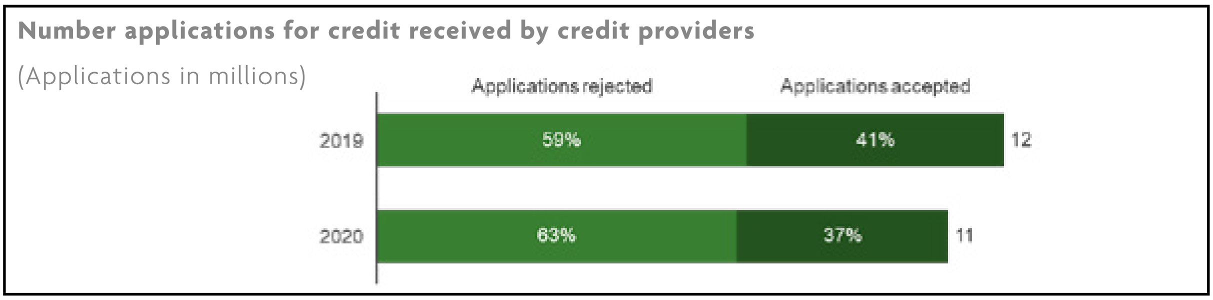
For the FSCA, finding solutions to consumer over-indebtedness is vital, and an important intervention is education around relief measures. The FSCA, in collaboration with the NCR and other regulatory bodies, has been proactive in educating consumers on the debt relief measures put in place to alleviate consumers from chronic over-indebtedness. Currently, there are two mechanisms in place that deal with over-indebtedness, namely: the insolvency law and the debt review. For low-income individuals in debt, the debt review, which allows chronically over-indebted individuals to have their debts reviewed and restructured, is most applicable. A debt counsellor is appointed at a fee to the consumer. The debt counsellor assesses the consumer's outstanding debt and available income, determines if the consumer is indeed over-indebted, and assists the consumer in restructuring the debt into a repayment plan. Under debt review, consumers are protected from creditors seeking to enforce repayment except through the debt repayment plan.

10.1.2 The growing informal credit and savings market

The informal credit market remains endemic in South Africa and poses a significant challenge to the sustainable and responsible use of credit. Based on amendments to the National Credit Act (NCA) in 2016, all credit agreements, regardless of the amount, are considered illegal if the supplier is not registered with the NCR. Historically, South Africans have made use of informal means to acquire credit. For many decades, black South Africans were unable to access credit formally. As a result, informal credit and lending models arose to fill a deep need.

More than half of all loan applications in the formal sector are rejected, pushing more people to seek informal credit. The graph below shows that in 2019, 59% of applications for credit were rejected, this rose 4% in 2020 as more consumers would have been left financially worse off, and would therefore fail the affordability test in the formal credit application process.[205]

Figure 10e: Formal credit applications[206]



205 NCR, 2021, Credit Bureau Monitor. Available here.

206 *Ibid.*

Unregistered lenders have long been operating in South Africa and are considered to be socially embedded in lower-income communities. In 2019, 28% of the surveyed individuals acquired credit formally from a banking institution and only 2% from a microfinance institution while 28% of individuals borrowed from friends and family; 16% of those surveyed borrowed from Stokvels (community-based savings and credit groups) and loan sharks known as "mashonisas".[207]

While popular in low-income communities, the use of informal lenders exposes consumers to various risks including high interest rates and dubious collection methods. Being located within communities, informal lenders can be visited after business hours and are easily accessible. Informal lenders offer a relatively easy-to-understand repayment formula, expressed as total amount repayable rather than an interest rate (for example you borrow ZAR1000, and repay ZAR1300 at month end). Since both borrowers and lenders are integrated within the community, this brings in elements of trust and reputation (of both the borrowers and the lenders) that may not be replicable by formal financial institutions. However, consumers have no legal or regulatory recourse when borrowing from informal lenders. Mashonisas typically have short repayment periods, high interest rates (between 30% - 50% a month) and often dubious collection methods. There have been reports of borrowers' Identity Documents (IDs) being retained, their bank card pins taken, the direct collection of grant payments, as well as the threat of violence in the face of non-payment.[208]

10.1.3 Regulatory relief: The COVID-19 Loan Guarantee Scheme

In response to the financial pressures faced by their customers, credit providers were able to extend finance and meet the demand for credit by consumers due to the injection of liquidity through measures introduced by the SARB. Additional regulations by the PA, such as lower liquidity and coverage capital requirements, further allowed banks to extend financing to consumers despite the weak economic environment and rising unemployment in the country.

The large banks all offered customers debt relief options over the course of 2020. The construct of the relief differed by bank but included a form of payment break or holiday. Customers were encouraged to continue meeting their obligations as best they could as the relief measures were intended to allow flexibility and were not debt write-offs. In the period between March and April 2020, during the most severe lockdown, payment relief to retail consumers amounted to ZAR 7,74 billion.[209]

To alleviate some of the financial distress, the National Treasury and the SARB, in partnership with commercial banks, have extended credit to businesses under the COVID-19 Loan

207 Wonga, 2018, Informal Lending Report. Available here

208 *Ibid*

209 The Banking Association of South Africa, 2020, Debt relief assistance for customers. Available here

Guarantee Scheme. The scheme aims to provide support to firms until economic activity improves, and is a mechanism to indirectly provide an income buffer for households through potentially lower pay cuts and lay-offs.

However, limited and poor quality applications reduced the effectiveness of the COVID-19 Loan Guarantee Scheme. As at 29 August 2020, 42,202 applications had been received by commercial banks for loans guaranteed by the scheme; although only 25% of these applications had been approved.[15] In most cases, applications were rejected because the business was not in 'good standing', or the loan value was too high such that the repayments were unaffordable for the business. In addition, many distressed businesses and customers were reluctant to take on more debt with the uncertainty around the length and severity of the economic impact of the COVID-19 pandemic.

10.1.4 Fintechs in the Retail Lending Landscape

A 2019 study[210] found the fintech lending segment made up of 28 fintechs with 18 providing online lending services. The segment is dominated by domestic fintechs and there is a balance between support for small and medium enterprises (SMEs) and individual borrowers. Although classified as fintechs, many digital businesses have grown quickly in this space; for example online lender, Pollen Finance is one of the biggest online lending platforms and was established in 2015 to serve a growing need for SME funding to support business growth. By 2019 the business had lent more than ZAR1 billion to SMEs in four years.

There are two distinct business models in the lending space: lending marketplaces and alternative lenders.[211] The former connects borrowers and investors without lending out their own capital and earning revenue from fees; while the latter lends capital from their own balance sheet, earning revenue from interest and service fees. As an example of innovation in the personal lending space, Mobicred offers a differentiated business model that allows consumers to apply for loans while shopping online This targets consumers who do not want to use a credit card and are looking for a centralised credit facility for their online purchases. The service and transaction fees are comparable to standard credit card offerings from traditional banks.

Mobile network operators (MNOs) have also entered the retail lending landscape by investing in product innovation, such as micro loans. The majority of lending in this space is airtime advancements. However, another example is the recent partnership between Vodacom and Nandos to provide credit to Vodacom users. The service allows Vodacom customers to enjoy a meal of their choice at Nandos and pay later at 0% interest.

210 IFWG, 2019, Fintech Scoping in South Africa. Available here

211 *Ibid*

A key development has been the use of alternative data sets to improve credit scoring and minimise risk in lending. Previously, the consumer's information on their credit activity was solely provided by credit bureaus, however with the use of alternative credit scoring, providers are able to combine data from multiple sources, such as airtime usage, mobile money usage, eolocation, bills payment history, and social media usage.[212]

This information can be used in credit assessments, ultimately increasing access to formal credit for individuals that may not have had a credit or transactional history. In other African markets, these models have allowed for the extension of credit to previously underserved markets. The relatively new means of credit scoring makes use of data from digital platforms and analyses consumer behaviour to inform a credit risk assessment.[213]Along with benefits alternative data can bring to credit scoring, regulators remain aware of potential risks such as underlying biases in data models and data sets; issues of informed customer consent and meaningful disclosures/transparency. Key learnings are being derived, including through applications and testing in the IFWG sandbox.

Table 10a: Artificial Intelligence (AI) in Credit Scoring

Fintechs such as Jumo, as well as retail bank FNB have been among the early adopters of alternative credit scoring.[214] Jumo, launched in 2015, is a South African-based banking as a service (BaaS) provider that powers the infrastructure for banks and fintechs to offer lending and savings products.[215] The entity currently uses AI to build credit scores and extend loans to borrowers even if they don't have a formal financial identity, collateral, or a credit record in six African countries.[216] In 2020, FNB launched Manila, an AI solution that helps the bank reimagine risk management and forensic due diligence processes.[217] Manila gathers data from multiple sources, creates a single view of a customer, and provides insights and a rationale to guide the decision-making process.[218] The AI solution checks for any red flags within FNB's database about a customer, which includes checking for a mule account (an account created on false paperwork using a stolen or manipulated identity, or belongs to a legitimate customer who has allowed criminals to use their account), and high-risk customers.[219]

212 The Africa Report, 2021, Will AI risk analysis really expand access to credit in Africa?. Available here.

213 Centre for Financial Inclusion, 2019, How Alternative Credit Scoring Can Work for the Unbanked. Available here.

214 Africa CEO forum, 2021, Will AI risk analysis really expand credit in Africa? Available here.

215 Insider intelligence, 2021,Jumo raises $120M to power fintech services across Africa. Available here.

216 Jumo, Innovation is all it takes. Available here.

217 IOL, 2021, FNB is leveraging AI to redefine risk management and ways of working. Available here.

218 Techfinancials, 2021, FNB Launches Manila, an AI Solution to Identify Risks and Fraud. Available here.

219 *Ibid.*

11. Payment Providers

The payments industry in South Africa is well developed and compares favourably with more developed economies. Consumers have access to an extensive and varied network of payment channels: over 30,000 ATMs, more than 400,000 POS devices, financial transactions at retailers and other outlets, internet banking and mobile banking apps as well as Fintechs and MNO offerings.

The industry facilitates interoperable payment transactions between registered banks and FSPs, allowing 91% of South Africans to participate in the formal financial system. On average, over ZAR350 billion is settled in South Africa on a daily basis through the National Payment System (NPS). This is made possible through the participation of a number of entities, including: settlement participants who are registered banks and hold a settlement account with SARB; clearing participants who can be banks or designated clearing system participants that are members of PASA; and at least one payment system operator (PSO) for each payment clearing house (PCH). A PCH is the legal, operational and technical arrangement that allows two or more participants to clear and settle payment transactions, in other words it is a requirement for interoperability within the system. South Africa has four PSOs: Strate Limited, BankservAfrica, Visa and MasterCard. These entities, either directly or by means of a System Operator (SO), send instructions to make or receive inter-bank payments. Third Party Payment Providers (TPPP) facilitate payments by accepting payment instructions from customers; and aggregating and routing these payments on their behalf to third parties. Unlike SOs, TPPP are able to hold funds in their own bank account for a short period of time before making payments to the third party concerned.

The National Payment Systems Act of 1998 (NPS Act) regulates payment systems in South Africa. The Payments Association of South Africa (PASA) is recognised as the body responsible for overseeing the participation of banks and non-bank players in the South African payment system[220]. Regulatory and supervisory oversight of the South African payment system is under review through the review and amendment of the NPS Act; the FSR Act also introduced payment services as a category of financial services falling under the market conduct supervision of the FSCA. The ambit of the FSCA will be more clearly delineated as the COFI Bill and NPS Act amendments are finalised.

220 *This is proposed to be changed through amendments to the NPS Act, giving the SARB stronger regulatory and supervisory oversight over participants in the payments system.*

Amendments to the National Payments System Act have allowed non-banks to offer services incidental to payments, allowing other entities to support and facilitate e-commerce, bill payments and payment processing for merchants. The SARB is reviewing the current legal and regulatory framework and has proposed expanding the role of non-banks in the payment ecosystem. The existing legal framework only allows retail, mutual and cooperative banks to handle customer funds. All deposit taking activities, including payments, are limited to banks. Non-banks require a banking sponsor for the provision of payment services. Under the revised regulations, non-banks would join the payments system as members of PASA, and through a clearing and settlement account with the SARB would be able to issue e-money, process domestic remittances and offer payment services independently. This would improve competition in the industry as well as improve efficiency and innovation, a positive outcome for customers.

11.1 Industry developments and key trends

11.1.1 The National Payment System Framework and Strategy

In 2018 SARB published the National Payment System Framework and Strategy - Vision 2025 in recognition that there is a need for continuous payment modernisation to meet the needs of the economy and the people of South Africa[221]. Vision 2025 sets out the goals and strategies for the national payments industry, aimed at building a world-class national payment. The strategy sets out the following nine goals:

- A clear and transparent regulatory and governance framework
- Transparency and public accountability
- Financial stability and security
- Promoting competition and innovation
- Cost-effectiveness
- Interoperability
- Flexibility and adaptability
- Regional integration
- Financial Inclusion

These goals are aligned to economic development goals contained in the National Development Plan and will enable the achievement of broader societal objectives such as financial inclusion through increased customer trust and familiarity with electronic payments systems.

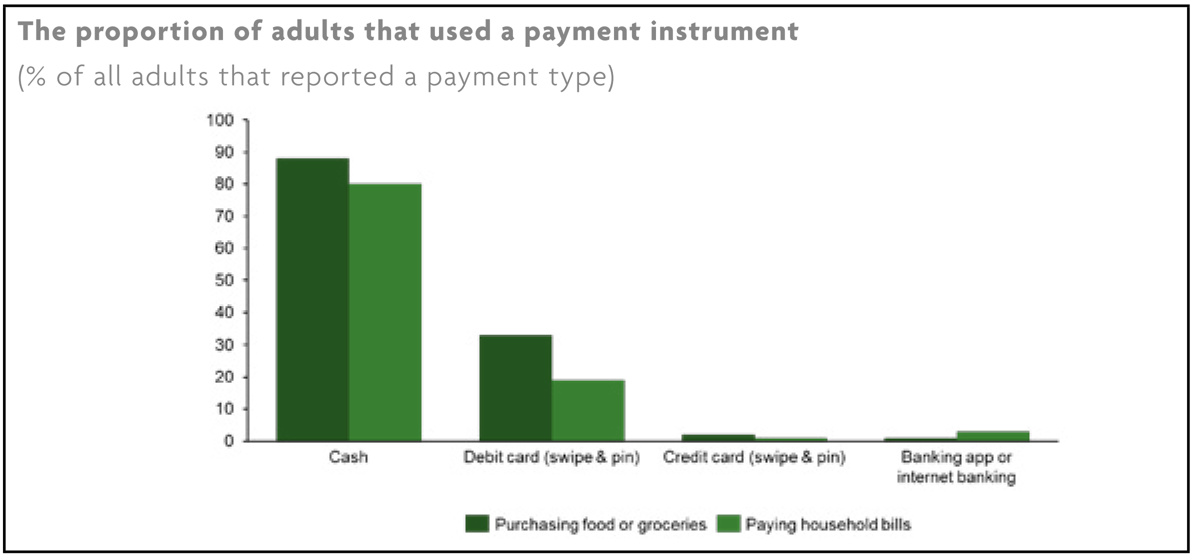
221 SARB, 2018, Reserve Bank launches National Payment System Framework and Strategy Vision 2025. Available here

11.1.2 The prevalence of cash and payment innovations

As previously discussed, there is a strong preference for cash in the South African economy, despite numerous payment options being available and the high percentage of banked individuals. Cash is estimated to be used for 89% of transactions, although only representing around 11% of payments value.[222]

The preference for cash is informed by a number of preferences including direct settlement, anonymity and no direct transaction fees. Many consumers prefer cash because it has no direct fees, it is reliable (there are no system outages or requirements for connectivity), settlement is direct and immediate, it is anonymous, and it does not require either party to have a bank account or share banking details. Low-income individuals also prefer using cash because it is easier to budget; cash allows consumers to keep real-time track on spending, juggle payments and shift priorities. It is also a natural limit on spending, constraining temptation to spend beyond your means using credit. Digital methods such as debit card payments prevent consumers from knowing exactly "where they are" at any given time as bank balance fluctuations can be delayed, or may not be readily available (for example, if a consumer only uses an ATM to check their balance).

Figure 11a: South Africans rely on cash for common transactions[223]



Payment cards and EFT credit transfers are the most commonly used non-cash payment instruments. By payment value, EFT credits (i.e. a payment initiated by the payer) accounts for 78% of transactions, followed by EFT debits (i.e. a payment initiated by the payee via a contract with the payer) which account for 6%. Payment by card accounted for only 5% of the total value of transactions, however it accounted for the highest number of digital

222 PASA, 2019. Project Future: Case of modernised real-time electronic retail payments: A case for change for South Africa. Available here.

223 FinMark.

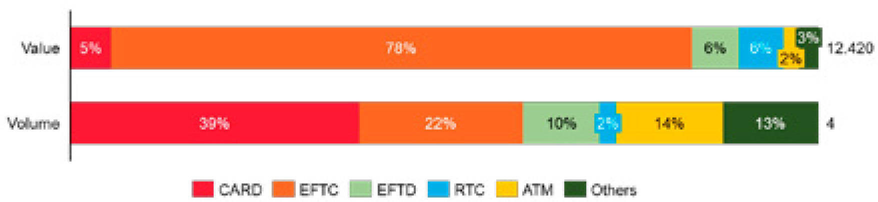
transactions in 2020, making up 39% of the total number of transactions.[224]

Payment cards and Real Time Clearing have both increased as a share of transactions by value since 2014. EFTs are widely used by employers to pay salaries and have replaced cheques in other transactions.[225] Cheque usage has been declining and has been discontinued as a payment instrument from March 2021.[226]

Figure 11b: Transactions by payment methods[227]

The value and volume of payments by payment method

(value in ZAR billion; volume in billions; 2020)



In keeping with international trends, banks and payment service providers have focused on payment innovations that offer customers convenient digital payment solutions. One example is ‘scan-to-pay’ which is based on scanning a merchant’s QR code in order to make a payment. A customer’s card details are stored on file in the payment app and the transaction can be completed without needing the physical card to be present. These transactions are quick and convenient and this has driven customer adoption; as has the added benefit of reduced exposure to COVID-19 as it limits touching devices. PayFast, a payment processing company, saw a 412% increase in QR between March 2020 and February 2021.[228]

There are currently multiple proprietary QR standards in South Africa; however, there has been some convergence in the industry, with payment services providers working to make their solutions compatible across banking and mobile apps. A lack of industry standards is one of the key reasons for poor interoperability which ultimately impacts the adoption of innovative solutions. Multiple or varied technology standards require different integrations with the POS device; each variation from the standard, or new integration causes roll-out delays in implementation and increases the cost of deployment.[229]

Some payment innovations such as mobile wallets are closed loop, i.e. only accessible to customers of the same bank or on the same network. Several banks have launched mobile wallets to enable their customers to use credit and debit cards from their mobile phones for a variety of payments including peer-to-peer payments; bill payments; Near-Field Communication (NFC) (known as tap-and-go) and QR code-based payments at merchants. There are also a few non-banks institutions offering mobile wallets and scan to pay functionality.

224 BankServ, 2021. Statistics division.

225 PASA, 2021, Annual report. Available here.

226 PASA, 2021, How did South Africa manage to end the use of Cheques? Available here.

227 BankServ, 2021, Statistics division.

228 ITweb, 2021, QR payments become the norm in SA, PayFast finds. Available here.

229 Deloitte, 2019, The Future of Payments in South Africa.

This type of innovation is not interoperable across the industry, this inhibits widespread adoption (as customers can only transact with other customers of the same FSP) and stifles innovation and competition at an industry level.

E-money offerings have had limited market uptake. MNOs have launched e-money products, but after poor performance these products were discontinued. In 2016, the two largest MNOs, Vodacom and MTN, both made the decision to terminate their mobile money offerings in South Africa. In a subsequent study by Finmark Trust, it was found that one of the key constraints to launching a successful mobile money service was an unsupportive regulatory framework - only locally registered banks can issue e-money as it is considered to be deposit-taking under the Banks Act. [230] This meant MNOs needed to partner with a bank to implement their solution; this partnership model increased the overall cost of the service and limited the ability to innovate and challenge existing payment services.

Also, the mobile money offering was not seen by consumers as materially different from established payments and remittance services offered by retailers; and importantly, customers had lower trust in MNOs and their agent networks versus the retailers that dominate the domestic remittance market. The South African population is highly banked and customers have access to financial infrastructure, through ATMs, branch networks and POS devices; this required the MNOs to develop an attractive value proposition to entice customers away from existing competitor offerings. Additional challenges included setting up and managing the agent network and poor technology choices to deliver the solution.

Despite the early failures, the mobile network operators have continued to seek financial services opportunities in the South African market. In January 2020, MTN launched MoMo (its mobile money service) in partnership with Ubank. This service is available to customers through USSD, and mobile apps and offers services such as cash-in and cash-out at MTN stores, payment to local mobile numbers and purchases at selected till points.[231] In May 2021, Vodacom announced a partnership with Alipay (a Chinese payment platform) to launch a "super app" that will enable their customers to access other financial services including loans, ecommerce and digital payments.[232]

230 Finmark Trust, 2017, Research Report on Mobile Money in South Africa. Available here.

231 Business Tech, 2020, MTN launches Mobile Money in SOuth Africa. Available here.

232 Reuters, 2021, Vodacom partners with China's Alipay to create "super app" in South Africa. Available here

Customer concerns around security have been an impediment to uptake in digital payments. Developments such as 3D Secure, which authenticates the customer using a PIN sent to the customer's mobile phone before an online purchase can be made,[233] has improved security and customer confidence.[234] The introduction of Chip and Pin cards was another initiative that resulted in a decrease in online fraud, and more recently virtual cards have allowed customers to purchase online without having to share credit or debit card details.[235]

Table 11a : A case for an increase in the adoption of safer digital payment methods

The adoption of virtual cards has been on the rise as more South African consumers shift to digitally driven payment methods. In 2020 two of the five largest banks recorded strong growth in the use of virtual cards, with Standard bank reporting a 400% increase in the issuance of virtual cards, and FNB reporting over ZAR1 billion in payments using virtual cards.[236] Virtual cards are a unique payment card that has a card number generated digitally through a website or mobile app. The card does not come with a physical card, and is associated with the customer's bank account.[237] The card provides customers with the option to set a maximum amount to spend or to be charged on the virtual card to prevent from being overcharged. Customers also have an option to lock the card to a specific merchant to prevent the card from being used elsewhere if the merchant is breached. Compared to other forms of digital payments such as credit cards, virtual cards are considered to be a safer means of transacting. This is because the card allows customers to shop online without having to expose credit or debit card details. Therefore in the event of a hacking, fraudsters are unable to obtain confidential credit card information. This innovation is growing in popularity, with Standard Bank, FNB, Absa and Capitec having introduced their virtual bank card offerings for individual and business customers in 2020. Uptake of the digital payment method has largely been driven by the exponential growth in online purchasing since March 2020 when the COVID-19-induced lockdowns were implemented.[238]

233 PASA, 2014, 3D Secure Frequently Asked Questions. Available here

234 Sabric, 2014, Online Shopping just got safer. Available here.

235 Payments Afrika, 2016. 3 D Secure in South Africa. Available here.

236 ITWeb, 2021, Virtual cards gain traction in South Africa. Available here.

237 Privacy, 2020, Virtual Payment Cards. Available here.

238 *Ibid.*

11.1.3 Industry initiatives

Over the past few years, the industry has been focused on implementing the DebiCheck system and is in the final stages of full transitioning out of the Non-Authenticated Early Debit Orders (NAEDO). The motivation for the DebiCheck system was wide-spread fraud referred to as "ZAR99 scams".

Table 11b: DebiCheck System

Under the NAEDO system, debits could be initiated by payees on a payer's payment card without providing an explicit authorization from the payer. The payer retained the right to dispute, but would be "out of funds" until the dispute was resolved. Payees were allowed to "track" a payer's account; if the debit failed due to lack of funds it was retried twice a day for several days until the payment was made. This system has led to wide-spread abuse where fraudsters would repeatedly initiate debits of small amounts, usually ZAR99 to avoid detection. It is estimated that ZAR1,6 billion has been stolen annually from customers' accounts.[239] Under DebiCheck the payee is required to provide a debit mandate (where the payer authorises a payment, captures the name of the payee, the amount per debit, the frequency and date of month when the debit order will be issued) to the payer's bank. The bank authenticates the debit mandate with the customer and only when the mandate is registered, the payee can initiate the debit order as per the mandate. The payer can revoke the mandate at any time. As of 1 May 2021, all new and renegotiated early debit orders must be processed through the DebiCheck system. The NAEDO system was terminated in October 2021, marking a major milestone in the fight against debit order abuse in South Africa[240]

In response to Vision 2025, BankServ, PASA and the Banking Association of South Africa conducted a study that recognised the need to modernise the public payment infrastructure. *Project Future* was established to implement specific payment architectures that would support a more modern payment landscape; the focus being on real time clearing infrastructure; to introduce Request to Pay (RTP) and alias-based payments. RTP is a pull payment where the payee initiates the payment and requests the payer to execute the transaction. Alias payments allow customers to set up an alias for recipients (such as a mobile number), and the alias becomes a proxy when selecting to pay the individual or merchant. Both these innovations will be run on the EFT payment rails and will create an alternative to card payments. These initiatives are expected to convert customers to digital payments and away from cash and will allow more micro, small and medium enterprises (MSMEs) to accept digital payments in a more cost effective manner.

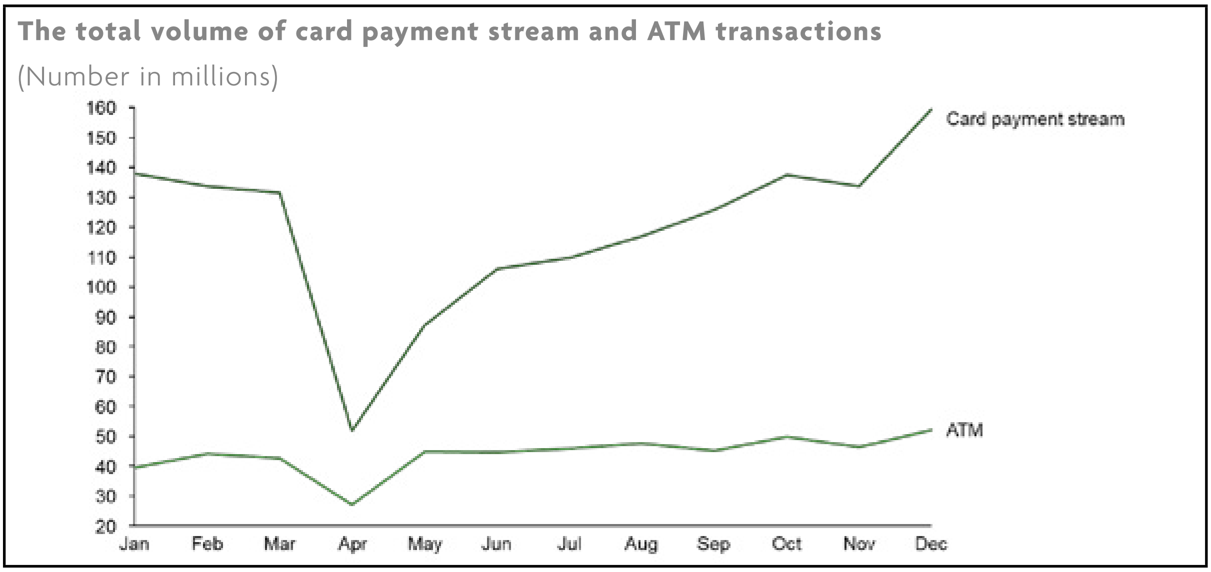
239 News24, 2019, EXCLUSIVE: Organised crime behind massive R1.6bn debit order scam. Available here.

240 PASA, 2021, Notice of Sunsetting of AEDO and NAEDO. Available here.

11.1.4 Usage of payment methods during the pandemic[241]

During the pandemic, more consumers adopted digital payments to avoid handling notes and coins, and card transaction volumes grew. By December 2020 volumes were higher than January of that year. The total value of payments made between 2019 and 2020 decreased by 1.3% from an average of ZAR12,5 trillion to ZAR12,4 trillion[242] as a result of national lockdowns that reduced spending. Card payments formed 38% of the total volume of transactions in 2020. There was an expected drop in payment activity in March and April 2020, but as lockdowns eased, consumers began transacting again, as illustrated in the figure below. A survey conducted by Mastercard found that nearly two-thirds of individuals preferred contactless payments and contactless transactions were 13 times higher at the start of the pandemic in 2020 in comparison to the previous year.[243]

Figure 11c: Volume of card payment systems made on a monthly basis in 2020[31]



Associated with the increase in contactless payments was a rise in fraud losses resulting from stolen and skimmed cards. Debit card fraud increased more significantly relative to credit card payments and for the first-time debit card losses surpassed credit card losses.[244] Sabric reported a 22% increase in debit card fraud for 2020, while on a more positive note, credit card fraud decreased by 7% in the same year.[245] The increase in debit card fraud can be attributed to increased debit card transactions on e-commerce platforms, which made the digital payment method more susceptible to phishing attacks and scams.[246]

241 *Data points reflect digital payments settled through Bankserv, and not all the payments made in the South African payments landscape.*

242 BankServ, 2021, Payments statistics division.

243 Mastercard 2021, Mastercard Study Shows South African Consumers Make the Move to Contactless Payments for Everyday Purchases, Seeking Touch-Free Payment Experiences. Available here.

244 PASA, 2020, Annual report 2020. Available here.

245 Sabric, 2021, MEDIA STATEMENT - SABRIC ANNUAL CRIME STATS 2020. Available here.

246 PASA, 2020, Annual report 2020. Available here.

12. Cross-Sector Themes Affecting the SA Financial Sector

Box 1: The shift to digital brings its own risks

The South African financial sector has seen the emergence of cybercrime at an accelerating rate.[247] In the first quarter of 2021, South Africa recorded the highest number of targeted ransomware attacks, the worst affected on the continent.[248] On a global scale the country has the third-highest number of cybercrime victims in the world; and on average costs the country approximately ZAR2,2 billion annually.[249]

Social engineering tactics have increasingly been used by fraudsters to extract personal and confidential information from victims, particularly in digital banking fraud incidents. In 2019 the number of digital banking fraud incidents increased by 20%, resulting in a gross loss of ZAR284,4 million.[250] It is expected that digital fraud crimes will eventually replace many 'traditional' bank crimes as digital crimes transcend time and physical proximity due to their virtual nature.

Heightened by the increased adoption of digital platforms is the increase in risk related to digital banking fraud. The large-scale move to remote working resulting from national lockdowns led to technical vulnerabilities related to network security and the uptake of digital banking channels by individuals as they were limited in their ability to visit a physical branch. As a result, digital fraud incidents increased by 33% in 2020.[251] The majority of the digital fraud was through the mobile banking app; constituting 59.7% of all digital fraud incidents.

It is important to note that the bank App fraud incidents recorded in 2020 were mainly a result of cell phone snatching rather than the banking app software being compromised to commit the fraud.

247 SABRIC, 2019, Crime stats, 2019. Available here.

248 Daily Maverick, 2021, Cyberattacks: South Africa, you've been hacked. Available here.

249 *Ibid.*

250 SABRIC, 2019, Crime stats, 2019. Available here.

251 *Ibid.*

In contrast, online banking fraud in 2020 consisted of relatively few fraud incidents, however the value of transactions were much higher. Online banking fraud incidents made up 11.1% (the smallest proportion) of all digital fraud reported incidents, and yet accounted for the highest portion of gross losses equivalent to 45.1% of all digital fraud transactions.

The pandemic allowed fraudsters to take advantage of consumers' vulnerability during isolated periods. Phishing and vishing[252] attacks were the most common method of obtaining banking login credentials to commit digital fraud. The success rate of digital fraud was much higher in 2020, increasing by 33%.[253]

Particularly concerning for the FSCA is the poor response rate by banks to reported banking fraud cases. Banks remain relatively slow in their response action (i.e. freezing bank accounts) in dealing with fraud. Despite this, it is important to note there has been a decrease in fraudulent debit orders, and this is likely due to lower debit order transactions as a result of the adoption of an effective debit check protection system.[254]

Box 2: The move towards sustainable financing in South Africa

Financial institutions across the world are playing an increasingly critical role in environmental, social and governance (ESG) initiatives, in line with the global initiative to tackle climate change and achieve sustainability. ESG aims to re-orientate investment towards sustainable technologies and businesses, and the achievement of positive societal outcomes.

In November 2021 world leaders gathered in Glasgow, in the United Kingdom for a global climate summit known as COP26. The aim was for nations to agree on a path to reduce global warming; nations are expected to reconvene in 2022 with actions that can be taken to keep global warming below 2°C and closer to 1.5°C. Significant decisions included an agreement to "phase-down" the use of unabated coal power and to accelerate the "phase-out of inefficient fossil fuel subsidies"; as well as agreements on climate financing - where rich nations agreed to mobilise USD 100 billion to assist poorer countries on climate financing initiatives. Other agreements were around adaptation funding where rich countries agreed to provide around USD 40 billion a year to help poorer countries become more resilient against wilder weather; and agreements on loss damage for vulnerable nations as a result of historical emissions.[255]

252 *Vishing is the fraudulent practice of making phone calls or leaving voice messages purporting to be from reputable companies*

253 Sabric, 2021, MEDIA STATEMENT - SABRIC ANNUAL CRIME STATS 2020. Available here.

254 *Discussed in detail in the payment sector*

255 UN, 2021, Climate Change Conference UK. Available here.

With the growing interest in sustainable financing, regulatory bodies in South Africa have been adapting the regulatory landscape to include the ESG standards in the financial sector. In October 2021, the National Treasury released an updated version of its technical paper Financing a Sustainable Economy, which was first published in May 2020. The paper lays the foundation for facilitating long-term investment in sustainable economic assets, activities and projects needed to support the transition to a low-carbon and climate-resilient economy, including net-zero carbon emissions by 2050.

The original paper established the Climate Risks Forum, chaired by the National Treasury, to develop an approach to meeting the net-zero emissions target on a voluntary basis. In 2022, the forum will publish its green taxonomy and principles for effective climate-related disclosures. In late 2021, the National Treasury established the Intergovernmental Sustainable Finance Working Group to ensure that regulatory instruments to manage climate-related risks to the financial sector are developed in a coordinated and coherent manner. The Prudential Authority and the FSCA, both within the group, are expected to publish guidance on a green taxonomy and disclosure framework, to inform the development of future regulatory instruments.

Regulatory guidance will take into account emerging international best practice and approaches, including work led by the International Sustainability Standards Board to deliver a comprehensive global baseline for sustainability-related disclosure standards. These standards provide investors and other capital market participants with information about companies' sustainability-related risks and help them make informed decisions. The National Treasury will also work towards harmonising the current reporting systems to deliver on these objectives.

Box 3: Regulating crypto assets in South Africa

Crypto-trading has become increasingly popular in South Africa, with daily crypto asset trading in South Africa exceeding USD145 million in January 2021. Along with the rise in trading has been a related increase in crypto-related fraud and scam cases. The collapse of Johannesburg-based Mirror Trading International, where USD581 million went missing, has been called the biggest crypto-related scam of 2020 by blockchain data platform Chainalysis.[256]

256 Bitcoin.com, 2021, South African Central Bank Governor Reiterates: 'Crypto Is Not Currency'. Available here.

Many South African investors have been attracted to crypto for various reasons, including the perception of potential high returns.[257] Bitcoin, the most well-known crypto asset, has increased 115% year-on-year for the last 10 years (+211 000% total return), making it the best-performing asset class in the last decade.[258] However, crypto assets remain highly volatile and inherently risky. This is evident when comparing the volatility of Bitcoin to an asset like gold, using historical volatility which measures price fluctuations from the average value over a given period - the price of gold fluctuated by 16% quarter-over-quarter compared to the price of Bitcoin which fluctuated by approximately 95% quarter-over-quarter.[259] Other risks identified include potential maladministration, failings of service providers, misleading advertising, product complexity, and unclear price formation and pricing practises.

To date, crypto asset trading platforms have been operating outside the purview of financial sector regulators such as the FSCA, but have been considered a taxable asset. The FSCA has limited jurisdiction in the regulation of cryptocurrencies. In November 2021, the FSCA published a draft Declaration of crypto assets as a financial product under the Financial Advisory and Intermediary Services Act, to aid in the regulation of crypto assets.

In June 2021, The Intergovernmental Fintech Working Group (IFWG), a collaboration of regulators in South Africa including the FSCA, published a position paper on crypto assets. The paper confirms that crypto assets will be brought into the South African regulatory purview in a phased and structured manner across three main areas: 1) anti-money laundering and combating the financing of terrorism; 2) cross-border financial flows; and 3) consumer protection through the application of financial laws.

The regulators have made the decision to regulate crypto assets to promote responsible innovation. As discussed, crypto assets are highly volatile and marketing material often highlights only the potential gains, without noting the possible losses, which can be misleading to retail investors. Given their decentralised nature, consumers often have no recourse when something goes wrong. Regulations are expected to be developed in a collaborative manner, and the IFWG is expected to be a dynamic environment where proposals will be refined and amended as the market and technologies develop.

257 Moneyweb, 2021, Cryptocurrency and herding behaviour. Available here.

258 Mail and Guardian, 2021, Protect your wealth in a volatile market. Available here.

259 *Ibid.*

13. Conclusion

The FSCA is part of a broader regulatory framework for the South African financial sector, made up of a range of authorities and laws, with complementary objectives, that together deliver and support national policy goals for the sector and ensure the South African financial sector is able to keep pace with the global financial system.[260] The FSCA takes its policy direction from the National Treasury, whose objectives are, in turn, informed by broader government strategic and development plans.

The FSCA Regulatory Strategy 2021 - 2025, outlines the focus on "implementing and embedding newly established approaches to policy development, regulation, supervision and enforcement" during the period ahead. Given its mandate, the FSCA has a clear impact on the financial sector and the broader economy, and can make a meaningful contribution to promoting growth, employment and poverty reduction. More particularly, the FSCA has stated the strategic priorities over the five year period:[261]:

- Improve industry practises to achieve fair outcomes for financial customers
- Act against misconduct to support confidence and integrity in the financial sector
- Promote the development of an innovative, inclusive, and sustainable financial system
- Empower households and small businesses to be financially resilient
- Accelerate the transformation of the FSCA into a socially responsible, efficient, and responsive organisation

The outcomes of these strategic priorities include: embedding good conduct and Treating Customers Fairly principles across the financial sector; enshrining trust in the sector is maintained; supporting financial inclusion of low incomes households and businesses; and enabling greater competition and contestability in the financial system.

A priority for the FSCA is to ensure that innovative offerings are inclusive. Currently, the reach of digital innovations remains limited, with higher income customers individuals being the targeted beneficiaries. The FSCA is currently working to address such discrepancies, and ensure digital innovations are inclusive across all segments of the market and do not entrench existing inequalities.

260 FSCA, 2021, Regulatory Strategy of The Financial Sector Conduct Authority: 2021 - 2025. Available here

261 *Ibid*

As technology allows for new products and asset classes, FSCA has to ensure regulatory frameworks are fit for purpose in this dynamic environment. Alongside other regulatory bodies, the FSCA has increasingly been exploring ways to ensure that technologies such as crypto currencies and blockchain are utilised in a way that ensures financial stability and consumer protection. The COFI Bill that is currently going through review addresses such issues as the oversight of non-traditional financial institutions, services and products.

The FSCA will continue to collaborate with other regulators to adapt the regulatory landscape to include the ESG standards in the sector. Ensuring that the requirements relating to sustainable finance set out by financial regulators, including disclosure and reporting standards, are well defined and communicated to the financial sector is vital. The FSCA will continue to work on the harmonisation of requirements relating to sustainable investments across the financial sector, and the incorporation of these requirements into conduct standards.

The FSCA aims for a holistic and intensive approach to regulating the conduct of financial institutions operating in South Africa - and will continue to engage with all relevant stakeholders to realise the vision of a fair, efficient and resilient financial system that supports inclusive and sustainable economic growth in South Africa.

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