Regulation and supervision of Microfinance Institutions: The Experience in South Africa - G. Coetzee

1. INTRODUCTION

In most developing countries the institutions inherited from our former colonial masters largely continued to exist past their "sell-by dates". The institutions have not changed to reflect the demands or requirements of post-colonial realities. This is certainly true in the financial sector, especially when considering this sector's support for small entrepreneurs. The irony is that in most of the former colonial powers' banking institutions have moved towards accommodating and enabling small entrepreneurs, while in the former colonies the institutions have been trapped in time and reflect their historical legacy. Rock and Otero (1997) argue that the current paradigm for prudential regulation and supervision has been designed for conventional collateral based finance, which presupposes the existence of "wealth". Wealth in these terms is normally seen as a freely transferable asset. In most poor communities assets are by definition scarce, however they are not easily transferable outside of the community.

Current financial legislation in South Africa reflects the needs of a small range of conventional "Western" financial institutions. Not only does this legislative regime not accommodate the demand for financial services from the majority of South Africans, but it also succeeds in protecting and nurturing the market of the current established and registered institutions. This market also include the savings of numerous poor South Africans, however these clients do not have ready access to loan products at these institutions.

Over the last 10 years in South Africa the growth of formal financial services provision to small and micro entrepreneurs (including farmers) changed considerably in profile. In the earlier period state supported development corporations and a joint government and private sector small business financing institution were the most active in the market. Some NGOs were attempting to service this market during the same period, notably the Get Ahead Foundation. With the advent of a new political dispensation in the country and a relaxation of controls, combined with increasing lack of employment and the inability of the formal economy to create new jobs, small and medium sized entrepreneurs flourished all over the country. The relaxation of apartheid controls on the mobility of people also contributed to this phenomenon. The quick increase in the numbers of enterprises resulted in an increasing demand for appropriate financial services. Microfinance NGOs and profit orientated small loan organisations mushroomed and at the same time the very costly provincial development corporations and provincial parastatal banks suffered severe setbacks.

Close attention to the access to financial services in the form of policy studies regarding the availability of financial services was initiated by the government (Strauss Commission, 1996; White Paper on Small Entrepreneurial Support, 1995). Several government structures were created to support small entrepreneurs and some national level institutions were restructured. With this emphasis on this end of the market and the results of these studies pointing more and more to the importance of savings mobilisation, questions were being asked on regulation issues. The Bank Act No 94 of 1990 came under close scrutiny as did the other relevant financial legislation. The first reaction from the regulator was to try to solve this ground swell in demand for financial services with further legislation. This did not prove to provide the complete answer and several different endeavours were launched. The most positive of these was a concerted effort by the microfinance fraternity in South Africa to improve information flows, both to the regulatory authorities to enable them to understand this "new" market phenomenon, but also to inform the micro-finance fraternity on the objectives and content of legislation.

In this paper the South African story on regulation and supervision will be summarised with emphasis on the regulation and supervision of non-standard banks (including micro finance

institutions, decentralised financial systems and parastatal banks). The rest of the first section provides some South African context. A background discussion follows providing some policy concepts on regulation and supervision issues. A discussion on the existing financial institutions and legislation is presented in section four. Thereafter it is shown that several initiatives are underway in South Africa with respect to both action and thinking on regularisation and supervision issues of non-standard banks. The article is concluded with some remarks on the process in South Africa.

2. SOME SOUTH AFRICAN CONTEXT

South Africa: Salient features of the financial market

The formal financial market serving the commercial sector is well developed and urban based. South Africa's financial instruments and institutions at the commercial end of the market are comparable to those of most industrialised countries. Our stock exchange, one of 16 in Africa, handles the highest proportion of African stock market trading. Interest rates and market variables have been liberalised, except for control over foreign exchange transactions by domestic residents, which is slowly being lifted. In South Africa there is one commercial bank outlet per 15 000 people, while Africa has one commercial bank outlet per 450 000 people (Coetzee, 1992). However, 70 per cent of the commercial bank outlets in South Africa are in urban areas. This implies that access to commercial bank branches in urban areas is higher (approximately 9 500 people per branch) than in rural areas (approximately 22000 people per branch). The uneven distribution of access in general is echoed in the financial market.

The efficiency of financial systems and policy is normally judged on the ability of the system to mobilise savings and channel them towards the most efficient application in the economy. Even an efficient and sophisticated financial system (Roux & Donaldson, 1992) is unable to meet all the financial requirements in an economy. Banks in South Africa do not lend enough to small business or small scale farmers, because they perceive the transaction costs and risks are too high.

The South African financial sector is increasingly dependent on electronic services. Commercial banks' information technology investments are generally high and automated activities are increasing in number. Deposit and related services are increasingly being rendered via automated teller machines and through the use of smart cards. These more efficient and rapid transaction methods are also safer, as they reduce cash handling. However, they are more widely available in peri-urban areas than in truly rural settings. In deep rural areas only the more conventional deposit and savings technology prevail. Banks note that the transaction costs associated with operating in rural areas outweigh the income that may be earned and that there is a minimal level of business required for branches to reach the scale where they become viable.

Retail Financial Institutions in South Africa

Table 1 outlines the range of retail financial institutions in South Africa. Besides the institutions outlined below, South Africa also has several development financial institutions that provide a range of wholesale and retail financial services. Under apartheid the development finance system was used to pursue the racist political objectives of the government and has been largely discredited, particularly in African communities. In the 'new' South Africa, the government is attempting to re-create these development financial institutions to correct for the failure of markets to allocate resources at socio-economically optimum levels. Khula Enterprise Finance Limited and the National Housing Finance Corporation (NHFC) are two new development financial institutions designated to provide services to retail financial institutions. Khula provides a mixture of loans, guarantees, and grants to approved financial retailers that serve the small and microenterprise market, particularly the informal sector. Retail financial intermediaries are assessed based on developmental criteria such as outreach to targeted groups and job creation, and institutional criteria such as portfolio performance and sustainability. NHFC serves a similar function with retailers that provide housing finance.

Table 1: Summary of formal retail institutions in South Africa

Retail institutions	Number of branches and agencies	Rural coverage*		Coverage in terms of clients reached (loan contracts or clients)
		% of branches	% of clients	
Land Bank [a]	25 to 180+	90+	90+	33 000 to 50 000+
Provincial parastatal banks [b]	66	50+	50	50 000
Development Corporations [c]	10 and declining	?	70	60 000
Post Office Outlets [d]	2365	?	60+	2 400 000
NGOs [e]	13 - 18	?	35	23 700
Co-operatives [f]	250+	80+	60+	142 000 members
Commercial Banks [g]	4055	33	?	?
Teba Cash [h]	172	40	?	700 000
FAF [i]	20	100	100	20 000
Small loans industry [j]	5200	?	?	377 clients per month per outlet

- * Broad definition of rural areas as non-metropolitan areas. ? - Data unavailable.

[a] 25 branches and "retail" through approximately 180 co-operatives. It is assumed that the majority of commercial farmers are clients of the co-operatives that borrow from the Land Bank.

[b] Include the Eastern Cape Banks, North-West and KwaZulu Finance and Investment Corporation. Based on Strauss Commission, 1996; Eastern Cape Banks Restructuring Report, 1997 and Agribank Report, 1997.

[c] Based on Strauss Commission, 1996; DBSA and Khula, 1997.

[d] This is the total of all grade branches of which 333 are full grade

branches. It is estimated that less than a 1000 branches provide full PostBank services. They consider the majority of their savings clients as living in rural areas (Strauss Commission, 1996)

[e] Estimates based on DBSA and Khula, 1997.

[f] Based on Strauss Commission, 1996.

[g] Situation on 1 January 1995 (Strauss Commission, 1996). The rural estimate is based on an earlier paper by Mostert, 1993 and reflect branches and agencies in non-metropolitan areas.

[h] Teba cash is the payment and cash handling arm of the mining employment bureau (Strauss Commission, 1996)

[i] FAF is the Financial Aid Fund of the sugar industry (Strauss Commission, 1996)

[j] Based on the report on the small loans industry in South Africa by Du Plessis (1995). It is difficult to estimate the clients reached due to repeat clients and short loan periods. The number of clients per month is derived from an average monthly turnover of R170 000 for the formal outlets, which translate to 377 clients per month at the average loan of R450 per client.

In addition to the formal financial sector, unregulated NGOs provide financial services' primarily credit, in market niches poorly served by government or commercial institutions. Generally offering microloans up to US$1,330 in disadvantaged communities, the NGOs tend to operate on a small scale. The informal financial sector is also alive and vibrant in South Africa. Informal financial transactions take place on a daily basis across South Africa. Evident of the multitude of transactions is that approximately R83m changes hands monthly in the urban areas through South African Rotating Savings and Credit Associations (ROSCA) called stokvels (Markinor, 1992).

Table 1 creates the impression that a vast number of clients make use of the services of financial institutions and that access should not be a major problem. Except for the commercial banks very few of these institutions provide a comprehensive range of services. The physical presence of these institutions is concentrated in the urban areas, except for the specialist agricultural financiers. Several studies (see Coetzee, 1997) indicate high savings propensities amongst the poor. Also, the institution where most of the rural poor keep their savings is the commercial bank. However, these institutions provide limited services to these clients, other than savings facilities.

3. BACKGROUND DISCUSSION

In most developing countries inadequate legal structures result in decreased transactions and inefficient market operation. This is especially true with respect to legislation regarding financial transactions. Direct and indirect legislation makes it difficult for lenders and borrowers to interact, especially between the formal and informal sector (Yaron *et al.*, 1996). The challenge in terms of legislation, regulation and supervision is how to create ‘good’ institutions. Successful institutions will lower transaction costs and increase efficiency in economic exchange. They are based on clearly defined property rights and uncomplicated contract enforcement. This, in turn, is only possible if the correct information is available and the legal system is amiable. Thus two tests are evident: are property rights secured, and is the rule of law enforced (Beghin & Fafchamps, 1994). In essence we

are looking at clarity in terms of benefits of programmes and enforceability of the law related to these programmes.

In financial markets lenders and savers need recourse to the law. Lenders need a system in which claims against property can be created, established and enforced (Yaron *et al.*, 1996). The more efficient this process, the more willing lenders will be to enter into contracts with borrowers. In many instances small and micro entrepreneurs are not in a position to provide collateral in the form of easily transferable property. Here other methods of collateral need to be investigated (see Coetzee, 1997, for a discussion of collateral substitutes). Legal reforms to ensure that lenders have efficient recourse to law benefits all other transactions, not only financial transactions.

In the recent approaches to provide financial services to small and micro entrepreneurs savings mechanisms are emphasised. The rediscovery of the "forgotten half" of rural financial markets necessitates that legislation that protects depositors be investigated. This also opens up the whole notion of the regularisation of non-standard banks. In many countries specific legislation is drafted to accommodate non-standard banks. For example, in several countries including America and Canada, specific legislation caters for credit unions (Sheng, 1996). Consumer protection is the primary objective of financial regulation (Wirth Report, 1986) and all efforts at regulation therefore have the consumer (indicating the depositor, but also the borrower) at heart. The regularisation debate in many countries has tended to be dominated by the dark shadow of scandals and abuses (Rider *et al.*, 1986). Proposals emanating from these discussions are therefore very strict, so strict that they have the potential to have a negative or dampening impact on the development of financial markets and the ability of these markets to allocate financial resources efficiently.

The guideline emanating from the discussion is that consumer protection is important, though not at such a level that it dampens the functions of the financial market. The challenge therefore is how to structure legislation to protect and facilitate the functioning of the market. In addition it should also facilitate entry into the market, especially in countries like South Africa where entry into many markets was a function of the political status of the entrant.

New demands for supervision due to the emphasis on savings mobilisation as an integral component of the new approach cannot be met on the basis of exemptions alone. Most of these institutions cannot meet the onerous reserve and capital adequacy ratio requirements of formal financial legislation. The transaction costs of supervision of a large number of small institutions are costly and dampen efficient supervision (Rock & Otero, 1997). The challenge therefore is to create new regulatory models for the supervision of financial institutions that serve the poor. Rock and Otero (1997) base a range of recommendations on a good descriptive study of regulatory efforts in Latin America.

One point of departure to address this dilemma is to differentiate supervision activities on the basis of the institutional characteristics of financial institutions. Institutions in which most members are involved in the running of the institution can benefit largely from self-regulation. As we progress on the continuum of collective action and institutional evolution towards institutions in which the owners (members) are not directly involved in running the institution (principal agent relationships), arrangements move from self regulation to complete adherence to the formal banking acts and supervision by a registrar of financial institutions (see figure 1 for a graphical presentation of this concept - figure 1 is an ordinal representation). Chaves (1994) studied the control and behaviour of saver-dominated institutions compared to those that are borrower dominated. Although this study did not analyse supervision in detail it was clear that in saver-dominated institutions the actions of borrowers are carefully monitored.

Figure 1: The relationship between regulation responsibility and operation and management of financial institutions

Self - regulation Externally

supervised

Member-driven institutions Management-driven institutions

4. EXISTING FINANCIAL INSTITUTIONS AND LEGISLATION

South African Reserve Bank

The Reserve Bank is the central bank of South Africa with the responsibility of protecting the internal and external values of the currency in the interests of balanced and sustainable economic growth. To achieve these goals, the Reserve Bank influences the total monetary demand in the economy by controlling the South African monetary supply and the availability of credit. It is important to note the independence of the South African Reserve Bank. Its ability to make practical and policy decisions independently of the government is guaranteed by the constitution. The Reserve Bank is responsible for holding a minimum reserve balance for all banks and for supervising banking institutions.

Registrar of Banks

The Registrar of Banks, an official of the Reserve Bank, heads the Department of Banking Supervision in the Reserve Bank and reports to the Minister of Finance. Extensive powers of supervision and inspection vest in the Registrar who may call upon the auditors of a bank to furnish notices and other information. Moreover, auditors must inform the Registrar of any matter relating to the affairs of a bank which, in their opinion, may endanger the bank's ability to continue operating, may impair the protection of the funds of the bank's deposits, may be contrary to the principles of sound management, or amounts to inadequate maintenance of internal controls.

Policy Board for Financial Services and Regulation

The Policy Board was established in 1993 to advise the Minister of Finance on matters relating to financial services and regulation either of its own accord or by the Minister's request. The Board's scope of advice includes laws that affect financial regulation, policy considerations that impact from the regulation, and any matter referred to the Board by the Minister. The Policy Board also facilitates communication between the Reserve Bank and the Financial Services Board (see below) to ensure the efficiency of financial regulation and the stability of the financial system.

Financial Services Board

The Financial Services Board was created in 1990 to serve as a watchdog over the non-banking financial services industry. The Financial Services Board regulates insurers, pension funds, financial exchange members, unit trusts, portfolio managers, investment firms, securities firms (including stockbrokers, fund managers, and the securities trading division of banks), and non-securities firms (such as trust companies, insurance brokers, and investment advisors).

The Banks Act No 94 of 1990

The Banks Act (1990) consolidated the provisions of previous South African banking legislation to deal with banks, building societies, and all deposit-taking institutions in the same manner. The main objective of the Act is to create a common regulatory framework for deposit-taking to safeguard the investments of depositors and protect the integrity of the banking system.

The approach of the Banks Act is functional, not institutional. It addresses the function of deposit taking rather than the institutions accepting deposits. The advantage of this approach is that various groups of banks are regulated by a single act, creating a more level playing field by eliminating past discrepancies in the regulation of these groups. The disadvantage is that the current regulatory conditions create high barriers to entry that has led to the emergence of a few powerful banking groups who dominate the industry. In 1996, the four banking groups controlled approximately 77 percent of all assets of deposit-taking institutions. The financial institutions operating under the Banks Act generally do not cater to the demands of low-income communities for financial services.

The Banks Act introduced a general prohibition on taking deposits from the general public unless the entity was registered as a bank. Under the current banking regulations, besides not mobilising savings from the general public, retail lenders are prohibited from accepting "deposits" from the investment community, except for loans from equity banks. This provision has a dramatic impact on the ability of non-traditional lenders to obtain wholesale funding.

Several institutions are being exempted from the requirements of the Banks Act. These are normally member driven institutions where self regulation in the form of peer monitoring is possible and does happen.

The Banks Act is based on international banking criteria and principles, as is its risk management requirements, which are in accordance with the Basle Concorde. These requirements rely on the risk management capacity of directors and senior management of banking institutions, and on capital adequacy and liquidity requirements. A bank is required to maintain total-share capital and unimpaired reserve funds of up to eight percent of its risk exposure. The current banking legislation does not encourage the provision of credit to potential borrowers with low incomes and without security. Only loans fully secured by mortgages on urban residential dwellings qualify for a fifty percent risk weighting for capital adequacy purposes; all other assets qualify for one hundred percent risk weighting.

A bank must also hold liquid assets, which must not be encumbered without an exemption by the Registrar, amounting to not less than five percent of the bank's short-term liabilities. It may not make a single investment for an amount exceeding a prescribed percentage of the institution's capital and reserves without permission from its board and specific reporting to the registrar. It must also maintain a reserve balance with the Reserve Bank between one and two percent of its liabilities.

The Mutual Banks Act No 124 of 1993

The Mutual Banks Act of 1993 was an attempt to add depth to South Africa's financial system by creating a banking category that had less stringent capital adequacy prerequisites but similar risk management requirements. It also attempted to involve communities in banking by including a provision for local boards for branches of mutual banks, the organisation of which must be mutually based rather than equity-based. The primary share capital of mutual banks is in the form of permanent interest-bearing shares that are not redeemable but may be transferred at the discretion of the board of directors. It is expected that over time the members of the community in which a mutual bank operates will acquire shares in the financial institution. The Act provides that a mutual bank may accept deposits and grant loans, advances or other credit. The prudential requirements for mutual banks are similar to equity banks that fall under the Banks Act. A mutual bank is obliged to:

- meet capital adequacy requirements by maintaining unimpaired reserve funds in the amount of at least US$2.2 million or up to eight percent of its risk exposures;
- maintain a minimum reserve balance with the reserve bank equal to five percent of its short-term liabilities;
- avoid portfolio concentrations in excess of a certain percentage without making a specific report to the Registrar; and

- give detailed monthly and quarterly returns, showing its various risk exposures and the manner in which it complies with capital adequacy and liquidity requirements.

The Act provides that the Registrar may require applicants for mutual banks to establish a relationship with an equity bank (referred to as a "guardian bank") to assist the applicant with technological infrastructure, management, and advice. A commercial bank can serve in a capacity similar to the guardian bank arrangement prescribed in the mutual bank legislation.

The capital and reporting requirements are so stringent and inflexible that mutual banks have not effectively increased access to financial services in South Africa. The most basic principle is that the benefits of formalisation should exceed the costs of reporting and supervising for practitioners, the Registrar, and the target market. It is also important that formalisation does not alienate the customer base. From the perspective of commercial banks, this category of financial institution may be an opportunity to improve their relationship with disadvantaged communities and consequently they may consider creating microbank subsidiaries.

Other Laws Affecting Access to Financial Services

Their are a multitude of legislative instruments governing the and impacting on the provision of financial services. For the purposes of this paper the following are highlighted:

Usury, Act (1968). The Usury Act regulates consumer transactions including money lending, commercial credit, and leasing. It states that no moneylender may receive finance charges at an annual rate greater than the maximum rate determined by the Registrar. Currently, the maximum effective interest rate (including all fees) on loans more than US$1,330 cannot exceed twenty-six percent and for loans below US$1,330, twenty-nine percent. The Registrar of Banks is responsible for enforcing the Usury Act. In 1992, to facilitate lending to low-income borrowers, the previous government issued a regulation exempting loans of US$ 1,330 or less from the provisions of the Act, provided that:

- The loan amount and finance charges owed by the borrower are paid within three years;
- The lender does not advance the loan until after a "cooling off" period of three days, during which time the borrower may terminate the transaction; and
- The lender must furnish to the borrower, in writing, the amount in Rands and cents of the loan amount and the sum of the finance charges and other costs payable (the interest rate does not need to be disclosed).

In 1994 the new government announced that it intended to remove the exemption to the Usury Act on the ground that it allowed lenders to charge interest rates that exploited low-income communities. This rationale for limiting interest rates is in the interests of consumer protection. Yet borrowers who do not have access to loans under a controlled interest rate have no choice but to take up high interest rate loans from moneylenders that operate outside the regulated financial system (if these loans are on offer). The removal of the exemption would make it impossible for microfinance institutions to achieve full-cost recovery, therefore causing the adverse effect of limiting the access to financial services in low income communities. The removal of the exemption is being protested by most key players in South Africa's microfinance community, including the broad-based Alliance of Micro Enterprise Development Practitioners.

Land Reform. The process of land reform currently taking place in South Africa has a profound impact on access to financial services. The current subdivision legislation provides that agricultural land may not be subdivided into smaller holdings without the consent of the Minister of Agriculture. This policy was implemented in a period when government policy promoted large commercial farms.

Access to Financial Services for Women. While not banking law *per se* the customary law that has historically been applied to Africans treats all married women as minors, rendering them unable to enter into legal contracts. Consequently women married under customary law must get their spouses to sign loan agreements. There is also gender discrimination by institutions dealing with small-scale entrepreneurs. While African women are major loan recipients of NGO retailers, other institutions that serve African borrowers, including development corporations and commercial banks, deal mostly with men.

Collateral. The use of movables as collateral for microloans is problematic. Although legally possible, the costs involved in complying with the stipulations of "The Security by Means of Movable Property Act" preclude its application to microlending.

The Co-operatives Act No 91 of 1981: In describing the "business of a bank," the Bank Act does not include the co-operative's borrowing money from its members. This allows members of a co-operative to make deposits with it in the form of a loan, subject to certain conditions. The loan from a member to a co-operative must be at least US$222 and the repayment period is usually twelve months or more. The co-operative must issue an acknowledgement of debt and the loan is repayable either at a fixed date or upon thirty days' notice by the co-operative to the member. Co-operatives are thus able to circumvent certain provisions of the Banks Act.

5. SOUTH AFRICA'S APPROACH TO REGULATE NON-STANDARD BANKS

Berenbach and Churchill (1997) used a framework of institutional classification (see Table 1) for the different approaches currently known towards the regulation of non-standard banks and specifically microfinance institutions. One category was added based on experience in West Africa (Coetzee, 1997). This categorisation will be applied in describing the recent history and current status of the regulation of non-standard banks in South Africa.

Table 1: Regulatory approaches to the microfinance sector

Initial steps	Self-regulation	Hybrid	Regulated under existing legislation	Exemptions and/or window until regulation of mature organisation	Regulation under a special law

Sources: Berenbach and Churchill, 1997; Coetzee, 1997.

However, the use of the term non-standard banks should be explained first. Although microfinance institutions are normally emphasised when discussing the recent regulatory challenges a broader approach is to encompass all institutions supplying services to micro and small entrepreneurs. These may be microfinance NGOs, village banks, savings and credit co-operatives, stokvels (South African rotating savings and credit associations). Although a concerted effort is made by the microfinance fraternity to address the regulation issues the recent reports on these efforts emphasise only one stream of activities (see Berenbach and Churchill, 1997; Porteous, 1997; Willemse and Goldblatt, 1997). In addition regulatory issues to do with provincial parastatal financial institutions and village banks are not receiving the same level of attention.

The rest of this section will provide a broader discussion of regulatory approaches to the microfinance sector in South Africa and will follow the different options as outlined in Table 1.

Initial steps

This approach is described by Berenbach and Churchill (1997) specifically with respect to South Africa and the Philippines. In South Africa the micro enterprise and micro finance institutions established an Alliance of Micro Enterprise Practitioners. This association serves as a platform to share experiences and technologies and also serves an important lobbying role. Some members of the Alliance joined forces with two local national development finance wholesalers servicing the housing loan and microfinance sectors (The National Housing Finance Corporation (NHFC) and Khula Enterprise Finance respectively).

Besides advocating for some of the regulatory reforms discussed above, members of the Alliance have been working Khula and the NHFC to develop a code of conduct that could serve as the framework for self-regulating the South African microfinance industry. To that end, the microfinance community established a committee to create "Statements of Sound Practice," outlining best practice standards for practitioners and forming the basis for a regulatory framework for the microfinance institutions.

This collective action by the microfinance industry is a giant step forward in a country where co-ordination of activities is indeed very difficult. Berenbach and Churchill (1997) point to two observations:

- First, that South African regulators do not rush in to regulate microfinance institutions as most of them do not mobilise deposits, and
- Secondly, the collective action is a necessary step in an evolutionary approach towards regulation of the industry.

Hybrid approaches

A recent study (Porteous, 1997) highlighted the essence of the current proposal on the regulation of the micro-finance industry in South Africa. The major stakeholders in the industry have been identified as retail depositors, wholesale depositors (investors), borrowers, retail financial intermediaries and regulators. The recommendations looked at a minimalist dispensation excluding deposit taking from retail depositors. Thus the primary aim of the proposed structure is industry development (in order to increase access to finance) and consumer protection (thus protection of borrower interests).

A supervising authority is proposed that will function as a private limited company of which key institutions will be members (Porteous, 1997). Retail financial institutions that meet certain criteria (read Statements of Sound Practice), who are registered with the proposed supervisory body (thus members) and who conforms to the rules and regulations of the supervisory body would be granted exemption under the Usury Act and the Banks Act. It is proposed that further specific limitations on institutions exempted in this way could be specified in the exemptions. These limitations could include limits on size of institutions and on the nature of their activities.

The proposal states that the governing body of the supervising authority will be appointed by the members of the company and by affiliated industry associations. A core body of permanent staff members would be appointed for the day to day running of the organisation.

The supervising authority will have the right to levy fines and/or de-register members as punishment for non-compliance. De-registration will also imply that exemptions are not in place any more for the specific institution that will also then be contravening the Banks Act (and/or the Usury Act) and thus be liable for the normal penalties specified in these Acts.

The set of standards that will be the guiding framework for compliance with registration requirements and will form the basis for supervision could be the Statement of Sound Practice as accepted by Khula and the NHFC as this Statement covers those areas of relevance for a regulatory

authority, namely a Code of Conduct, a Code of Governance, a Code of Financial Disclosure and a Code of Risk Management. As is rightly argued by Porteous (1997) the Statements of Sound Practice is a good starting point for compliance, however it needs to be redefined in terms of minimum standards that would allow efficient supervision.

The funding proposal for the supervisory body states that it will run at a cost of approximately R1.5m which will be financed by once-off application fees and annual accreditation fees and government funding. The idea is to decrease the government funding as member volume grows and to use donor funding only for establishment purposes.

The above proposal seems to fit the best in the hybrid category as it describes a third party in the form of the supervising authority that will be the regulator as long as members comply and are exempted from the normal Acts. It also contains a bit of self-regulation as the supervising authority consists mainly of the micro-finance industry, and it contains a bit of the exemption category since it operates on exemptions from the Banking Act.

Self-regulation and Exemptions

Certain "common bond" institutions are exempt from the provisions of the Banks Act. These include *stokvels* and credit unions on the condition that they are members of a self governing umbrella body - such as the Savings and Credit League of South Africa or the National Association of Stokvels of South Africa - and have less than US$2.2 million in assets. The common bond exemption assumes that the members of a stokvel or credit union know each other well thereby reducing the asymmetric information problem. In living or working closely together, members are able to monitor peer behaviour. It is further assumed that the local association receives sufficient supervision by falling under the aegis of an umbrella body. In addition, since each local association is a closed system, a failure at the local level will not affect the broader financial system.

One of the prime features of the search for regulation of microfinance institutions is the numerous applications for exemptions from the Banking Act by these institutions. Exemption is always granted after ensuring that some other mechanism of supervision is in place. Quite often new institutions are allowed to operate for a while until the Registrar of Banks is convinced that along term arrangement is need or risks are being identified. The recent demise of two pyramid schemes in South Africa placed a lot of attention from the Registrar on the micro-finance industry and the exemption applications.

The latest application for an exemption is for the South African village banks or Financial Service Organisations. The village banks operate on the same basis as savings and credit co-operatives. In the application for exemption it is clear that the organisation must be member based, may not hold deposits from members amounting in the aggregate to more than R10m, must operate as a client of a commercial bank, can provide savings and credit facilities and the exemption expires on 31 December 2000.

Regulation under a special law

The purpose of the Mutual Banks Act discussed in section was to involve members in the ownership of the bank and communities in the running of a bank. In a way this is a special act since it was the first formal reaction from the state to acknowledge that the current Banks Act is not conducive to answer to the financial demands of the new South Africa. The first institution to be registered under this act was the Community Bank. This was a commendable effort by society, the commercial banking sector and the state to soften the financial legislation of this country.

Unfortunately the Community Bank failed and amongst the reasons for failure one should consider whether the Mutual Bank Act was the appropriate legislation vehicle. Furthermore, the Community

Bank was established in a milieu where not much emphasis was placed on slow savings first strategies to build up a healthy financial institution, although the essence of the Community Bank was based on the mobilisation of deposits from the Communities it wanted to service. Even while everybody acknowledges the importance of savings mobilisation as part of the institutional approach to the sustainable provision of financial service not many microfinance institutions would include this in their portfolio of services. It is not clear whether it is only the result of the narrow financial legislation, or whether other factors also could contribute to this reticence.

Provincial level example

Another example of a process towards special legislation is the current planning process for the restructuring of the provincial development finance institution in the KwaZulu Natal Province in South Africa. As the current provincial development finance institution incorporates both credit and savings facilities. These are however run as separate entities. He savings arm of this institution is the most successful provincial level savings service in the country. It operates out of 44 branches in the province and has mobilised savings in excess of R200 million. The structuring of the future institution is part of the country wide process of restructuring of the provincial parastatals.

As the new structure will have a savings component the provincial government appointed a team to investigate the regularisation of the savings service. During the process one proposal was to emulate the Banking Act at provincial level. This process would include the relaxation of some of the requirements of the Banking Act and incorporating all the risk mitigating elements of the Banking Act that protects depositors in the provincial legislation. This proposal is now being investigated and discussed with the Registrar of Banks.

Tiers for the unbanked

In so far as different banking needs and requirements can be identified, the tiering of banking legislation and regulation according to distinctive institutional features which are directed to suit client needs. For too long banking practice in South Africa has been driven by a minority client group. This problem can be stated from the perspectives of the functions of current institutions or from the view of client demands. The conclusions may well be very different. In this analysis we have taken an institutional/functional perspective which would have to be modified of articulated client demands. The principle of tiering implies that the level of supervision can vary with the level of exposure in terms of the qualitative features as argued earlier in section three (see figure 1) or the risks associated with their activities. Effective tiering implies that each tier has distinctive characterises which address a market niche and that legislation provide for transition between niches. Tiering will echo the reality of the South African situation. Tiering also involves risks. As the concept is new close monitoring and evaluation of the unfolding of such a concept is of importance.

6. CONCLUDING REMARKS

The efforts to ensure a sensible approach to the regularisation of the microfinance sector are well under way in South Africa. This is the product of both mistakes and innovative approaches. As is evident South Africa has of legislation that make it very difficult to expand services to those clients that could pay for services, but were not served in the past. It is not expected that the commercial banking sector will provide a broad range of financial services to these clients. Other than savings or deposit facilities very little if any products are targeted on this market. However, it is also clear that the Registrar of Banks is more sensitive to the needs of the microfinance market than in the past. This is the effort of a broad consultative process initiated by the actors in the sector after they have organised themselves in a lobbying mechanism. The current government also emphasise the support to the microfinance sector which is evident in their creation of Khula and NHFC, and their support for the restructuring of the South African Land and Agricultural Bank. These efforts, together with the simultaneous attention given to provincial legislation, have the potential to adjust the South

African financial legislation over time to accommodate a far broader range of financial institutions than is currently the situation.

However, we should not be lulled into complacency by the evolutionary approach along which regulatory issues are addressed. Evolutionary approaches takes time and may not provide us with answers over the short to medium term. The current practise of an exemption orientated approach implies an 'abnormality' in reacting to expressed client need with exemptions rather than focused and tailor made legislation. The regulatory powers have enough international and local evidence to venture in this direction. This may provide us with a more enabling banking environment over a shorter time period, where institutions of different size, ownership structures and product ranges can all be accommodated within a financial system that enjoys the support of both the international and domestic markets as well as the majority of South Africans. This could be possible under the tiering arrangement discussed in this paper.

REFERENCES

Beghin, J. & Fafchamps, M. (1994). Constitutions, institutions and political economy of Farm Policies: What empirical content? Invited paper read at the International Conference of Agricultural Economists. Harare, Zimbabwe (August 22-29).

Berenbach, S. & Churchill, C. (1997). Regulation and Supervision of Microfinance Institutions - experience from Latin America, Asia and Africa. Microfinance Network, Occasional Paper No. 1

Chaves, R.A. (1994). The Behavior and Performance of Credit Co-operatives: An analysis of co-operative governance rules. PhD Dissertation. Department of Agricultural Economics and Rural Sociology, Ohio State University, Columbus, Ohio.

Coetzee, G.K. (1992). Review of Conference on "Rural Development and Finance", University of Ouagadougou (Burkina Faso). *Development Southern Africa*, Vol. 9, No. 1:89-104.

Coetzee, G.K. (1997). Institutional Change in Rural Financial Markets in South Africa. Unpublished PhD Thesis, University of Pretoria, Pretoria.

Jonck, J. (1997). The case for self-regulation of the microfinance industry. Paper read at Workshop on microlending held at the South African Reserve Bank (August), Pretoria.

Porteous, D. (1997). Framework for microlending: A Proposal. Paper read at Workshop on microlending held at the South African Reserve Bank (August), Pretoria.

Markinor. (1992). New perspectives. April 1992 Newsletter of Markinor, Johannesburg.

Rock, R. & Otero, M. (1997*). From margin to mainstream: The regulation and supervision of finance*. Monograph Series No. 11, Accion International.

Roux, A & Donaldson, A. (1992). Development and the financial sector. In Schrire, R. (ed.). *Wealth or Poverty - Critical choices for South Africa.* Cape Town: Oxford University Press.

Sheng, A. (ed.). (1996). *Bank restructuring: Lessons from the 1980s.* Washington DC: The World Bank.

Strauss Commission. (1996). The Interim Report of the Commission of Inquiry into the Provision of Rural Financial Services and the Final Report of the Commission of Inquiry into the Provision of Rural Financial Services. Pretoria: Government Printer.

White Paper on Small Entrepreneurial Support. (1995). Government Printer. Pretoria.

Willemse, R & Goldblatt, S. (1997). South African Case Study. In Berenbach, S. & Churchill, C. (1997). Regulation and Supervision of Microfinance Institutions - experience from Latin America, Asia and Africa: Case Studies. Microfinance Network, Occasional Paper No. 1, Volume 2.

Wirth Report. (1986). Restructuring Financial Markets: The Major Policy Issues. Report by the Sub-Committee on Telecommunications, Consumer Protection and Finance of the Committee on Energy and Commerce of the United States House of Representatives, Washington DC, July.

Yaron, J., Benjamin, M. & Piprek, G. (1996). Rural finance: Issues, design and best practises (draft). Environmentally Sustainable Development Studies and Monograph Series, The World Bank.

1998/02/03