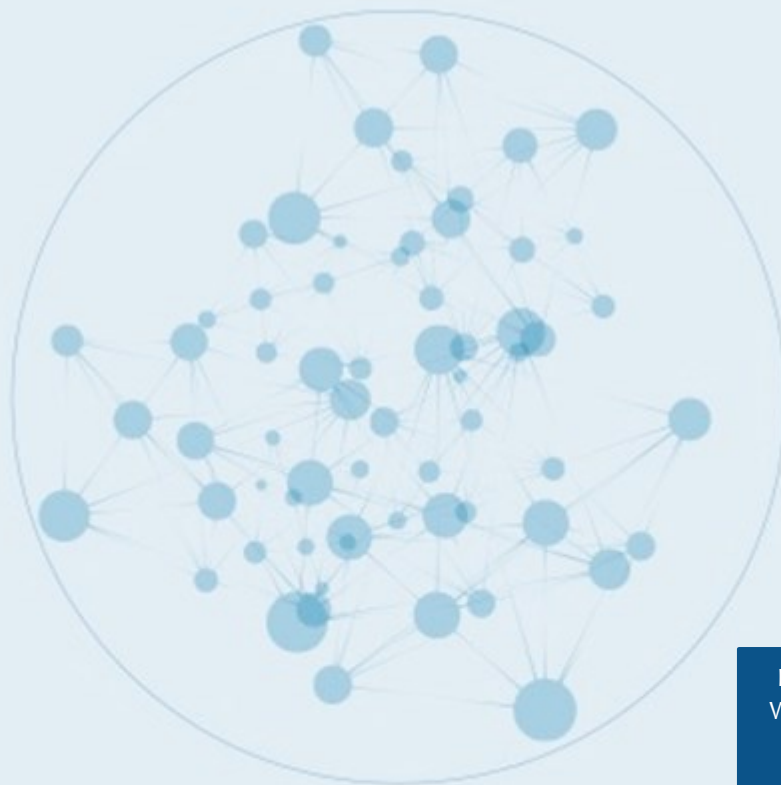




DESIGN OPTIONS FOR A SUSTAINABLE FINANCIAL SECTOR

Lessons from inclusive
banking experiments



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The UNEP Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it will publish its final report in October 2015.

More information on the Inquiry is at: www.unep.org/inquiry or from: Ms. Mahenau Agha, Director of Outreach mahenau.gha@unep.org.

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About this report

This working paper results from a workshop the UNEP Inquiry and CIGI held on 2-3 December 2014 in Waterloo, Canada to discuss options for a sustainable global financial system. The workshop included participants from a range of academic and research institutions from the Waterloo region and abroad, including the University of Waterloo, the University of London, Harvard University, and the University of Gothenburg.

Comments are welcome and should be sent to simon.zadek@unep.org.

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Abstract

Over 200 years ago, Adam Smith put forward the notion that individuals seeking to benefit themselves through trade were led as if by an invisible hand to a situation in which society as a whole could benefit. It can be argued, however, that social objectives such as sustainability, and inclusiveness, do not emerge spontaneously through market forces. Such outcomes have to be designed through legal structures and institutions. In other words, for the invisible hand to operate, there needs to be a visible hand behind it. The financial inclusion experiment in South Africa provides lessons for the design of the type of financial sector required for the transition from greed to green.

1 Design options for a sustainable financial sector

The notion of an *Inquiry into a sustainable financial sector* (UNEP, 2014) may be construed to suggest that the financial sector can and ought to enable economic sustainability, and that this is in fact what is expected of a well-functioning financial sector. Such a construct would require a broad overview of the whole system in which the role of the financial sector can be shown to go beyond efficiency (in the sense of the lowest intermediation costs between saver and investor) and look into the actual outcomes achieved through the allocation of real resources. It is precisely the ability of banks and other financial intermediaries to influence the rate of investment that gives the financial sector a key role in society (Keynes, 1971). However, the question here is whether or not investment does, in practice, contribute to the sustainability of the planet. In this paper it is assumed that sustainability goes beyond financial stability, and includes social objectives around the protection, rather than degradation, of the environment.

But how does the financial sector enable sustainability? In particular, is it appropriate for policy and regulation to guide this role, or can we rely on the machinations of the financial sector (through the invisible hand) to deliver what is required? This leads us to ask who (or which convention) determines what is socially acceptable?

Over 200 years ago, Adam Smith put forward the idea that a large number of independent individuals all pursuing private ends were led as if by an invisible hand to a situation in which society as a whole could benefit. The invisible hand metaphor has been used to symbolize the operation of free markets¹ and is often depicted as an ideal, if only government (and big business) could be kept out of things. But underlying this ideal is the supposition that in an environment where everyone minds his own business, the overall order will establish itself spontaneously and can be left to look after itself (Mittermaier, 1987). This *dogmatic free market view* is one that advocates that the market be left to its own devices, with only minimal regulatory interference. To expand the metaphor, the hand behind the invisible hand is (in this view) also an invisible hand.

A more pragmatic approach is one that recognizes that markets operate differently, and have different outcomes, if different laws governing behaviour are in place. Markets can be seen as delicate mechanisms that need to be supported by institutions such as the legal system, and can also be destroyed by them. Seen in this light, we can envisage a visible hand behind the invisible hand. That visible hand, which encompasses the institutional framework established by society and government, provides the environment in which the market functions (Mittermaier, 1987).

This *pragmatic free market approach* argues that the kind of institutions that free markets require in order to operate do not emerge spontaneously through market forces. Such institutions (including legal structures) have to be purposefully created in order to fulfil that function. There must be a visible hand (an appropriate legal and regulatory environment which encompasses social convention) behind the invisible hand in order for markets to operate fairly and allocate efficiently, appropriately and sustainably.

Clearly, the position one takes as a dogmatist or pragmatist determines one's views on the appropriateness of designing interventions for the financial sector with particular allocative outcomes in mind, such as inclusion and sustainability.

¹ It is noted that some argue that it was Samuelson in his 1948 textbook, rather than Smith 200 years before, that set out the robust free market and *laissez-faire* associations of the invisible hand in order to provide support for capitalism during the cold war (see Kennedy, 2012). Others, like Mittermaier (1987) and Viner before him, suggest that Smith's own ideas changed during his lifetime. Nevertheless, it was Smith who coined the phrase and the invisible hand metaphor has taken on a life of its own.

In its pure form, the dogmatic approach resists any form of regulatory intervention.² However, most dogmatic free marketeers appear to accept the need for a central bank to introduce liquidity as and when needed to instil stability (e.g. Benston and Kaufman, 1996). We shall assume then that for a dogmatist, the only tolerable regulatory interventions in the financial sector would be those that ensure stability. In this view, a stable financial sector generates efficient intermediation costs and oils the wheels of commerce. The imposition of any additional objective on the financial sector is not only superfluous – but also unacceptable – as it diverts the financial sector from its appropriate role, which is to allocate resources as the invisible hand leads. The invisible hand allows for a neutral or natural outcome. We will refer to this view of the role of the financial sector as Financial Sector^{Dogmatic}.

For a pragmatic free marketeer, market outcomes are not neutral, but have come about as a consequence of state and social influences that have been institutionalized. As such, the policies and regulations that have led to such outcomes should change in line with social convention or when the outcomes are unacceptable. In this view, it is not only the cost of financial services, but the ability of the financial sector to allocate resources in a socially desirable way that is the benchmark for a well-functioning financial sector (Hawkins, 2004). We shall refer to this concept of the role of the financial sector as Financial Sector^{Pragmatic} indicating that the outcomes are not neutral but the result of the interaction of policy, regulation and social convention.

From the pragmatic perspective, the belief that the market can always and everywhere be relied upon to produce socially acceptable allocation, is itself a construct of particular policy, regulatory and social convention.³ While the hand behind the invisible hand may appear invisible, this is merely an illusion. The dogmatic-pragmatic dichotomy provides the backdrop to the analysis – the successes and failures documented below have much to do with the design of the hand behind the invisible hand, and the extent to which this hand is acknowledged.

In the discussion that follows, Section 2 develops the reasons Financial Sector^{Dogmatic} allows for a role by the central bank but resists the imposition of objectives other than stability for the financial sector. It also considers why this is the dominant view in the sector and under what circumstances Financial Sector^{Pragmatic} can play a role.

In sections three and four, lessons for the *Inquiry* from financial inclusion experiments in Kenya and South Africa are explored. In particular, the case study of South Africa (after 1994) is presented. A number of initiatives took place in the early 2000s to try to encourage financial inclusion, given that the South African financial sector was characterized as one that served an enclave of the middle class and elite. Initiatives included the establishment of a Financial Sector Charter Council – a body to monitor transformation and inclusion, the development of entry-level financial products and legislation to allow tiered banking. The discussion examines the relative success of these initiatives.

Section five concludes by identifying lessons from the Financial Sector^{Pragmatic} experiments for the general debate on a sustainable financial sector.

² Adherents of the free banking approach fall into this category – but this is a minority view. Even Milton Friedman's, monetary rule, it could be argued is a form of intervention.

³ This convention is associated with four assumptions: (a) a given endowment of wealth among individuals; (b) a competitive market (c) administrative efficiency of the market and (d) absence of externalities (Benston and Kaufman, 1996). See further below.

2 The dominance of Financial Sector^{Dogmatic}

A useful summary of the debate on the appropriate regulation of the financial sector may be found in the May 1996 edition of the *Economic Journal*. Here we see why the dogmatic approach (characterized here as Financial Sector^{Dogmatic}) accepts the necessity of a central bank and a stable financial sector, but rejects any imposition of further social or political objectives.

Benston and Kaufman (1996) state that an unregulated system will produce an optimal allocation of resources, given four assumptions:

- a given endowment of wealth among individuals;
- a competitive market;
- administrative efficiency of the market – that cannot be improved by government interference; and
- absence of externalities.

In their view, despite the fact that there might be violations of the first and the second assumptions in the banking sector, this does not warrant regulation. They appear to provide a weakly positive argument for government provision of deposit insurance (violation of the third assumption), but their argument for regulation rests on the existence of externalities. The positive externalities they identify have to do with money as an accepted medium of exchange and store of value – the more predictable the value of money, the more valuable it is. The negative externalities have to do with contagion related to bank failure. They argue that monetary stability is a prerequisite for bank stability – and the key role for a central bank.

Following Friedman’s proposal (1960), we want the central bank to increase some definition of money at a relatively steady rate and certainly prevent declines, and abandon attempts to do more. Not only is prudential regulation unnecessary for monetary control – it is detrimental to it (Benston and Kaufman, 1996). While the debate on which variable (no longer the money supply, but the inflation rate) should be held stable has developed in subsequent years, the acceptance that stability is necessary appears to have endured. For example, in following statement of the South African Reserve Bank (in which stability is mentioned seven times), the promotion of financial stability is tied to the objective of price stability: “The Reserve Bank is required to achieve and maintain price stability in the interest of balanced and sustainable economic growth in South Africa. The achievement of price stability is quantified by the setting of an inflation target by Government that serves as a yardstick against which price stability is measured. The achievement of price stability is underpinned by the stability of the financial system and financial markets. For this reason, the Bank is obliged to actively promote financial stability as one of the important determinants of financial system stability.”⁴

The commitment to stability, within the general understanding of Financial Sector^{Dogmatic} is articulated within the mission of international bodies such as the Banking for International Settlement (BIS): “The mission of the BIS is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks... Monetary and financial stability is a precondition for sustained economic growth and prosperity.”⁵

⁴ <https://www.resbank.co.za/AboutUs/Mandate/Pages/Mandate-Home.aspx>

⁵ www.bis.org

The dogmatic free market approach that is associated with the laissez-faire achievement of a profitable and stable sector would prefer to do so without the clumsiness and untidiness of social, political or environmental objectives. Financial Sector^{Dogmatic} has become a philosophical defence to perpetuate the existing institutional constructs that are well-suited to the incumbents of the financial sector.

Shifting the consensus view from a dogmatic to a pragmatic free market view – even for a time – is unlikely to happen unless there is considerable pressure on the financial sector and its regulators. Observation of the South African economy shortly after the introduction of democracy presents such an exception. There was considerable popular pressure and expectation, as well as an influx of new participants – not entirely schooled in the ideology of Financial Sector^{Dogmatic} in positions of relative power and influence. The next section explores the process in more detail.

3 Inclusive banking experiments: Kenya

While the South African experience is fairly broad-ranging, the Kenyan example revolves around the mobile money experiment. M-PESA was initiated in 2005 as a microfinance repayment mechanism and was piloted during 2005-2006, with the authority of the Central Bank of Kenya.

At the time, there were some 2.5 million bank accounts in Kenya and it was estimated that less than 20% of the population had bank accounts. Di Castri et al. (2014) provide a graphic summary of mobile money innovation in Kenya. By mid-2006, M-PESA had been re-designed as a money transfer mechanism and authorisation for this was sought from the Central Bank of Kenya. After a process of exchange of information between Safaricom and the Central Bank of Kenya, during which M-PESA business was distinguished from banking business, M-PESA was launched at the end of the first quarter of 2007. By the end of the year, some 1.3 million mobile money accounts were registered. During the following year, a number of innovations followed: M-PESA was used to pay bills and salaries, facilitated card-less ATM payments and was accessible at Post Bank branches. The process did have detractors – for example, on the insistence of the Kenya Bankers Association, the then Minister of Finance ordered an audit on MPESA in 2008. However, the uptake of the facility by consumers (some 8.9 million mobile money accounts were registered by the end of 2009) suggested the service was meeting a need.

During this process, the legislative and regulatory process was adapted to formalize mobile money. The willingness of the authorities to adopt and modify legislation to facilitate inclusion suggests a pragmatic view was adopted by the authorities. In 2009 the Finance Act was modified to allow Agency Banking, and the regulations were promulgated the following year. The National Payments System Act was passed in 2010 and its regulations published after extensive public consultation in 2014. Further partnerships with M-PESA were concluded, including those with Equity bank, and other mobile-money alternatives became available through the activities of Orange, MobilePay and Airtel. Mobile money accounts in Kenya now allow access to a number of basic financial services including:

- money transfers to individuals and merchants,
- servicing of premiums, household services and loans
- access to pre-paid credit cards and savings accounts.

By March 2014, there were 26.2 million registered mobile money accounts and over 116,000 mobile money agents. By 2013 it was estimated that over 66.7% of Kenyans had access to financial services.

The Kenyan example shows that innovation around a particular social need, together with engaged and adaptable legislation and regulation (Financial Sector^{Pragmatic}) can prove to be a catalyst for change (Hawkins, 2011).

4 Inclusive banking experiments: South Africa

By 1994, the provision of financial services to an elite enclave of South Africans was clearly politically unacceptable. Then, as now, the South African financial sector could be characterized as sophisticated and concentrated (National Treasury, 2014). In 1994, the sector could also be described as serving the elite, upper middle class and corporate business almost exclusively.

The first data on the extent of exclusion were produced by national survey only in 2004. At the time, some 48%, or 13 million of the total adult population in South Africa (defined as age 18+), were thought to be banked. Some 39% or 10.5 million people in South Africa have never had a bank account, and a further 3.5 million people, or 13% of the adult population, were previously banked, but for a variety of reasons were no longer banked (FinScope, 2004). There were a number of reasons put forward as to why the majority (52%) of adult South Africans were excluded: bank account usage was linked to formal and regular income (Ardington and Leibbrandt, 2004), urban dwelling (which was linked not only to access to services – but ability to produce proof of residence) and the possession of a valid ID document (Feasibility, 2005).

The four largest banks (ABSA, FNB, Nedbank and Standard Bank) – dominated the retail market and accounted for some 84% of deposits and 90% of loans.⁶ There were only two small mutual banks with very localized footprints. There was (and is) an absence of building societies and a paltry credit union movement (that served perhaps up to 8,000 members).

In 1999, a Regulation Round table⁷ was held at Ministerial level, with a view to examine the appropriate objectives of financial regulation (and the financial sector itself). The six overarching objectives identified at the time were:

1. Maintaining confidence in the South Africa financial system
2. Ensuring fair treatment for consumers of financial services
3. Promoting the efficiency of the financial system
4. Facilitating broad access to financial services
5. Promoting public awareness and understanding of the financial system
6. Reducing financial crime

This list of objectives reads as a description of Financial Sector^{Pragmatic} rather than Financial Sector^{Dogmatic}. Only two years later, however, an internal report prepared by the South African Reserve Bank, named *Financial stability and the regulatory architecture*, firmly re-asserted the view of Financial Sector^{Dogmatic}. This paper was criticized (by Leape, 2001) for ignoring the access imperative (Objective 4 in 1999). The tussle between the dogmatists and pragmatists was still undecided.

It took popular opinion to tip the balance: in 2000, the South African Communist Party mobilized the “Make the Banks Serve the People” – also known as the Red October Campaign – to highlight the concerns of the majority of South African adults, excluded even from modest transactional banking facilities. Financial exclusion is associated with the lack of security and flexibility – aspects generally taken for granted by those who have access to bank accounts. Where households do not have access to savings or credit facilities, a shock to the household cash flow can become a crisis. An inability to obtain credit from formal, mainstream sources generally implies that credit has to be obtained elsewhere at a

⁶ As at the end of 2005, Bank Supervision Department, Annual Report 2005.

⁷ 30 March 1999, held with the Minister, Deputy Minister and Director General of Finance at the time (documented by Leape, 2001).

high price. At a personal level, this lack of security and flexibility is most likely to disadvantage the vulnerable: a pensioner without a bank account by which to receive a state grant or pension, for example, is likely to have to travel to collect the pay-out, may have to pay for check cashing facilities and may subsequently be more vulnerable to theft. The Campaign demanded universal access to affordable and appropriate financial services for all South Africans. At first, this demand was dismissed by the financial sector as unrealistic and unviable (Nzimande, 2004).

The pressure placed on the authorities and the sector became formalized when in 2002, the Nedlac⁸ Financial Summit agreed initial financial inclusion and transformation targets. The proposal agreed to by government, business, labour and the community included a number of commitments by the participants:

1. Ensure access to basic financial services
2. Research the economics of basic financial services
3. Develop sustainable institutions to serve poor communities
4. Promulgate new enabling legislation for so-called second tier and third tier deposit-taking institutions
5. Make proposals to enhance the developmental impact of the regulatory framework
6. Support financial co-operative and micro-credit providers
7. Regulation of micro-credit providers
8. Regulation of credit bureaux
9. Elimination of discrimination in the sector
10. Access for HIV/AIDS sufferers
11. Capital markets and investment to direct investment to developmental projects
12. Developmental finance institutions to make a developmental impact
13. Saving initiatives to be undertaken

Subsequent public responses to Parliament on the report-back of the Financial Sector Summit and Charter in September 2004,⁹ suggest that there was perhaps less consensus than originally projected by the agreement. For example, Mr Masilela, on behalf of the government, stated "... the government acknowledged ... it found it appropriate to respond to the issues raised by the (Red October) campaign. There was a need to increase access to services that encouraged investment and saving..." However, the government "...could not dictate to financial institutions where to invest..." The report-back also revealed disquiet from the labour and community representatives that the Financial Sector Charter was exclusively designed by industry, that it was voluntary, and that there was no independent monitoring.

However, in spite of some fundamental differences of opinion, the Financial Sector Charter was seen as one of several initiatives born of the rise of Financial Sector^{Pragmatic} at the time. While the Charter was regularly described as a voluntary set of guidelines produced by industry in response to the Red October Campaign and the Nedlac Financial Sector Summit, there was pressure from the authorities to create such a social institution. The aim of the Charter was to "transform the sector in five years",¹⁰ by promoting "a transformed, vibrant, and globally competitive financial sector that reflects the

⁸ The National Economic Development and Labour Council (Nedlac), was established in 1994, to allow for social dialogue between government, business, labour and society on social, economic and labour policy. While Nedlac initially played a pivotal role in ensuring social consensus on a number of early policies and legislation, its influence has waned and it is now described as a forum.

⁹ Parliamentary Monitoring Group, www.pmg.org.za, Record of Meeting on 17 September 2004.

¹⁰ Coovadia, for industry, as quoted by Parliamentary Monitoring Group during the Parliamentary meeting on 17 September 2004

demographics of South Africa, and contributes to the establishment of an equitable society by effectively providing accessible financial services to black people and by directing investment into targeted sectors of the economy.”¹¹

The Charter allowed for a Council to “interpret the Charter and adjudicate on reports from financial institutions on the performance against the Charter” (PMG, 2004). The first Financial Sector Charter Council (FSCC) Annual Review was published in September 2006 for the year 2005. The last Annual Review published by the FSCC in 2010 was for 2008, which showed that none of the access targets had been met, with particularly weak achievements by the non-bank financial institutions. While targets for the banking industry had nearly been met – in that some 77% of the LSM 1-5 market had access to a banking service point (such as a point of sale device or mini-ATM) within 10 km from their place of residence and 74 % had access to a full banking service point within 15 km of their place of residence, this was still below the target of 80% for both categories. Of interest here is why the “poster-child” of the financial inclusion objectives failed, and why it was allowed to do so. The matter is addressed in section five below.

In its last review, the FSCC noted that there was an impasse regarding the attitude of firms towards reporting in line with the Charter, as the Department of Trade and Industry’s (dti) Codes of Good Practice (COGP) on Broad-Based Black Economic Empowerment had over-taken and disrupted the process. The Annual review notes: “It was widely anticipated that the FSC would be gazetted as a sector code in 2008 during the transitional period for aligning existing charters with the Codes and converting them into sector codes. This conversion did not take place as Charter participants could not reach agreement on alignment between the Charter and the Codes.”¹²

The Financial Sector Code was gazetted by the dti in 2012. While the Code included detail on the access standards relating to inclusion for each industry in the sector, there has been no public reporting on the inclusion objectives since the end of 2008. Instead, in large part, the inclusion goals have been aligned with the outcomes of the annual Finscope study, whose headline figure on the percentage of the adult population with access to any formal financial service (typically a transactional bank account) is seen as absorbing all the inclusion goals of the sector.¹³ It is this association of access with a bank account that has also fed the interest associated with the progress of the National Bank Account (e.g. National Treasury, 2014).

One of the chief concerns to be addressed by the National Bank Account or Mzansi account – as it came to be called – was the fact that the fees on entry level savings and transaction accounts eroded the value of the deposits. Since interest rates ranged from zero to 2.5% on positive balances and since there were monthly administrative fees as well as fees on deposits and withdrawals, there was little incentive for consumers to use bank accounts for modest savings. The data in Table 1 shows the fees (monthly, deposit and withdrawal fees over the period of a year, and as a percentage of a total deposit of R 1,600). In 2004, the fees for ABSA Flexibank were the highest at 7% of the total value of the amount deposited over a year. A comparative exercise was performed for 2014 fee structures, showing the differential fees for branch usage and the cheapest alternative – being ATM or retailer. In general, as the banks have developed cheaper alternatives to branch use, customers have been penalized for using branch

¹¹ www.banking.org.za/index.php/consumer-centre/financial-sector-charter-code

¹² Financial Sector Charter Council, 2010. 2008 Annual Review Report on the transformation of the financial sector, p. 2.

¹³ At around 63- 64%, this remained largely unchanged for the period 2008-2012. Then in 2013, after the social grant payouts were linked to a bank account, boosting the number of first-time bank account holders by around 1,9 million, this rose to close to 70% of all adults (Finscope 2013).

infrastructure. Although the Mzansi account is no longer on offer, it appears the exercise did have a moderating effect on the pricing for entry-level accounts. Around half of the banks continue to charge monthly fees on these entry-level accounts, and those that do not typically charge slightly higher pay-as-you-go fees. What is unknown is how these fees could have reduced over time with a functional mobile money alternative.

Table 1: Fees on entry level saving account options – pre- and post-Mzansi

Entry level account offerings ¹⁴	Fees - using bank branches to perform deposits/withdrawals* (2004)	Fees as % of value of total deposits (2004)	Fees - using bank branches to perform deposits/withdrawals ¹ (2014)	Branch Fees as % of value of total deposits (2014)	Fees - using cheapest alternative (ATM/retailer) to perform deposits/withdrawals* (2014)	Cheapest Fees as % of value of total deposits (2014)
ABSA Flexibank	R118.10	7%	R407.70	25%	R239.80	15%
Capitec Global One	R32.00	2%	R96.80	6%	R73.00	5%
FNB Smart Account	R82.55	5%	R178.19	11%	R19.20	1%
Post Bank / Smart Save	R46.40	3%	R60.30	4%	R60.30	4%
Standard Bank E-Plan/Access	R90.80	6%	R487.20	30%	R90.00	6%
Standard Bank E-Plan Access (irregular employment)	R90.80	6%	R112.00	7%	R22.00	1%
Nedbank/Pick 'n Pay Go Banking	R28.40	2%	R101.25	6%	R22.75	1%

* Monthly account fees, initial deposit of R500, 11 monthly deposits of R100, 3 withdrawals of R250 and one final withdrawal

The Mzansi bank account was launched four years after the Red October campaign in October 2004.¹⁵ The key distinction of the Mzansi account was that the banks (the big four and Postbank) agreed not to charge a monthly service fee on such accounts. The effect of the monthly fee on standard accounts, together with the plethora of deposit and withdrawal fees on Mzansi accounts was that fees eroded the capital value of deposits.¹⁶ The abolition of the monthly fee as well as the agreement by the banks to drop the surcharge for “off-us” or foreign ATM withdrawals was hailed as an important step to achieving affordable banking at the time. The features of the account were however very basic, with debit order facilities only being added two years later.

The design of the account was largely based on what the banks were prepared to offer, rather than being based on what un-served consumers required. Indeed, the lack of demand side analysis led to the banks withholding certain features from the account in the belief that the Mzansi accounts would “cannibalize” other accounts (National Treasury, 2014). The Mzansi account was relatively simple, having restricted features (such as no debit order facilities for the first years). There were two main factors at

¹⁴ Falkena, et al (2004) and for 2014, Various bank websites, retrieved 20 November 2014: www.fees.nedbank.co.za/pricing-guide/entry-level-banking; www.standardbank.co.za/standardbank/Personal/Fees,-rates-&-prices/Interest-rates/AccessSave; <https://www.capitecbank.co.za/global-one/save/rates-and-fees>; <https://www.fnb.co.za/rates/TransactionalAccounts.html>; www.postbank.co.za/Ratesfees/Savings/bakgotsifees.html; www.absa.co.za/deployedfiles/Absacoza/PDFs/Rates%20and%20Fees/Pricing%20Brochure/2014%20Pricing%20Brochure.pdf

¹⁵ Other entry-level products were also designed for the non-banking industry, for example, Fundisa is a collective investment scheme with lower costs design to help lower income families save for education, and the life insurance product Zimele was also developed.

¹⁶ Falkena et al. (2004) show in a comparison of different banks for typical account use that the fees could erode up to 20% of the value of deposits.

play influencing the uptake of the Mzansi account – employers of domestic and other casual labour typically insisted that employees opened accounts to facilitate wage payments (which led to some individuals having multiple Mzansi accounts); at the same time, the Postbank converted its client base to Mzansi account holders to take advantage of the reduced interbank charge on ATMs – Postbank had no ATM base (National Treasury, 2014). By December 2008, around 2.8 million bank accounts (Mzansi and other) had been opened which qualified under the Charter Access Standards, and of these, around 60% were for first time transactors. Around 20% of the 2.8 million accounts were dormant at the time of reporting (FSCC, 2010). The data in Table 2 show that even in the case of a simple metric like number of registered accounts, the data reported by different institutions still vary.

Since 2008, the Mzansi account has lost impetus – although the National Treasury still recorded some increase in the number of accounts until 2010. While the Mzansi accounts are still offered by banks, most banks have developed new entry-level products that they offer in preference (which earn higher interbank fees, for example).¹⁷

Table 2: Cumulative number of Mzansi accounts registered 2005-2010

Data source	2005	2006	2007	2008	2009	2010
Financial Sector Charter Council*	1.3	2.8	2.0	2.8		
National Treasury Report **	1.4	2.2	2.6	3.2	3.9	4.5
Solidarity ***	1.4	2.1	2.3	3.2	3.8	

* Financial Sector Charter Council, 2010. Excludes post office

** National Treasury, 2014, (based on Bankserv data – Mzansi accounts had a unique identifier in the payment system process given that different interbank fee applied. Data should include post office)

*** Solidarity Research Institute, (2009) (based on Finscope 2009 data, national survey)

In order to address the monolithic banking landscape, the government published the Dedicated Banks Bill and the Co-operative Bank Bill (both intended to create space for a tiered banking system) in 2004. The Dedicated Banks Bill intended to enable savings and savings and loans banks to contribute a second tier of banks in South Africa to supplement the first tier commercial banks. Its expressed aim of promoting access to banking services in otherwise underprovided areas was a clear departure from Financial Sector^{Dogmatic}.¹⁸ Moreover, the Co-operative Banks Bill was published to enable member-based banks to be established. Together, these bills would allow for a tiered banking system which may more adequately meet the needs of the unbanked. Second tier banks could operate on the back of other operations – such as retail or cellular businesses, while third tier banks were member-based banks which take deposits from and make loans exclusively to their members.

At the time the Dedicated Banks Bill was hailed as a departure from the existing national banking legislative environment as it potentially allowed for firms not traditionally associated with banking, such

¹⁷ Lower inter-banks fees on ATMs, which have taken some six years to develop and negotiate with the banks (after the recommendations of the Competition Commission in 2008) will produce losses for some of the banks – for example, Nedbank has indicated that it will face an annual reduction in income of R88 million when the new interbank fees on ATMs come into play in 2015.

¹⁸ “The licensing of savings and savings and loans banks and their consequent provision of financial services will assist the banking industry and the nation with improving access to financial services to a broader market.” (memorandum to the Bill, 2004). The government also saw these tiers of banks as potentially enhancing competition (Report-back, 2004)

as retailers, cell-phone companies and micro-lenders to provide a limited range of banking services to South Africans in non-traditional – and possibly more cost effective – ways.¹⁹

Part of the interest in dedicated banks arose from research that indicated that:

- The fees and charges attracted by entry-level products were a disincentive to low-income users
- The combination of low-interest returns and high fees means that savings can be significantly eroded
- Those unfamiliar with ATM and internet technology pay a premium for over the counter transactions
- The credit available to low-income individuals such as micro-loans and retail credit, is substantially more expensive than mainstream products
- The combined effect of the lack of a secure environment where capital is not eroded by high fees, together with access to very expensive credit which imposes a heavy debt burden, means the poor are unlikely to improve their circumstances (Falkena et al., 2004)

In South Africa, many years of political and economic isolation, together with considerable vertical integration in the banking sphere, stifled the emergence of a vibrant market for new payment system infrastructure. Flushed with optimism, the Financial Sector^{Pragmatic} mooted the possibility that the introduction of a range of new dedicated banks could encourage third-party payment systems, reduce infrastructure costs and provide more affordable services to South Africans currently excluded from financial services provision.

That, however, was not to be. Some 10 years on, the Dedicated Bank Bill has yet to be promulgated. The initial enthusiasm of the National Treasury (Annual Report 2004/5) to the new tiers of banks (which suggested considerable support for Financial Sector^{Pragmatic} – see Table 3 below) waned, with the 2010/11 Annual Report stating: “The feasibility of separate legislation is being reconsidered in view of the global financial crisis.”

¹⁹ The entry of new banks has been facilitated by technological advances that have generally lowered the barriers to entry and also reduced running costs (Llewellyn, 1999 and Lascelles, 1999).

Table 3: Dedicated Banks Bill process

Reporting year	Action	Comment in National Treasury's Annual Reports
2004/05	Published for public comment	Seen as mechanism to encourage competition and entry of smaller banks & non-banks into financial sector ²⁰
2005/06	To revise Bill taking public comment into	This process has proved to be more complex than anticipated, and publication of the revised versions of Bill was postponed to the 2006 financial year ²¹
2006/07	Was incorporated into the Banks Amendment Bill	Amendment to the Banks Amendment Bill to give effect to effect to dedicated banks – to be finalized by July 2007 ²²
2007/08	Incorporation into Banks Amendment Bill was rejected	No specific reference to the progress of Bill ²³
2008/09	Work in progress	No reporting on progress of the Bill ²⁴
2009/10	Anticipate to table separate Bill in Parliament	Expected to be tabled in 2010
2010/11	Anticipate to table separate Bill in Parliament	The feasibility of separate legislation is being reconsidered in view of the global financial crisis ²⁵
2011/12	Dedicated Banks Bill to be introduced through the Mutual Banks Act, for which the bill has been drafted	Work in progress ²⁶
2012/13		No reporting on progress of Bill

Source: National Treasury Annual Reports from 2004/05 to 2012/13

The Cooperative Banks Act, 40 of 2007 was promulgated in 2008. Since inception two co-operative banks have been established for particular communities. These two represent the most vibrant of the cooperatives in existence.²⁷ There are some 12 registered co-operatives (not yet banks) who have some 20,000 members in total.

²⁰ An important aspect of the economy's development is to improve access to financial services by a substantial portion of the population located in the lower-income levels. This resulted in major work being undertaken on the **Dedicated Banks** and Cooperative Banks Bills. These pieces of legislation seek to create the opportunity for the establishment of second-and third-tier banks. Third-tier banks would be able to provide basic banking services such as opening savings accounts but, would be limited in terms of available investment vehicles. Second tier banks would have a more flexible regulatory regime, allowing them to provide loans and providing them with a wider array of investment vehicles. Public comments on these Bills were received during the period leading up to January 2005. Road shows were also undertaken to various village banks in all the provinces to explain the Bills' objectives. These road shows were also used as forums for collecting comments at community levels in both urban and rural areas. Public support and appreciation has been evident throughout this process. (NT Annual Report 2004/2005, p. 1)

²¹ After receiving comments on the Cooperative Banks and **Dedicated Banks Bills**, the NT focused on revising the bills to take comments into account. This process has proved to be more complex than anticipated, and the NT has had to postpone the publication of the revised versions of these bills to the 2006 financial year (NT Annual Report 2005/06, p. 32)

²² Dedicated Banks Bill incorporated into the Banks Amendment Bill – to give effect to dedicated banks (NT Annual Report, 2006/07, pp. 19 & 43)

²³ NT AR 2007/08 confirms Amendment Act, but does not explain anything about Dedicated Banks also nothing in 2008/09

²⁴ NT AR 2009/10, p. 90 – Table Dedicated Banks Bill in Parliament (Work in progress), expected to be tabled in 2010.

²⁵ NT AR 2010/2011, p. 79 reports a different story - The feasibility of separate legislation is being reconsidered in view of the global financial crisis

²⁶ NT AR 2011/12 p. 36 Dedicated Banks Bill to be introduced through the Mutual Banks Act, for which the bill has been drafted

²⁷ The Annual report of the Co-operative Bank supervisor states that these two co-operative banks have 2000 members (SARB, 2014)

5 Lessons for designing a sustainable financial sector

The financial inclusion experiments in Kenya and South Africa provide insight into some of the elements that contributed to the rise of the pragmatic view: primarily an awareness that a financial sector whose objectives were limited only to stability failed to address the social deficits associated with widespread financial exclusion. In South Africa, the political support base for the Financial Sector^{Pragmatic} policy, an initial social compact (the Nedlac Financial Sector Summit and subsequent Financial Sector Charter Council) designed to ensure accountability, and new attitudes of players in the spheres of government, business, labour and community contributed to the initial rise of the pragmatic view. However, in spite of all of these forces for potential change, many of the objectives of the experiment failed to materialize. In Kenya, what appeared initially to be a contained experiment (in mobile money) proved to be a force for widespread change which massively addressed exclusion. While Kenya started its experiment in 2007, with considerably more of a deficit in terms of financial inclusion than South Africa (19% served, rather than 48% in South Africa in 2004), by 2013, the relative levels of financial inclusion were pretty much the same (at 67% and 75% respectively).

In this section, a number of possible lessons are highlighted which have some bearing on the Inquiry.

5.1 Visible hand support of Financial Sector^{Pragmatic} – while the going is good

In Kenya, following the initial experimentation with mobile money and the early successes of M-PESA, the Finance Act was changed to allow for Agent banking in 2009. In South Africa, although the initiatives of the 1999 Regulatory Roundtable, the investigations into the Competition in Banking (Falkena et al., 2004) and the investigation into the Appropriate Regulatory Framework for the sector (Feasibility, 2004), the publication of the Dedicated Banks Bill (2004), and the establishment of the Access Codes of the Financial Sector Charter Council (2005), all suggest considerable appetite for change and commitment to a pragmatic approach, little was done to effect changes to the legislation. The visible hand did not change much. Key potential legislative and regulatory changes, such as an agency banking provision – which would have allowed mobile money in South Africa – have never come about and the associated accountability never eventuated. The key objective of inclusion was never made part of the mandate of any particular regulator, and so while the policy of financial inclusion still exists, it amounts to lip service.²⁸ The gradual disassociation of the National Treasury from the Dedicated Banks Bill over a period of time was accompanied by a narrative of focusing on stability.

Moreover, while the Central Bank of Kenya chose to permit innovation to run ahead of legislative change, this has not been the case in South Africa. Underpinning the approach of the Central Bank of Kenya is the acknowledgement that appropriate legislation may lag technological innovation (Kimenyi and Nhung'u, 2009). However, such innovation needs to be monitored. For example, the Central Bank of Kenya allowed for a monitored pilot phase, during which time it assessed the risks of the product and determined that the product did not involve deposit-taking, as no intermediation was involved. Moreover, the amounts transferred were ring-fenced and not available for the operations of the firms involved. After a successful pilot, the Central Bank of Kenya set out its reporting requirements and provided Safaricom with a letter of no objection. The reporting requirements included monthly reporting of pre-determined metrics, but also regular meetings with key stakeholders (Nyaoma, 2009). At the same time it was mindful of the need for stability and of the need to monitor the developments. While the risks

²⁸ For example, the National Treasury (2010, pp. 5 & 59) still highlights the inclusion vision, and takes custody of it, but it is unclear how they intend to do this without an operational arm.

of mobile phone banking include “fraudulent movement of funds, network hitches and mismatch of cash balances at the pay points” (Kimenyi and Nhung’u, *ibid*), the engaged Central Bank of Kenya was confident that under its oversight the risks did not outweigh the benefits brought about by the innovation.

The lesson seems to be that where objectives change, the impetus needs to be seized upon. If the growing awareness of the excesses of humanity and the resulting degradation of the planet requires that the objectives of the financial sector change, then the visible hand should reflect this.

5.2 Enroll international standard setting bodies and agreement on metrics

The South African experience highlights how in spite of considerable potential, the energies directed towards financial inclusion by the government, business, labour and community have been limited. The dogmatic view – which essentially strives to ensure the primacy of profitability and stability and hence rejects the imposition of any other social objectives – tends to be the default view of the industry and its regulators. Changing the default position of the incumbent players and regulators requires considerable sustained resources, and, unless there is awareness that the default position is likely to reassert itself, these energies may be spent for nothing.

The dogmatic position is also the articulated view of the international setting bodies, such as the BIS. Given this, when regulators and the industry seek to defend the Financial Sector^{Dogmatic}, reference to international standards typically quietens any pragmatic views. Hence, key to ensuring that social objectives are also accommodated for within the design of the financial sector is that such objectives are also adopted on the agendas of international standard setting bodies. In the case of inclusion, after the lobbying of many players, financial inclusion has been incorporated in the language of the G20, (e.g. Princess Maxima on the Global Financial Inclusion Action Plan, 2014). However, as the experience of South Africa shows, clearly defining the metrics as to what should be measured would also be useful. While South Africa’s latest inclusion survey suggests that the level of 75% has been achieved, this is largely as a result of the government registering 1.9 million social grants recipients with banks accounts (this accounted for over half of the annual increase from 2012 to 2013). What other parallel surveys have shown is that while the social grants recipients are seen as included, the reality is that their use of social grant accounts is generally limited only to the withdrawal all of the funds received each month. Whether this amounts to the vibrant use of financial services evidenced in the case of the mobile money accounts in Kenya is questionable.

5.3 Engage with the beneficiaries of the objectives of Financial Sector^{Pragmatic}

The experience underpinning the Financial Sector Charter and the roll out of the Mzansi account in South Africa shows an absence of willingness of both the authorities and industry to engage with the intended beneficiaries of the financial inclusion objectives. The realities of regulatory capture means that authorities (even those who for a time identify with Financial Sector^{Pragmatic}) still generally associate with the objectives of the financial sector, and in general have little opportunity to engage with consumers or other social groups. The implication of this is that while it might be necessary to introduce some sort of visible hand to the proceedings, there is no guarantee that the type of visible hand introduced is the correct one from a social point of view unless there is adequate engagement with society and other knowledge groups. As the experiment of banking the social grant recipients has shown in South Africa, an expedient approach to understanding the complexities of social objectives can simply produce empty results.

5.4 Harness the knowledge and capacity of associated industries

While the analysis above has largely focused on supply-side initiatives, there is a substantial demand-side story that remains unwritten. The increased inclusion and usability of financial products that occurred in Kenya was largely a consequence of innovative technology harnessed by software and mobile telephony companies, rather than the financial institutions themselves.²⁹ In part this is because it is the nature of these non-bank businesses that they have better market intelligence on how consumers can and will use their products. The financial sector has been notoriously reluctant to undertake its own demand-side research, certainly in South Africa.

The lesson appears to be that the expertise of those with more knowledge of consumer requirements and less inertia than the financial sector will need to be included in defining and achieving socially desirable objectives. In the South African example, the financial sector itself set its own targets in terms of inclusion. Some of the targets (like the physical access ones for point of presence for the banking industry) were, in the view of some commentators, always within reach of the banking industry – they did not report on their successes for three years of FSCC Annual reports and then in the report published in 2007 reported that they had achieved 99% of their target. While this accusation may be unfair, the uptake of non-bank financial institution offerings fell so short of their own FSCC targets, it suggests complete lack understanding of the needs of the underserved population. Either way, the process could have benefitted from external standard setting and monitoring.

5.5 Establish and maintain objectives of Financial Sector^{Pragmatic} as a priority

The regulatory response in Kenya to the changes mobile money were bringing about in 2008, 2009 and 2010, led to the promulgation of the National Payments System Act, an Act that involved considerable social consultation of the associated regulation. This process, together with the earlier changes in the Finance Act, meant that the process was being evaluated on a continuous basis. In contrast, while the failure to promulgate the Dedicated Banks Act, Agency Banking and e-money provisions in South Africa failed to eventuate, other objectives such as Know Your Customer and Anti-Money laundering (KYC-AML) received legislative status through the Financial Intelligence Centre Act, No 38 of 2001, as amended (FICA), which in the view of industry players created a significant barrier to financial inclusion and low cost banking.³⁰

Moreover, the Regulation of Interception of Communications and Provision of Communication-Related Information Act (RICA) of 2002, as amended, which governs the use of mobile phones has not been aligned with FICA, and separately requires proof of residential address for mobile banking.

The lesson appears to be that unless the priority of the Financial Sector^{Pragmatic} objectives is established, and guarded, other objectives – particularly those that are imposed from international standard setting bodies – can harm the process despite good intentions.

²⁹ For example, improved transactional capability has been brought about by local payment software companies like Wizzit, Intecon and ATM solutions, which have enhanced the user interface and functionality using commonly held mobile telephony and existing “banking” infrastructure.

³⁰ In a review of the agency banking in South Africa, conducted by FinMark Trust in 2011, the majority of industry players indicated that FICA remained a significant barrier to financial inclusion and low cost banking, in spite of Exemption 17 of the Act. While Exemption 17 (of FICA) was put in place to deal with instances where potential (or existing customers) do not have verifiable addresses, ambiguity in the regulation remains subject to interpretation and some banks have interpreted them conservatively, perhaps even over-complying, rendering Exemption 17 null and void.

5.6 Change incentives underlying the Financial Sector^{Dogmatic} position

The South African experience highlights how in spite of considerable potential, the energies directed towards financial inclusion by the government, business, labour and community have not amounted to very much.

The lesson appears to be that incumbent players are unlikely to undertake new activities and projects which are not incorporated within personal and corporate incentive structures. Any attempts to direct the sector through Financial Sector^{Pragmatic} need to be aware that the incentives linked to the workings of the invisible hand will continue to influence activity.

The success of the M-PESA launch through uptake by consumers created the incentives for agents to spring up throughout Kenya. By contrast, the Mzansi account in South Africa was seen as a loss-leader by industry and generally underadvertised. Most banks did not provide details of the Mzansi product on their websites (Feasibility, 2005). Instead, other account options were typically punted.

Regulators also have incentives to deflect change – to avoid uncertainty and disruption on their watch. The industry and regulatory incentives can create a bastion of inertia. Recent work associated with improving market conduct in the sector – for example the Treating Customers Fairly programme in the UK and South Africa has focused on the need to re-design incentives to change market behaviour. For example, incentives should take into account metrics for suitability and sustained use of financial products not just sales targets. In the same way for Financial Sector^{Pragmatic} to succeed, the accountability of boards and incentives within the industry need to be changed accordingly.

While not the same as that of sustainability, the objective of financial inclusion on the sector and its regulators also represents an imposition to those who worship at the shrine of Financial Sector^{Dogmatic}. Like the objective of sustainable investment decisions, the objectives of financial inclusion influence the way market forces operate, as well as existing resource allocation and market outcomes to create Financial Sector^{Pragmatic}.

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