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Good and bad ideas from the parliamentary hearings on the banking sector

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Banks and their regulators were grilled in parliament before a joint sitting of the Standing Committee on Finance and the Portfolio Committee on Trade & Industry on 4 February. For the most part, the event generated more heat than light. As the creator of our laws, parliament is critical to a healthy financial system

In this note we separate the good ideas and the bad ideas that emerged during the hearings. **We hope the good ideas gain traction – banks and MPs should work together to turn them into reality.**

The banks were called to present on a set of questions provided to them in advance. Each bank prepared a presentation that was submitted in advance and then appeared to present and answer questions. The initial questions focused on banks' lending for development and productive asset accumulation, as well as banks' contribution to transformation. These questions were well framed, but further questions during the hearings were less so.

Some members of parliament exhibited clear concerns about banking practices, such as perceived discrimination in lending. But these were often based on misconceptions of banking models. The genuine issues – how to include the unbanked population, deliver transformation of the economy, finance small businesses and the informal economy – do require attention. In our view, there is ample scope for banks and MPs to work together to achieve much good for the country in doing that.

We have produced this note to support efforts toward positive change.

Misconceptions

The questions posed during the hearings reflected some misconceptions. We think it is important to clarify some features of the banking sector to be able to provide productive analysis on how the problems that MPs are concerned about can be addressed.

First, it is important to clarify the role banks play in an economy. Put simply, banks look after the deposits of the country and make loans. Banks do well when those they lend to are able to repay those loans and interest. That enables them to cover their costs, including interest paid to depositors, and generate a profit that enables their growth. **The critical function that banks must perform is risk management** – using the savings of the public, they must determine who is most able to pay them back when lending. South Africa's banks are reasonably good at this, ensuring that their credit losses are manageable and do not put the public's savings at risk, even during unexpected shocks such as the Covid pandemic.

Banks are highly regulated to ensure this risk is well managed. One mechanism to do so is to require banks to hold shareholders' money as a layer of protection. If a bank's loan books perform worse than expected, **shareholders are the first to lose money, protecting depositors.** We've seen this play an important function in banks that have become distressed in the past. For example, in the case of African Bank, which collapsed in 2015, shareholders lost everything, but depositors were protected.

> **Banks cannot increase lending without increasing capital. The primary source of capital is from profits.**

Banks cannot increase their lending without also increasing their capital, because of the regulatory requirement to hold a certain amount of capital against every loan they make. The main way they do that is to generate profits, some of which is paid to shareholders and some of which is kept by banks to add to their capital. Because shareholders must face much more risk than depositors, they require a return to justify taking such risk. South Africa's banks average a return on equity of around 15%, which represents the yield on the capital that banks hold as a risk buffer. This can be compared to the yield that investors earn from government bonds, now around 10-11.5%. In other words, bank investors get a risk premium of 3.5% to 5% over what they would get by taking no risk and investing in government bonds. During Covid, when bank profits were hit by bad debts amid the lockdowns, return on equity fell sharply to around 5%. If shareholders choose government bonds instead of banks, banks' ability to grow their lending and the economy is significantly compromised.

There was also confusion about the role of concessionary finance and development finance in the banking system. **Commercial banks do not provide concessionary or development finance.** Some MPs suggested that this was some sort of failure on the part of banks. However, the basic model of banking is to intermediate between savers and borrowers, ensuring that borrowers provide revenue and savers are protected.

> **Commercial banks do not provide concessionary finance. But they can partner with development funders to stimulate lending to targeted sectors.**

Development financiers that provide concessionary loans have a very different business model which is focused on achieving development objectives. Concessionary finance is a tool that can be used to achieve these.

Banks and development financiers can and do work together. Banks can support development financiers by using their distribution networks and risk management tools. For example, several large international development funders provide wholesale concessionary loans to commercial banks, which can then provide finance for targeted purposes such as small business lending. There are clearly opportunities for banks and government to work together in a similar way, which can include guarantee schemes, which we discuss below.

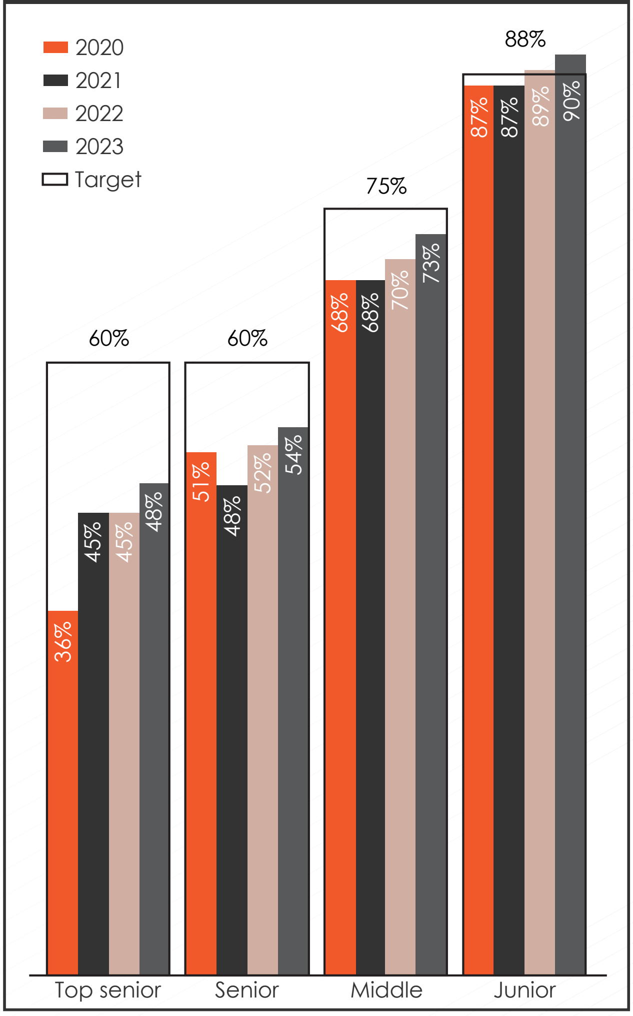
Yes, there is a race problem

Some MPs made claims about banks being untransformed and discriminating against black customers. Points were also made about account closures by banks. These must be disentangled to determine the good points from the bad.

Bank management

In terms of staff, banks look far more like the wider population than they have in the past. Recent data from the Banking Association South Africa[1] shows that junior management levels are now exceeding targets set in the Financial Sector Charter with over 90% black representation. This falls at more senior levels (see the graph below), but the trend is in the right direction, despite overall bank staff numbers having been declining. Senior levels depend on the level below to provide a pipeline of talent, with entry into a bank depending on the wider skilling system and its ability to provide black graduates with the skills needed (typically, more quantitative skills). Nevertheless, at the most senior level of the executive committee, almost half of those who run banks are black. The pipeline strongly suggests that proportion is set to increase.

Proportion of managers in banks who are black



Source: BASA

Black ownership

Much was made at the hearings of the absence of a "black bank", which appears to primarily refer to shareholding of the banks. Banks are unlike other businesses in that shareholders play a key role in the risk profile of a bank. Banks with large and stable shareholders are perceived to be safer than other banks and can therefore attract more deposits. As a result, banks prefer institutional shareholders who can potentially stand behind the bank in the event of distress.

There are two notable features of the shareholdings of South Africa's banks:

- **There is a large foreign shareholding.** About 35% of South Africa's banks are held by foreign asset managers and other investors. Given South Africa's overall need for foreign investment to compensate for the lack of domestic savings, it is a great strength that the banking sector can attract this level of foreign investment.
- **The Public Investment Corporation is the largest domestic shareholder in South Africa's banks.** It has a substantial stake in every bank ranging from 5% (Absa) to 16% (FirstRand). The PIC receives by far the biggest share of dividends paid by banks, receiving R28.7bn or 55% of all dividends paid by banks to local investors in the period of 2021-2023, according to analysis by Krutham. The next largest recipient of dividends is the Industrial and Commercial Bank of China, a strategic investor holding 19.4% of Standard Bank, which received R11.4bn over the same period. The next largest was US-based fund manager Vanguard Group, which received R7.4bn.

> **Banks are mostly owned by big institutions. The biggest domestic shareholder is the Public Investment Corporation, which receives more than half of the dividends banks pay to local investors.**

The balance of shares is dominated by other institutions, including Ninety One, Sanlam, Coronation and Allan Gray. There are, though, several large black shareholders invested in the banks including Lebashe Investment (7.3% of Capitec), Newshelf 1405 (7% of Absa) and FirstRand Empowerment Trust (4.9% of FirstRand).

The institutional shareholdings are generally held on behalf of pension fund members, unit trust investors and insurance policyholders. The race of these ultimate beneficiaries is difficult to determine, but will reflect broad wealth distribution in the country, given that these investment vehicles hold the savings of the country.

Actions such as the banks' BEE deals which generated R57bn of net value for black shareholders[2], and employment equity that results in higher salaries for black staff, contribute to increased wealth in black hands, though transformation of wealth distribution is an economy-wide project. South Africa exhibits among the worst levels of inequality in the world, which has a strong racial character and this ultimately reflects into savings that are managed by institutions and invested into the shares of banks.

Client discrimination

A few questions in the hearings indicated a strong view that bank practices were discriminatory, particularly in lending. The view appears to be that black businesses and individuals find it particularly difficult to borrow because of discrimination by the banks.

The banks defended themselves from this accusation by pointing to the objective processes that are behind credit decisions, based on assessment of the credit worthiness of an applicant. While we accept that credit assessments are objective and therefore have limited scope for prejudice to play a role, we do think the banks and parliamentarians could have found each other more effectively on this issue. It may be the case that bank credit decisions are objective but nevertheless result in outcomes that are systematically biased against black applicants in general.

> **Even though bank credit decisions are based on objective criteria, these can have the effect of compounding racial inequalities in the economy.**

The challenge facing banks and their role in shifting patterns of wealth in an economy is that credit markets favour those who have scale and assets. Banking, like most goods and services, exhibits economies of scale. Lending to a large business is cheaper for a bank per rand lent than lending to a small business.

Banks also have lower costs when they lend to more credit worthy clients. Credit worthiness can be affected by several factors, but the ability to pay is driven by the earnings and assets of the borrower. A borrower with high quality collateral, or high salary relative to total debt, is relatively low risk. That means clients who are already wealthy will have the easiest and lowest cost access to credit.

These economic realities mean that without interventions, banks will compound inequality. Access to credit will be easiest and cheapest for those who are most well off. Given South Africa's history, this means banks will inevitably provide lower cost credit to white borrowers relative to black borrowers, simply because of the costs and credit features and without intending any prejudice.

There are, however, interventions that do lean against this trend thanks to the Financial Sector Charter, which set specific transformation targets for the banks on access and transformational lending. The banks set out their performance against these targets, all of which indicate extensive, explicit, efforts to shift the distribution of wealth in the economy.

Unfortunately, there was limited real engagement with the reality of bank business models in the hearings. On one hand, Parliamentarians seemed to misunderstand the economics that drive bank credit decisions. On the other hand, banks seemed to misunderstand the objectives and policy importance of ensuring the banking system does not entrench racial inequality.

> **There is ample opportunity for banks to work with parliamentarians, and National Treasury, to find ways to mitigate risk and increase lending to black borrowers.**

There were, though, calls for banks and parliamentarians to work together to make progress. This could potentially bear fruit. In our view, **the critical concern is to find ways to mitigate credit risk in lending to borrowers without collateral.** In driving growth of lending to black borrowers, policy must not attempt to undermine normal credit assessment processes, which can potentially create disaster. Government has in the past deployed guarantee schemes to reduce bank credit risk in financing specific kinds of borrower. Government has the greatest risk-baring capacity because it is the largest balance sheet with the highest credit rating in the country. However, such credit guarantee schemes have had mixed success (for example, the Covid Bounce Back scheme which evolved into the Bounce Back Solar Loan). That mixed success stems from weaknesses in the design of schemes but also a failure of some banks to adapt systems and processes to use such schemes. Much could be achieved if banks and government worked together more effectively to deliver effective mechanisms to mitigate risks and increase lending to black borrowers.

Account closures

Another area of contention in the hearings was bank account closures. Banks played a decisive role in frustrating state capture protagonists by closing the accounts of those implicated. Banks have for many years been required to close accounts of those who pose a reputational risk or risk of misuse of the financial system for illegal activities. The practice came in for extensive criticism in some of the questions, particularly from the MK Party, with the case of Sekunjalo cited in particular.

> **Account closures can unacceptably impinge on the rights of individuals. MPs and banks should work with regulators to create a minimum service that banks must provide to any customer.**

The banks rely on the Bredenkamp precedent[3], a Supreme Court of Appeal judgment which affirms the banks' absolute right under contract law to enter or exit contracts with counterparts. The banks nevertheless explained that there are procedures they follow to determine whether it is appropriate to close an account, which include principles of fairness. Banks are required under various laws to assess risk of client involvement in criminal activity and to act against such risks or face fines. So, both for these legal risks and reputational risks it is understandable that banks would act swiftly to terminate banking relationships.

However, this again is an area where banks and the parliamentarians could have found each other but failed to. We doubt that the Bredenkamp precedent would survive an appropriate Constitutional Court test case because not having a bank account imposes severe constraints on the ability of people to exercise their constitutional rights. In increasingly cashless societies, which is actively encouraged by many policies, it is almost impossible to live without a bank account.

We advocate for a regulated minimum standard of service that banks should be required to provide anyone who asks for a service from them. This is integral to banks' social license to operate, and the fundamental role banks play in enabling people to exercise their rights. However, such a requirement should only be to provide a minimum standard: an account that allows for payments, of amounts up to R5,000, in line with current Financial Intelligence Centre and Reserve Bank guidance (Directive 1 of 2022) on the threshold at which client identification and verification is required. However, should it be demonstrated that clients are in fact using such an account for illegal activity, it should be closed regardless.

More debatable is whether a compulsory service requirement should apply to legal entities. While legal entities do not have rights in the same way as natural persons, the frustration of bank access for such entities can indirectly affect the rights of employees and other stakeholders. On balance, though, banks' rights under contract law would carry more weight in the case of legal persons.

In short, we think banks and MPs could productively work on schemes to improve bank credit risk when lending to black customers and develop rules requiring compulsory bank account provision.

In the course of the hearings, several other ideas were tabled. We discuss these below.

Good ideas

Public-private partnerships (PPPs). The banks emphasised that economic growth cannot be driven by the banking sector alone and that PPPs are crucial to address the country's challenges. PPPs allow the private sector to finance, build, operate and maintain public infrastructure (or any one of those roles). Banks have played important roles in the financing of PPPs, though it is important that they are structured correctly with risks appropriately distributed to public and private sectors. The recent tabling of amendments to regulations that govern PPPs by National Treasury[4] is a positive step towards increasing the number of PPPs that banks can then step in and finance.

Focus on MSMEs' credit access. The financial sector conduct authority (FSCA) noted the need for more targeted financial products for micro, small and medium enterprises, in addition to the existing products that the banks indicated they were already offering the sector in their respective presentations. Acknowledgement by the banks that alternative credit data models could improve MSME lending and financial inclusion is a constructive step towards widening access to credit. We think this can lead to useful outcomes, including the establishment of central repositories of small business credit risk information that credit bureaus can access. The absence of such information constrains banks' ability to assess credit worthiness of small business borrowers.

Unlocking tribal land for collateral. Capitec's proposal to explore the use of communal and tribal land as collateral for credit facilities is a potentially transformative idea. If structured correctly, this could unlock and enable access to capital for previously excluded communities, fostering economic participation and asset ownership. However, this will need to navigate the difficult politics around tribal control of such land.

Increased collaboration between capital providers. The proposal to coordinate the "pools" of capital, including from banks, development finance institutions (DFIs) etc, has the potential to increase the impact of financing economic development. As discussed above, development funders can provide wholesale funding into banks to support wider lending.

Reform in affordability assessments. MPs highlighted how the criteria outlined in regulation 23A of the National Credit Regulations (NCR) might disproportionately be a disadvantage for historically underprivileged individuals. This was acknowledged by the banks, with Standard Bank noting that this flaw in the system creates unintended biases. We address this issue in more detail below. Amendments to NCR section 23A to account for structural inequalities could improve financial access in SA.

Best idea of the hearings: Credit decisions and regulation 23A of the National Credit Regulations

Standard Bank highlighted a fundamental flaw in credit decisioning, which is inherently discriminatory due to structural socioeconomic disparities. Regulation 23A of the National Credit Regulations was designed to ensure fair access to credit by setting clear affordability assessment criteria, defining minimum living expenses and mandating full disclosure of credit costs. However, its rigid application fails to account for historical economic inequalities, because it relies on credit applicants being able to demonstrate that they have the cash flows to service the debt, particularly three months of payslips or bank statements showing cash flows. This requirement makes it impossible to fund a startup by an unemployed person or a business that deals in cash, or borrowers with erratic cash flows that do not fall within the most recent three months.

> **Updates to regulations under the National Credit Act could materially improve access to credit by informal businesses and small business start-ups.**

While the regulation aims to prevent reckless lending, it inadvertently favours individuals in formal employment and compounds the features discussed above of providing easier credit to those who already have wealth.

The rigid affordability assessment model does not adequately recognise alternative income streams, exacerbating financial exclusion. This issue underscores the urgent need for regulatory amendments to Regulation 23A. Policymakers must consider more flexible and inclusive approaches, such as incorporating alternative credit data models, reassessing minimum living expense benchmarks and refining income verification methods to accommodate non-traditional earnings. There is also much else that can be improved in the regulations, including allowing for digital origination of loans.

Addressing these flaws without compromising credit risk management is essential for promoting financial inclusivity. The current framework, while well-intentioned, entrenches economic disparities.

A regulatory overhaul is necessary to ensure that historically disadvantaged individuals have fair access to credit, thereby fostering broader economic participation and sustainable growth.

Bad ideas

State-mandated lending targets. Some MPs suggested that government should force banks to lend to specific sectors regardless of credit risk. While financial inclusion is crucial, mandating lending could lead to reckless credit extension, increased non-performing loans and systemic risks. It would be a much better idea to ask how the state can use its balance sheet to derisk banks to enable more targeted lending.

Misconceptions around racial bias in lending. There was strong criticism from MPs regarding alleged racial profiling in interest rate decisions. However, banks clarified that pricing is determined by risk-based models, not race. Even though historical disparities exist and are acknowledged as issued needing to be resolved, the hearings appeared at times to lose focus on addressing the broader economic structural factors affecting access to finance.

Politicisation of banking regulations. Some MPs accused banks of political bias in closing accounts, particularly referencing the Sekunjalo matter. While reputational risk frameworks must be transparent, forcing banks to keep accounts open despite regulatory concerns could undermine financial integrity and potentially result in increased scrutiny from the prudential authority. Nevertheless, as outlined above, it would be a good idea to introduce a compulsory minimum service level that banks must provide.

Nationalisation of the SARB and creation of a state-owned bank. The idea of nationalisation of the SARB and creating a state-owned bank resurfaced. However, history has shown that state-owned banks are often mismanaged and pose significant fiscal risks – lessons should be drawn from the ongoing Ithala matter. A better alternative would be strengthening existing development finance institutions.

Opposition to Ithala's liquidation without consideration of regulatory realities. MPs were highly critical of the Prudential Authority's decision to pursue the provisional liquidation of Ithala Bank. However, MPs must recognise that banks should be regulated according to a common set of standards and they should have sustainable business models. Ignoring financial sustainability concerns in favour of political considerations would certainly not support a well-functioning banking system that can meet the aspirations of South Africans.

So, what for the future?

The hearings highlight the challenges of balancing financial stability, transformation and economic inclusion. While MPs raise valid concerns about banking sector shortcomings, some arguments are based on misconceptions rather than evidence. Banks, for their part, acknowledge the need for reform and improvement but caution against interventions that could lead to unintended consequences.

A pragmatic and collaborative approach is required. PPPs, regulatory refinements and innovative lending models, such as leveraging alternative credit data, could unlock financial opportunities for underserved communities. At the same time, maintaining a prudent and sustainable banking sector is essential to long-term economic growth and stability.

Ultimately, the hearings reinforce the importance of structured, evidence-based engagements to drive financial inclusion and economic growth in SA.

Talk to us about how we can help you

Shaping a more inclusive and resilient banking sector requires informed dialogue and evidence-based solutions.

At Krutham, we provide deep expertise in financial policy, banking and market dynamics to help clients navigate complex challenges. If you are interested in exploring how our insights can support your work, reach out to us at joburg@krutham.com or visit our website at www.krutham.com.

Sources

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