The Establishment of a state-owned commercial bank and its impact on the South African Economy

Applied Research Project Report

Zandile Diza

Student number: 2498970

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Abstract

This study investigates firstly, the current financial inclusion landscape of South Africa, the gaps or rather the limitations that exist in the current banking system that require direct intervention of the government as well as how effective the role of the development financial institutions (DFIs) in the economic growth and development of South Africa and the challenges therein**.** Secondly, we investigate the need for the establishment of the state-owned bank, its clear mandates and objectives in the economic development of South Africa.

Keywords: State-owned bank, South African banking sector, Development Financial Institutions (DFIs, Financial Inclusion

DECLARATION I, Zandile Diza, declare that this consultancy report / business venture proposal / social entrepreneurship project is my own work except as indicated in the references and acknowledgements. It is submitted in partial fulfilment of the requirements for the degree of Master of Business Administration in the Graduate School of Business Administration, University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination in this or any other university. (Type your name in full here, and sign in the space above)

ZDiza

Zandile Diza

Signed at Centurion On the 7 May 2023 day of 2023.

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CHAPTER ONE

BACKGROUND

An inclusive financial system is essential to develop the country's economy. Financial inclusion was observed by the initiative of the government to include financially excluded into the formal financial system by developing a policy framework for financial inclusion in South Africa and to sketch the approach to its implementation. Financial inclusion implies bringing low income and disadvantaged groups under the coverage of banking by providing them access to banking services at an affordable cost. Banking industry plays an important role in the growth and development of the economy in a country like South Africa, which comprises rural, semi-urban and urban areas.

Various types of financial institutions which serve different purposes and cater to diverse demands of society exist within the banking industry. Two significant players are commercial banks and development finance institutions. Although they both offer financial services, their goals, roles, and target markets are different from one another. Commercial banks are profit-oriented financial institutions that provide a wide range of services to individuals, businesses, and governments. They act as intermediaries between depositors who provide funds and borrowers who require financial assistance. Commercial banks accept deposits, offer loans, facilitate payments, provide credit cards, issue guarantees, and perform various other banking services. Development banks, also known as development financial institutions (DFIs), are specialized financial institutions established with the objective of fostering economic development. They focus on supporting long-term investments and projects that contribute to economic growth, infrastructure development, and social welfare. Development banks often operate under a public mandate and collaborate with government entities to achieve developmental goals. Development banks often prioritize underserved sectors or segments of the economy. Their target clientele may include SMEs, agricultural cooperatives, rural communities, low-income individuals, and infrastructure projects that contribute to the overall development of the country.

Sapienza, in his study discovered that compared to commercial banks, state-owned banks charge lower interest rates. He also found that state owned banks are biased towards lending to disadvantaged areas, and that some lending appears to be politically motivated (Sapienza, 2004). The article named “Government ownership of Banks” mentions that ownership by the government is inversely associated to the expansion and development of the financial sector. Although some theories suggest that state-owned banks cause state capture and inefficiency, however, there is evidence that they can also correct market failures (La Porta , Lopes-De-Silanes, & Shleifer, 2002). Critics argue that market failures can be better addressed through regulation and subsidies rather than through direct state ownership. This view is based on the perception that politicians may take advantage of the state-owned bank by using it as a tool to maximize their political or personal interests.

This study is inspired by the ongoing public interest on the feasibility of the establishment of a state-owned bank in South Africa. In his budget speech in 2021, the then Finance Minister of South Africa and the President in the recent State of the Nations Address (SONA), announced the possibility and the need to create a state-owned bank that will operate as a fully-fledged bank the same as with the existing privately owned commercial banks in the retail and business banking segments (Bloomberg, 2021). The Minister of Finance added that the rationale behind the establishment of a state bank is to address market failures owing to the stringent operating models (highly profit driven) of private owned banks. Private-owned banks are unable to provide certain financial services to low-income groups and start up and small businesses. He also said that this bank will help with the consolidation of the current structure of the Development Financial Institutions (2020 Budget Speech, 2020). These groups are predominantly out in the rural towns and local townships away from affluent areas making it difficult to access.

The primary reason why poor people stay poor is often attributed to a lack of access to finance. Access to finance has been recognized as a crucial element in helping people to transform production and economic activities, which is something South Africa has to concentrate on in order to bring majority of the people out of poverty (Polloni-Silver, Da Costa , Moralles, & Neto, 2021). Financial inclusion and development could improve financial stability, which would have a favourable impact on the economy. Example would be by way of increasing credit extension to SMMEs in order to expand their businesses and subsequently create more jobs. Also, getting more savers to participate in the financial system (Banerjee & Duflo, 2010) . According to Banerjee (2010) he also mentioned in his study that the main goal of the state bank should be to improve people's lives, and it must be motivated by a larger social goal that supports national priorities and objectives like the expansion of manufacturing, agriculture, small businesses, and employment levels as well as the advancement of underdeveloped regions.

South Africa is faced with same challenges as stated above, and continued lack of state-owned bank may further perpetuate these challenges. This study is trying to address this challenge as part of market failure or existing gap in the South African banking sector that require government's direct intervention by way of establishing a state-owned commercial bank. In addressing this question, the study reviews the role of the development financial institutions (DFIs) and the banking sector, the challenges and limitations that these banks are faced with in closing the gap. These institutions are currently strategic drivers in the South African financial inclusion and development agenda (Mhlanga, Dunga, & Moloi, 2021). However, the persistent inequalities and slow economic development and transformation remain.

Financial exclusion, affecting the poor and low-income earners as they cannot afford the costs of related financial services, has been evidenced in previous studies as amongst the main causes of poverty and inequalities in South Africa. Lack of required documentation to open a bank account, high rate of unemployment, lack of trust in the banks, high banking fees, location and financial literacy are noted as the main challenges of financial inclusion in South Africa. Various studies and literature as covered in this report (Chapter two) evidence that financial inclusion can be used as a tool that can contribute to financial development, economic progress, a decrease in income disparity, and the elimination of poverty. Keynes (1937) has suggested that bank credit serves as the road that production travels on, and that if bankers understood their responsibility, they would provide the transportation necessary for the community's productive resources to be used to the fullest extent possible. Matsebula, (2020) suggests that even though there is an increase in usage of financial services by the people of South Africa between 2003 and 2017, this was skewed towards higher income households, with low-income earners and rural communities still being left out. Some literature continues to point out that government involvement can enhance the economy's overall functioning, particularly in making up for the imperfections in the coverage of the current banking system (Atkinson and Stiglitz, 2015).

The expectation is that the establishment of a state-owned bank could improve financial inclusion and further aid with the transformation of the country's banking sector, support the development needs of the country as well as its poverty reduction goals. The banking and financial industry is crucial to the economy because it enables money circulation, advancing of credit to various sectors and income groups, and ensures liquidity in the financial market. In addition to banking sector, South Africa also has DFIs which offer investment financing and mobilize financial resources for vital economic sectors where the market is unable to make sufficient investments. The DFI's already provide the infrastructure required for access to communities outside affluent areas. This places them in better stead to recognise and boost local potential due to their proximity to these communities. However current and ongoing challenges faced by these DFI's as explained in detail in chapter 2, make them ineffective in adequately playing their role, this study further unpacks these challenges and views on how the State can better optimize these resources to inform the role of state bank.

1.2. PURPOSE AND PROBLEM STATEMENT

1.2.1 Research question

What market failures exist in the South African banking sector that require government's direct intervention by way of establishing a state-owned commercial bank? Is there a need for the establishment of a state-owned commercial bank?

1.2.2 Problem Statement

South Africa has a sophisticated banking system with an asset base to GDP ratio above that of the most developing markets, and controls assets to the value of 6,5 trillion, mutual banks accounting for R3,4 billion (FSCA, 2022). The South African banking industry is robust despite the difficult economic climate because of an independent and well-run central bank (the South African Reserve Bank). As a result, the banking sector's three key ratios (i.e, liquidity coverage ratio, efficiency ratio and the net interest margin) have stayed stable, and capitalization has significantly increased in 2021 thanks to risk-weighted asset growth and higher earnings (GCR Ratings, 2022). The market remains highly concentrated, with the big 5 banks being Standard Bank, FNB, Absa, Nedbank and Capitec holding 90% of the market share and 83% of the industry deposit book (FSCA, 2022).

The environment is gradually changing, as banks face growing competition from recently founded institutions like Tyme Bank, Discovery, and Bank Zero, as well as institutions that are technology-enabled and an increasing number of retailers and cell phone networks that offer financial services and products. Although the country's bank account penetration has improved due to the new entrants, it has also been noticed that the majority of the clients they bring on board are switching from the biggest banks. (FSCA,2022), This demonstrates that the new banks are probably offering incentives to existing bank customers to switch to their new ones. Despite an increase in transactional account access, there is still a lack of real accessibility to financial services as seen by low account usage and low ownership of investment and insurance products.

It is evident that the financial sector in South Africa is characterised by market failures in the supply of banking services, with privately-owned institutions either undersupplying such services or supplying them inefficiently. The groups most often affected by these market failures tend to be poor, marginalised or otherwise vulnerable people. Another frequently affected group is the small and medium enterprises that are either too large to benefit from microfinance or too small to attract commercial loans. State intervention in the provision of banking services aims to address such market failures, thereby enhancing financial sector development and financial inclusion, while also promoting socio-economic development

The relatively high banking fees, which restricts the use of banking services is mentioned as a problem as well. The study conducted by the World Economic Forum states that due to the traditional banks' high operating costs, South African banks' fees are up to four times more expensive than those of nations like Germany, Australia, China, and India. Many people are prepared to accept the risk of theft and loss that comes with carrying cash around just so they can avoid paying bank fees (cash deposit fees, cash withdrawal fees & other transacting costs), leading to the payment of approximately 60% of purchases in cash.

Another limitation is that banks seem to have created substantial barriers for individuals in the low-income segment and the informal businesses to access products such as loans and credit cards as they often do not meet the requirements for loans and other related services due to lack of documentation such as proof of residential address, proof of income and business financial statements. Financial literacy and education have also proven to be a major contributor to financial exclusion. Issues like proof of address can be solved even for rural or communal people through use of local Chiefs or Councillors or related authority.

Lastly, the business model of private owned banks is largely profit driven, measured by headline earnings, return on capital/equity and dividend per share. This is how shareholders measure their worth and expect payment of dividends year on year. These shareholders are investors in their own right and therefore continue to push for high earnings with expectation to consistently growing these returns. As such, private banks do not have the large appetite for start-up businesses and low-income earners as they are viewed as either high risk or low returns. The temptation is normally to target well established business operations, and individuals with good and strong track records to maximise on returns and achieve high profit margins.

The study by the FSCA shows that small and medium-sized enterprises (SMMEs) receive less financial support than individuals do, especially when it comes to micro and informal businesses. This situation puts South Africa behind many emerging market competitors and demonstrates the fact that the country's sophisticated banking operations only tend to cater to the middle and upper classes of the economy because they view the low-income segment and small informal businesses as being riskier. The low-income class and small businesses continue to be left out, which slows economic growth and falls short of the national developmental goals of increasing employment to lower unemployment rates, combat poverty, and reduce inequality.

Even though South Africa has the strongest financial systems in the world, government believes that the people of South Africa are crying for more financial inclusion. In BCG's recent Sustainable Economic Development Assessment (SEDA). The ability of South Africa to transform wealth into well-being is ranked low at 149 out of 162 nations, thus inefficient utilization of the country's income resources to improve the lives of citizens. Expanding access to financial services for individual and small enterprises could reduce the country's persistent inequality and stimulate economic growth that will lead to poverty reduction. This situation can stay the same or worsen if economic and financial growth falls behind. By assuming the role of a state bank as a catalyst for financial inclusion and expanding loan activities toward

SMEs and the unbanked, this trend may be improved more favourably in the future. Financial inclusion is anticipated to have more beneficial economic knock-on effects, such as increasing SME employment creation and GDP growth (National Treasury, 2020).

1.2.3. Research objectives

(a) The purpose of this study is to investigate the feasibility and factors that necessitate the establishment, of a state-owned bank in the commercial and retail segment of the South African banking industry**,** by looking at the current South African banking structure and its ability to sufficiently provide services for the client outside the mainstream economy, playing in the informal and small business space and lower income groups.
(b) Examine the expected contribution of the new state bank in enabling the Development Financial Institution's (DFIs) role and performance in economic development.
(c) To explore corporate government structures that the government could have in place to ensure the success of the new state bank.

Research Questions

(a) What role would a state-owned commercial bank play in economic development, its contributions?
(b) What market failures or gaps would a state-owned commercial bank be addressing?
(c) How would the establishment of the state-owned commercial bank enable DFIs role in the economy?
(d) What performance measures can government put in place to ensure success of the state commercial bank?
(e) What controls and corporate governance measures to consider in ensuring accountability of the state bank?

Delimitation

The scope of this report is investigating the establishment of the state-owned commercial bank by looking at the current financial inclusion landscape, overview of the banking sector and the overview of largest development financial institutions (DFIs) which are the Land Bank, the IDC and the DBSA. It is also important to note that this research is limited to the South African context.

CHAPTER TWO

2. Literature Review

2.1 Financial inclusion

Financial inclusion is broadly defined as the ability of people to access a range of financial services at competitive and affordable prices (Demirguc-Kunt & Levine, 2000). Financial services may include but are not limited to transactional savings and cheque accounts, credit lines, investments, and insurance products.

Financial inclusion is also recognized in the South Africa's National Development Plan Vision 2030 as one of the essential tools that might support the nation in achieving its objectives of eradicating inequalities, unemployment and poverty through decent jobs and sustainable livelihoods (Louis & Chartier, 2017). The government of South Africa anticipates that by 2030, there will be a roughly 90% rise in the percentage of the people who have access to transactional financial services and saving options, or who have utilized banking services (Louis & Chartier, 2017). Increasing access to banking services is what financial inclusion aims to achieve for those who are less fortunate while simultaneously bringing costs down through a mix of competitive pressures and other infrastructural cost reductions (Mhlanga, Dunga & Moloi, 2020).

Oyelami (2017) used pane autoregressive distributed lag (ARDL) to examine the factors of financial inclusion in sub-Saharan Africa. The study's conclusions demonstrate that the region's financial inclusion is significantly influenced by both supply-side factors such as interest rates and bank innovation as measured by automated teller machines and demand-side factors like income and literacy levels (Oyeyami, Saibu, & Adekunle, 2017). By the same token, Evans (2016) examined variables influencing financial inclusion in Africa from 2005 to 2014 using dynamic panel data regressions. The study discovered that variables such per capita income, money as a percentage of GDP, literacy rate, internet connectivity, and the availability of Islamic banks have a significant influence on Africa's level of financial inclusion (Evans & Adeoye, 2016). The research also came to the same conclusion that financial inclusion in sub-Saharan Africa and Africa is influenced by income levels and literacy rates. According to Ikdal (2017. p 1), “one way to improve the well-being of people in communities is through financial services' uptake, use, and sustainability. They also went on to say that family prosperity automatically leads to GDP growth, reduction of poverty rates which will subsequently lead to less crime, a safer and a more promising future for South Africa (Ikdal , et al., 2017).

In addition to literature on global firm-level data finds that small, medium sized businesses are faced with greater financing challenges as they obtain less or no lending at all from commercial banks. This then leads to company owners like SME’s having to use informal lending structures such as Mashonisa (Micro-lenders) and Stockvels to borrow money and end up paying exorbitant interest rates and administration fees. As a result, small firms in Africa see access to credit as a disadvantage and a constraint to growth (World Bank, 2013).

The importance of SMEs for the development of the economy cannot be emphasized enough. These small businesses are essential for job creation and providing products and services all around the country and furthering the country’s economic growth plans. Estimates suggest that there are over 2 million informal businesses in South Africa who are unable to access credit from banks (Intellidex, 2020). According to the World Bank (2013) 36% of adults in South Africa rely on informal loans, which is greater than the percentages in the other BRICS nations and other developing nations (World Bank, 2013) .The South African economy is frequently referred to as having two distinct economies: (1) a developed, high-end sector with resources and wealth comparable to those in developed nations; and (2) a less developed, low-end sector operating primarily in townships, informal settlements, and rural areas (World Bank, 2013). Most of the informal and small-scale activities that make up the less developed economy are comparable to the micro- and small-business sector in other Sub-Saharan African nations (World Bank, 2013). Financial inclusion in the nation has been further stifled by the largest banks' long-established operational structures and procedures that are better suited for middle-to-high income segments than to low-income segments (The World Bank, 2013, p 23). The fact that these large banks must maintain complicated operations and technological systems that were not intended for less expensive accounts contributes to the perception that they charge exorbitant bank fees (World Bank, 2013).

The evidence above demonstrates that South Africa still has a challenge of financial inclusion despite progress made, as indicated by unequal access to and utilization of financial services and as well as a highly concentrated ownership structure in the banking industry. Costs of travel to access banking services, distance, and structure of banking operations in South Africa are some of the barriers to improving financial inclusion.

Overview of the South African Commercial Banking Sector

2.2.1 Introduction

A retail and commercial bank is defined as a financial intermediary that serves individual, small, and medium size business customers by providing essential liquidity, transacting, savings and insurance functions via various services and products (Lip, 2022). This type of an institution is expected to maintain and accept customer deposits in exchange for a fee as well as low-cost funding, as deposits cost banks less than borrowed capital (Lip, 2022). Banks use depositors' funds as a source of capital to establish credit facilities, and these deposits are used to lend credit to borrowers.

The low cost of capital (deposits) is a benefit to the banks and should ideally be shared with ultimate borrowers in the form of low cost of credit (fees and interests charged at the point of borrowing) to bank’s customers. However, given the operating model; stringent credit and profit models used by banks, which generally demand decent returns for its shareholders, good dividend pay-outs, this benefit is not usually realised by customers (Lip, 2022). This is potentially the area that state bank can exploit for the benefit of its customers and its sustainability and introduce a healthier competitive environment.

In conclusion, it can be said that a retail and commercial bank's primary job is to connect depositors and money borrowers at a cheaper cost than outside finance, at least in an ideal world. To do this, they provide a variety of goods and services with the goal of generating profits and building wealth for their stockholders or shareholders (Lip, 2022). In order for retail and commercial banks to earn respectable returns on equity, which are correlated with the expansion of the banks' deposit book, credit portfolio, non-interest revenue, and interest generated income, deposit collection becomes essential.

Retail and commercial banks also provide value-added services and products to their customers, such as transactional accounts, payment solutions, invoicing, collections, merchant solutions, e-wallet, foreign exchange services, and internet banking, to help make banking more convenient and accessible for the end user as well as to increase economies of scope and scale and gain full share of wallet (the amount of revenue that the bank makes from each customer on a range of products and services). Retail and commercial banks also offer insurance and advice services to help customers manage risk and make sure their estate planning is in order. All these services are provided to customers at additional fees and charges and use as form of other non-interest income for the retail or commercial bank.

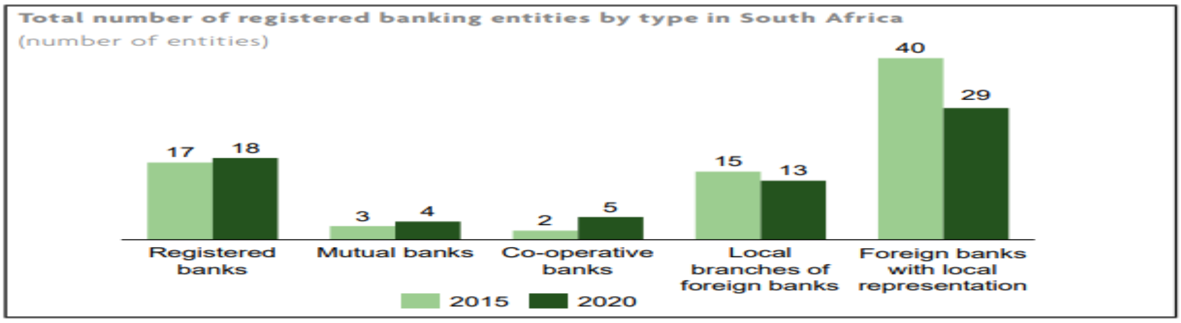

Figure 1 Total number of registered banking entities in South Africa

Source: FSCA, Financial Sector Outlook Study, 2022

Currently, there are 18 South African controlled private-owned banks, 3 mutual banks, 13 foreign branches, 2 co-operative banks and 29 foreign banks operating is South Africa (FSCA, 2022). A co-operative bank is defined as a registered co-operative entity whose members share a similar line of work, are employed by the same employer or in the same commercial district, who share membership in a common organisation and live in the same community or geographic area.

2.2.2 Banking sector concentration

Financial market concentration is reflected by how much a financial sector is dominated by a small number of larger institutions in the market, as determined by market share (IMF and World Bank, 2005). In the financial industry, concentration can take the form of asset concentration or institutional concentration, when a few numbers of institutions control a significant part of the resources in any given sector (D'arista, 2009). Demirguc-Kunt and other economists said that concentration in the financial sector has an impact on industry competitiveness, bank stability, financial sector efficiency, policies, and regulations (Demirguc-Kunt & Levine, 2000)They also recognized that bank concentration has costs and benefits for the growth of the financial sector, and this conundrum has led to conflicting views on how concentration affects financial sectors. On the one hand Demirguc-Kunt and Levine (2000) discovered that bank concentration increases market power and stifles efficiency and competition. Law and Abdullah (2006) also found that market concentration causes inefficiencies that limit access to credit, which inhibits growth. Failing to reduce concentration affects systemic efficiency through a decrease in credit availability, an unequal distribution of credit, a decrease in support for small creative enterprises, and has negative effects on how monetary policy is conducted (Law & Abdulla, 2006)

Despite an increase in transactional account access, low levels of account use show that there is still a lack of access to financial services. The report by FSCA, 2022 show that 83% of those with bank accounts use non-bank channels such as mobile money through M-Pesa, MTN and Vodacom app, while 68% still rely on informal channels such as microlending organisations. If social grant beneficiaries were removed, roughly 69% would be regarded as legally banked. Low income and a lack of resources are the main causes of South Africa's poor adoption of banking services. Concerns about debt and a poor or restricted savings culture exist in the South African financial market. As evidenced by the aggregate household savings rate of 0.7% and debt to income ratio of 75.3% (FSCA, 2022). This situation can stay the same or worsen if economic and financial growth fall behind. Increasing loan activities toward SME's and the unbanked, as well as taking up the role of a state bank as a catalyst for financial inclusion, may therefore assist improve this trend more favourably.

Due to high concentration in the banking sector, the largest banks seem to have developed decision- making policies and compliance structures that are more aligned with the middle- and high-income segment, a behaviour that is further suffocating economic development, which suggest the need to establish a more conducive and enabling environment for new delivery mechanisms that will help extend banking services to the millions of South Africans who are under-banked, particularly in the outskirt areas.

Okeahalam 2001, found that “when there is high concentration there is a likelihood of collusive oligopoly which means that the power of the consumer on price, product offering, and the level of service delivery becomes weak”. This leads to banks not wanting to tap into markets that are deemed unprofitable, hence the many black township entrepreneurs that remain under-banked and with no or limited access to credit. He continues to say that the need for competition in the banking sector is still required to break the collusive behaviour among large banks (Okeahalam , 2001).

Yeyati, 2004’s views on state- owned banks is that they should be more active in sectors where market failures are more prevalent, i.e., where there is a need for external financing. This is the essence of this study, as also supported by this literature and challenges faced by South Africa in addressing economic and financial growth.

2.2.3 Funding and lending model of retail and commercial banks

Banks pay interest on the money they take in from depositors (savers), which contributes to the bank's primary funding cost. On the other hand, banks gain interest from the loans and credit facilities they offer to borrowers, which makes up a significant portion of their income (Lip, 2022). Bonds and other debt securities can be issued by banks in order to raise money from savers through the financial markets. Banks’ listed shares on the stock exchange represents and form part of the bank’s funding structure.

To be specific, lending rates are the interest rates paid by borrowers, and funding costs are the interest rates given to savers. There are more types of funding as mentioned above, e.g equity/bonds. Businesses and consumers decide how much they want to borrow or save based on the interest rates that banks charge borrowers and pay to savers. Understanding the funding costs and lending rates of banks as well as the factors that affect them is crucial for a complete understanding of how monetary policy is transmitted (South African Reserve Bank, 2022)

Overview of Development Financial Institutions in South Africa

2.3.1 Introduction

It is crucial to know that commercial and development banks have different goals and ways of doing business. Development banks have a clear development mandate, which in certain cases is restricted to financing to certain industries, such as agriculture, SMEs, manufacturing, imports and exports, mining, and infrastructure projects. Instead, the mandate of commercial banks is typically broader (Government Service Insurance System, 2011).While most development organizations function as second-tier organizations with entirely distinct business models and cost structures from commercial banks, which operate as first-tier organizations. As a result, comparing the successes and activities of these two institutions is unreasonable (Panizza, 2022). A bank is required by the Basel Third Accord to keep a specific amount of cash or liquid assets in relation to its risk-weighted assets. Tier 1 and Tier 2 assets for a bank have to make up at least 10.5% of its risk-weighted assets. Tier 1 capital which consists of the shareholder's equity and retained earnings is the primary funding source of the commercial banks. Tier 2 capital includes hybrid capital instruments, revaluation reserves, and subordinated term debt are funding sources of the DFI's. The tier 2 capital structure is considered less reliable than the tier 1 capital structure because it is more difficult to calculate and even more difficult to liquidate.

Development banks are frequently referred to as financial organizations that are mandated to provide financing for long-term capital projects that are believed to provide positive externalities that would otherwise be unattractive and not funded at all by private commercial banks (Yeyati, 2004). This report focuses on role of the main and the large DFI's in South Africa being: The Land and Agricultural Development Bank, known as the Land Bank, the Industrial Development Bank (IDC), the Development Bank of South Africa (DBSA).

2.3.2 The Land and Agricultural Development Banks (Land Bank)

The Land Bank is a state-owned agricultural development bank that provides capital lending to the South African commercial and emerging agricultural farmers for purposes of acquiring land, equipment, asset maintenance and production. One of its key mandates is also to make credit accessible to previously disadvantaged groups referred to as development and emerging farmers in align with the country's National Development Plan (NDP) and Agricultural Master plan (The Landbank website, 2022). South Africa' agricultural economy is known to be highly diversified and includes products of all major crops, livestock products and a well-developed poultry and egg production. The agricultural sector contributes 10% to SA's total exports earnings (South Africa-Country Commercial Guide, 2021), and the Land Bank as a 30% market holder is a great enabler towards this growth in this sector. Business Day 2020 announced that the bank defaulted on its debt commitments as a result of liquidity problems brough by non-performing loans. This default has resulted in the Land Bank not being active in the granting of new loans for periods-2020-2022 as stated in their integrated annual report 2022 (Land Bank, 2021). The financial reports of 2022 have shown that Land Bank restored its profit coming from significant losses, however, still remain in default.

2.3.3 The South African Development Bank (DBSA)

The South African Development Bank is South Africa's state-owned development finance institution, entrusted with the mandate to promote economic growth through sustainable development projects and programs in South Africa and other African countries. "The Bank hopes to intensify its development influence in South Africa, SADC, and the rest of the African continent by increasing access to development finance and successfully integrating and execution of sustainable development strategies (DBSA, 2021).

The bank has a R100bn asset base with R39bn equity and realized profits of R1,4 bn in 2021, which reflect a growth of 182% from the previous year's profit of R503 billion (DBSA, 2021)The organization remains financially stable despite high gearing of 155%, which is way above 100%, influenced by external debt funding from capital markets bonds and equity.

2.3.4 The Industrial and Development Corporation (IDC)

The Industrial and Development Corporation is fully owned by the South African government. Its mandate is to maximize the development of the country through industrialization and funding of black-owned and black empowered companies, women and youth owned enterprises. "The IDC's purpose is to grow sustainable industries; support entrepreneurs improve lives" (IDC Integrated report 2021). Its objectives are aligned to National Development Plan (NDP) and industry master plan as set out by the government (IDC website, 2022).

IDCs financial performance continues to be sound with profits of R 3,3bn in the 2021 financial year despite incurring losses in the prior year. Profits have since reduced to R2,7bn in 2022 but continued to grow its asset base or balance sheet from R 143bn to R177bn, its investments holding (shares held) in various entities contributes to this balance sheet and profit line., However almost70% of its liabilities are from debt capital markets (Annual financial statements, 2021), which again confirms skewed funding model of these DFI's.

2.3.5 Funding model of Development Finance Institutions (DFIs)

DFIs are government investment companies that combine the broad development goals of conventional multilateral aid organizations with the business strategy used by banks and investors in the private sector. Some of the DFIs are mostly funded by government, though some such as the IDC and the Land Bank also raise capital from private investors. In many cases, DFIs like the IDC, the DBSA, the Land Bank, are expected to sustain their operations and growth from their investment returns despite them largely relying on debt instruments to sustain their lending activities. DFI's have a different profit target to that of commercial banks, and therefore DFI's are not targeting high returns as they have to balance political & socio-economics interests while at the same time have to sustain themselves under challenging funding conditions.

2.3.6. Challenges and limitations facing South African DFIs

Regarding the financial performance of the DFIs, there have been worrying developments. Its financial performance has been marked by increasing losses, subpar loan recovery, and ongoing reliance on the government to support their operating expenses. They have not adequately addressed market flaws or closed the funding gap for the unfunded sector of the market, and instead continue to perform poorly when it comes to furthering its explicitly stated social goals and objectives (Le Pere. G.L. 2020). The integrated annual reports of these DFI's such as the IDC indicate a reduction in lending activities towards black-owned businesses in the financial years 2021-2022. According to the IDC integrated annual report for 2021/22 about 30-40% of the approved loans went to black owned businesses. According to the 2021/22 integrated annual report, the Land Bank shows limited lending activities in the 2021/22 financial year. The funding towards agricultural black owned businesses is also not comparable to funding provided to established commercial agricultural businesses.

Due to their inability to get deposits from clients, these DFI's funding model, which heavily relies on debt capital markets, may have an effect on the nature of their lending or credit activities and may explain the patterns stated above. The DFI's unlike commercial private owned banks, do not take deposit as they are not licenced to do so.. The above trends do indicate the DFI's inability to sufficiently address the funding gap or market failures. This trajectory is not ideal for South Africa's transformation economic development agenda (Global Impact Investing Nework, 2016).

It has also been noted that DFIs continue to work under challenging conditions with increased pressure to reduce existing inequities and promote economic growth. The self-sustainability of DFIs, however, has been a challenge and a significant factor in their institutional and financial vulnerability (Le Pere, 2020). In other words, the funding model of DFI's and how there are governed is part of the challenges to address. The government has long acknowledged the issue of continuous financial resource limitations (depleted cash balances owing to increasing country debt levels in relation to its GDP growth). This is a blatant sign that the government will soon stop being a reliable source of funding for DFIs. This factor has also been amplified by various rating agencies when justifying rating downgrades of these local DFI's amongst other reasons. The National Treasury has also begun limiting the kind of guarantees often given to SOEs and other DFIs so they can better access capital markets financing to supplement their operating budgets. Le Pere, 2020 also mentioned that National Treasury would continue to be hesitant to provide this support going forward, leaving a major hole in the funding of these DFI's (Le Pere, 2020). Expecting future capital injections to be limited, DFI's are looking for alternative funding sources outside government resources. This would prove to be a difficult hurdle to overcome as these DFI's continue to be controlled by the State with their strategic and policy direction influence by the political environment-hence making them less attractive for funding coming from capital market, various pension funds and note holders as risk is considered high (Global Impact Investing Nework, 2016).

Currently, the DFI's carry what is termed the "unfunded mandate" where there is an expectation to deploy capital into developing local economics and transform local sectors, while no adequate funding is provided by the State due to reasons above.

Key challenges of these DFI's are high debt levels or at least heavy reliance on debt markets for support. Increasing costs of borrowings as they are rated by global rating agencies based on the size of their balance sheet, financial performance, and government financial support or lack thereof. The limited alternative funding support put a strain on their balance sheets and financial returns hence restricting their ability to execute on their developmental mandates and continue to leave the majority of entrepreneurs, small, medium and informal businesses unattended.

As part of addressing market failure a funding gap is paramount to this. This is one of the gaps the State Bank is anticipated to minimise, i.e., by ensuring a diversified funding stream through deposits, revenue from transactional activities (non-interest income). None of the DFI's have a deposit taking capabilities nor earn revenue from transactional activities but only rely on revenue generated from interests earned after deducting cost of debt from capital markets.

The fall of South Africa's unsecured lending giant, African Bank (ABIL) in 2014, sets a very good example of a financial institution that is fully dependent on funding from capital markets, but lacks the deposit-taking and transactional banking ability to support its operations. DFI's still find themselves in this category.

The above challenges do trigger a question on whether DFIs would have been in the same position if they were under the control of a state-owned commercial bank, and enabled to take deposits, transact, and trade like normal commercial bank! The study attempts to respond to this question and its main problem statement.

2.4 Banking Sector Regulators and Frameworks

The South African Reserve Bank (SARB) Act, 1989, the Prudential Authority as a juristic person under the SARB, together with the Bank Act, the Mutual Banks Act and the Financial Services Regulation Act (FSR), assume responsibility for the registration, regulation and supervision of banks. The Financial Sector Conduct Authority (FSCA) is the regulator for the financial services sector, including banks in terms of FAIS Act (37) of 2002. The National Credit Regulator Act (NCA) is responsible for the regulation of credit, promoting the development and accessibility of credit to the market, particularly the previously the disadvantaged persons. It also prohibits and protects consumers from reckless and irresponsible lending by financial institutions. The Financial Intelligence Centre Act, which mandates regulatory agencies to maintain compliance with its standards, performs obligations for AML/CFT (anti-money laundering and countering the financing of terrorism) (IMF Country Report No.22/39, 2022).

The report on financial inclusion, conducted by Intellidex, 2020 states that the problem of financial exclusion is not only caused by lack of interest from the banking sector, but it starts with the National Credit Act (NCA). Due to the fact that small and informal businesses do not keep financial records or banks statements, according to the rules and regulations of the NCA lenders are required to conduct credit assessments to prove creditworthiness prior the to issuing of loans (Intellidex, 2020). This could still be the challenge for the state-owned bank as the expectation is that regulations should apply to the state-owned bank the same way that they apply to privately owned banks. However, assuming that the state bank will actively grow participation of new entrants (unbanked) to now start developing their own banking track records, and therefore enabling both state bank and other commercial banks to provide lending support to this sector that is currently locked-out or disqualified. A State Bank is anticipated to assume this responsibility operating within the current regulatory universe. In closing regulations like the NCA also do recognize developmental agenda of government-in that the regulations consider development loans as part of lending instruments to avail to low income or individuals with a limited track record. The likes of the Land Bank and SEFA do already play in this development space applying similar NCA regulation enabling development loans (NCA of 2007).

Another challenge as mentioned on this report is the lack of credit data for SMMEs which may assist to use their good account conduct to access loans through wholesalers such as Trink Group Holdings for those businesses that are in the printing industry. Having a transactional history and track record however does increase the likelihood of obtaining credit as this data can inform the affordability assessment, character, and money management behaviour of the client. This target market is currently unable to build this track record and worsen any future chances of participating in credit to grow their small businesses or establish same. This study is attempting to provide these solutions or alternatives through establishing a state-owned bank to enable this segment market access to banking services.

These Acts also provide a comprehensive legal framework for banking supervision in South Africa and the key objectives of these regulatory bodies is to ensure maintenance of the soundness of the South African banking system through application of international regulatory and supervisory standards and practices.

2.5 Impact of ownership on banking performance

Does it matter if a country's commercial banks are wholly or partially owned by the government? Although there haven't been many attempts to directly address this issue, the considerable amount of literature on state-owned businesses in general suggests that it does matter. More notably, during the past 25 years, officials in many nations at all developmental stages have chosen to privatize banks, suggesting there is increasing understanding that privately owned banks are preferable compared to state-run banks. It's possible that an increasing number of people prefer private bank ownership because they anticipate more economic and financial stability (Yeyati, Micco, & Panizza, 2004)

State-owned banks are often believed to be detrimental for financial stability, which is supported by the propensity of countries that have in the past chosen to privatize banks following a systemic crisis. Growth and stability do not necessarily coexist. Financial costs associated with banking crises are high, and output losses are even higher. Post - crisis, governments have concluded that privatization is one way of reducing the financial burden of state-owned bank recapitalizations. In order to improve the financial system, as well as reduce the likelihood of upcoming crises and the associated financial losses., privatization is typically included in the package of policy actions (Andrews, 2005).

The distortions brought about by state-owned banks, according to Andrews 2005, can reduce the financial sector's capacity to spur growth even if full-blown crises are avoided. These deformities encompass several dimensions. State-owned banks could be expressly or tacitly expected to finance state-owned businesses that are losing money, to finance certain regions or industries on non-commercial terms, or to grant loans based on political ties rather than risk assessment. Andrews 2005 further argues that state-owned banks may be ineffective, allowing ineffective private sector banks to flourish in markets with less competition, or alternately, they may allow effective banks to make tremendous profits.

Brei and Schclarek 2014 are agreeing with Andrews that due to an implicit or explicit guarantee from the government, compared to privately owned banks, state-owned banks could offer lower cost of funds (Brei & Schaclarek, 2014). If these funds are utilized to support ineffective state-owned businesses, it may push out private intermediation, said Michael Andrews (Andrews, 2005).

Thoughts on state ownership of banks and other businesses have changed over time, and post-World War II officials were generally far more in favor of public control. As a result, governments in many nations took a more active ownership role of businesses and the offering of products and services of all kinds through the middle of the 20th century. Despite privatizations, state-owned banks still have a significant impact on the financial systems of many nations. The traditional "development view" of state-owned banks argues that when financial institutions are not established enough to support private banks to supply financing demands, government ownership can promote growth. This viewpoint was accepted on a global scale as governments continued to form new commercial banks in Africa, Asia, and Latin America during the 1960s and 1970s while nationalizing the existing ones. This point of view was paired with the contention that the government ought to oversee the crucial economic sectors (Brei & Schclarek, 2014). This trend was exacerbated by the reputation of colonial institutions, such as foreign-owned banks, which were commonly accused of favoring the economic interests of their shareholders and significant international clients at the expense of residents and companies. It's important to be aware of how the regulatory environment for banks has changed, with tighter controls and embedded good governance reducing the risk of bad governance and political influence. Examples in this regard include SASRIA (South African insurance company owned by the state), the entity continues to adhere to the regulatory requirements as per insurance policies, despite state ownership. Therefore, where there are clearly defined rules and oversight bodies, risk of poor governance is minimised (Brei & Schclarek, 2014)

2.6 Bank of China as an example of a successful state- owned commercial bank

Introduction

With a high level of financial service penetration, a wide range of service providers, and a recent surge in service coverage, China has made great strides toward financial inclusion. China has progressively created a distinct and sustainable growth path through its financial inclusion strategies, which aim to improve the financial well-being of farmers, SMEs, and low-income individuals. The State Council of China published a plan on December 31, 2015, for the advancement of financial inclusion (2016-2020). The plan outlines a strategy for enhancing the accessibility, satisfaction, and quality of financial services and products, with a focus on SMEs, rural residents, low-income individuals, the poor, the elderly, and those with disabilities as the target market for financial inclusion (Chen & Yuan, 2021). The primary driver of the Chinese financial system is the banking sector, with bank lending serving as the primary financial channel for the country's real economy. There were 4607 banking and financial institutions in China by the end of 2019, and their combined assets were around RMB290 trillion (about USD41.5 trillion). Chinese banking and financial institutions have significantly increased the scope of their service networks, product adoption, and innovation under significant policy guidance. They are committed to promoting the development of financial inclusion. China's financial inclusion progress is ahead of the world average when compared to other economies, particularly in terms of digital financial inclusion and people's financial awareness (Chen & Yuan, 2021).

Bank of China (BOC)

Among Chinese banks, Bank of China (BOC) has been in operation the longest. The BOC was legally founded in 1912, and its main responsibility was to support the nation's foreign trade and specialized exchange with the aim of providing for the needs of the general population while growing China's financial services sector. Despite numerous difficulties and losses, the bank managed to become the best bank in the Chinese financial industry and built a strong reputation in the international financial market. The Bank of China took advantage of the government's plan to use foreign capital and cutting-edge technology to stimulate economic growth during China's reform and opening phase by strengthening its competitive position as the nation's main source of foreign funding (Bank of China, 2022).

The bank became a fully state-owned commercial institution in 1994, and in 2004 the Bank of China Limited was established. In 2006, it was listed on the Shangai Stock Exchange and the Hong Kong Stock Exchange. The BOC was named a Global Systematic Important Bank in 2018, making it the first financial institution from an emerging economy to receive this designation for eight years running. Today, Bank of China has subsidiaries in 57 countries and regions represented by its global service network, in addition to having institutions located all over the Chinese mainland. In order to offer its clients a full range of financial services, the bank has built an integrated service platform based on the pillars of corporate banking, personal banking, financial markets, and other commercial banking services, which cover investment banking, securities, insurance, and other areas (Bank of China, 2022).

The bank has created a very strong brand identity that is well-known among its clients and the industry at large. In order to transform BOC into a world-class bank in the new era, with a greater contribution to developing a modernized economy and the efforts to realize China's dream of national rejuvenation and the aspirations of the people to live a better life, BOC strives to enable performance through transformation, increase the strength of the nation through reform, and foster innovation to promote development.

From a governance perspective, BOC is run by a dedicated and cohesive board that shares responsibility for the organization's direction, control, and long-term performance. The bank operates within a properly defined governance framework that allows for the effective transfer of control while also establishing clear reporting lines. Five committees, each mandated to offer advice, suggestions, and particular expert guidance on issues impacting the business of the bank, support the Board. The leadership team is tasked with the operational administration of the company, acting on the direction established by the Board, with their performance and effectiveness being regularly reviewed against predetermined goals and guidelines (Bank of China, 2022).

2.7 The efficiency and the contribution of state-owned banks in economic development

Yeyati, Micco and Panizza (2004), mention that while the state-owned banks tend to be less profitable than the private owned, the perception is that they are still safer due to the ability to pay lower rates on deposits banks and to also charge lower interest rates on credit extensions. They also emphasize that state-owned banks may not always maximize profits but rather the main objective should be to promote social welfare. They further justify that state bank’s credit lending is known to respond less to economic downturns compared to private banks and could therefore play a role in creating economic stability.

Yeyati and other economists, (2004) in his comparison of performance between state, private and foreign owned banks found that state banks in developing countries perform less than private banks in as far as profitability, impairments, and operating expenses are concerned. Whereas, in industrial countries, state banks perform more or less the same as their private counterparts.

It is said that in the late 1980s to early 1990s financial sectors went through a vigorous restructuring with the intention to improve performance in the industry (Figueira, Nellis, & Parker, 2006). State-owned banks were privatized, barriers to entry to foreign capital were scrapped and new regulatory frameworks aimed at reducing chances of committing fraud and abuse of the depositor's money were established. However, the time series analysis that was conducted to test the impact on performance and efficiency post these changes was ruled out due to lack of reliable data. Figueira and other researchers 2006 found that private owned banks do not necessarily outperform state-owned banks, but where there is a combination of private and foreign ownership there seem to be an improvement in performance.

Another finding by Figueira is that levels of efficiencies differ in state-owned, private, and foreign owned banks. It is also important to note that some previous studies have suggested that private ownership does lead to improved economic production and efficiencies (Megginson & Netter, 2001) . What this means is that performance in the banking sector cannot only be based on ownership but may also be associated with the economic environment as well as the legislative regulations of a particular country (Figueira, Nellis, & Parker, 2006).

CHAPTER THREE

Research Methodology

3.1 Research design

There are various methods used in complete a research topic as outlined below. Qualitative ~~r~~esearch looks at the how and the why of human decision-making process and captures the different point of views of other people about a particular subject matter without pre-determining the results. It allows the researcher to formulate the hypothesis.

Qualitative ~~D~~esign uses non-numerical data that is mostly expressed in words and the data is usually arranged in various ways depending on the research objectives. The sample size is usually smaller. The data is analysed by summarizing, categorizing and interpretation. Researchers use this type of method when they want to understand or explore an idea (Dawson, C. 2009).

For this study we will adopt the qualitative research design due to the fact that it provides a rich and contextualised picture when attempting to answer the problem questions, which is to investigate the current state of financial inclusion in South Africa, how people in low-income segments experience financial inclusion as well as ways in which the state can support the development banks and Identify how well the financial markets are currently meeting people's needs.

3.2 Sampling technique and sample size

Secondary data in the form of documents and primary data in the form of questionnaires was used to conduct this research.

Secondary data sourced from documents as mentioned above, as well as primary data in the form of questionnaires was sampled and analysed using the thematic analysis method It is important to note that a methodological triangulation method (use of more than one data source), where both secondary data and primary data were collected in order to develop a deep and comprehensive understanding of the topic being researched as well as to increase the validity and quality of the results.

Both the Secondary Data and Primary Data Methods was used to arrive at a conclusion. The secondary data around the matters of financial inclusion in South Africa as readily available and sufficient to be able to address some of the research questions. The following documents will be reviewed amongst others:

1. Statistics South Africa, General Household Survey (2020).
2. Understanding the drivers of financial inclusion in South Africa, Mhlanga, Dunga, Moloi (2020).
3. FSCA, 2022, Financial Sector Outlook Study.
4. FSCA (2020), Financial Inclusion Strategy
5. Financial Inclusion Policy: an inclusive financial sector for all by National Treasury of South Arica (2020)

6. FinScope SA Consumer 2021 Survey Results
7. FinScope SMME Survey,2020
8. SA Future Economy: Repositioning State-Owned Enterprises (SOEs) and Development Financial Institutions (DFIs) by Wits School of Governance, 2020

Primary data was collected in the form of open-ended questionnaires and a sample of 20 participants was taken from the population of Managers in the Development Financial Institutions, particularly The Land Bank, The Industrial Development Corporation (IDC) and The Development Bank of South Africa (DBSA).

Managers have answered questions by providing their own personal views and opinions on the subject matter and not as representatives of the organisations.

3.3 Method of Analysis

We have utilised the inductive thematic method for the analysis as this method has allowe for exploring and setting of various themes in which to categorise data. Thematic analysis is one of the most popular analysis methods that are used to sift through qualitative data in an organized manner in order to be able to analyse it more effectively to uncover hidden trends.

These steps followed when analysing data:

- Familiarization - which involves a lot of reading and going through the data many times in order to understand and make sense of it for my analysis.
- Data c ~~C~~oding – identifying main features that stand out and make notes and comments about what I can do with different parts of the data, as well as looking at recurring regularities in the data to determine themes that are similar or different. Use of different colors of highlighter according to each research question that we need to address.
- Generating Themes and Patterns – identifying patterns and themes in the data to form the basis of analysis.
- Reviewing the themes to make sure that they are appropriate and sufficient for my research objectives in order to make sure that the analysis is going in the right direction.
- Naming and defining the themes- to avoid confusion between different themes and data.

Write up – begin with the writing up and presentation of the findings and observations.

3.4 Ethical, confidentiality, reliability, and validity considerations

The questionnaires were distributed in the form of emails, the consent forms, and the participant information sheets formed part of the email.

To ensure confidentiality of the participants, the primary data collected is stored in my personal laptop. The laptop is password locked. The data will be stored for a period of five years from the date of collection and can be made available to the school if needed.

The study received ethical clearance from the university prior to conducting the research.

CHAPTER FOUR

4. The Analysis of data and presentation of results

This chapter's objective is to analyse and discuss the results of both secondary data in the form of documents and primary data in the form on open-ended questionnaires relating to the research questions which are "**What market failures exist in the South African Banking Sector that require government's direct intervention by way of establishing a state-owned commercial bank? Is there a need for the establishment of a state-owned commercial bank in South Africa?** AS stated in the previous chapter, the sample of secondary data was taken from readily available documents and the primary data was collected from a sample of Managers of three of the South Africa's most popular DFIs (DBSA, IDC an The Landbank).

4.1 Market failures or gaps that exist in the current South African banking system that require state intervention in the form of establishing a state-owned commercial bank

4.1.1 Current state of South Africa's socio-economic position

Woldometer (March 2023) estimates that there are 61,336,640 people living in South Africa. The main causes of South Africa's high poverty rates include factors like the country's poor economic growth, persistently high unemployment rates, increased household reliance on credit, high consumer prices, and income inequality. In the last quarter of 2022, the unemployment rate was projected to be 32%, with young unemployment projected to be 43%. South Africa has the greatest rate of inequality in the world, according to estimates from the Gini Index. The dual economy, where the wealthy keep getting richer while the poor keep getting poorer, reflects this. According to the Finscope Consumer Survey (2020), social grants account for 35% of household income in South Africa, followed by salaries from the commercial and governmental sectors at 24%, family support at 24%, and the remaining 18% from part-time work, rentals, and own businesses. The IMF Country report (2022) stated that in order for South Africa to create enough jobs for the new job market entries each year, its GDP must increase by at least 5% annually. Furthermore, it was highlighted that South Africa's domestic savings, at 16%, are well short of the 30% that is needed to support levels of investment, a sign stating that South Africans would almost certainly still be poor in the future. Despite the fact that 80% of the population has a bank account, structural problems in the financial sector have been identified to affect the economy's potential to grow. This is because cash is still the most common form of payment. According to the study conducted by FSCA (2022), cash purchases accounted for 52% of all consumer transactions in South Africa in 2018. The financial system in South Africa is also significantly bloated due to the banking sector's extreme concentration. The five largest banks, Standard Bank, FNB, Absa, Nedbank, and Capitec Bank—account for about 90% of the banking sector's assets and 83% of its deposits.

These results have the following implications:

The operational structures, technology, compliance, and decision-making practices of these banks have grown into such big organizations, better suited to the middle- and high-income segments. Large banks are therefore struggling to satisfy demand of potential clients in the low end of the economy in a way that is financially feasible The National treasury stated that lack of or limited competition may result in fewer levels of innovation, limited consumer choice, and avoided pricing competition, all of which could make banks less eager to work with lower-income groups of the population. Due to their complicated business models and technological systems that weren't created for basic accounts, big banks have exorbitant fees. National Treasury is also of the view that banks have not yet taken advantage of comprehensive credit information technology to increase take up of lending products in the SME and microlending spaces. However, the introduction of low-cost banking accounts and various distribution channels by the newly established banks has forced the larger banks to follow suite in launching their own low-cost distribution channels as well as low-cost transactional accounts, which is steadily changing the competitive environment and landscape of the South African banking sector

It is also stated that compared to other BRICS nations, South African SMME sector is underdeveloped while playing a crucial role in economic growth and employment.

4.1.2 Financial inclusion landscape in South Africa

As shown in figure 1 of appendix 2, bank account access in South Africa has increased significantly with over 89% of the population above the age of 16 having at least a transactional account. This image illustrates how far South Africa has come in integrating the previously unbanked into the country's financial system. The Financial Sector Study by FSCA state the factors that contributed to this improvement such as the introduction of affordable products such as Mzantsi account, the distribution of social grants through bank accounts, improved distribution services and digital banking infrastructure. While levels of access to bank account have improved, many other financial goods and services do not reflect this improvement. It is acknowledged in the Financial Inclusion Policy by National Treasury that many South Africans' financial requirements, particularly those of the poor and low-income earners, are not sufficiently met. Therefore, focus on gaining access to and making sustainable use of a variety of financial products and services that are suitable for client needs and financial situations is required.

The South African government has a vision of a future South Africa where every citizen has an equal opportunity to engage in the mainstream economy, as stated in the National Development Plan (2013). Due to its central position in the economy, the financial sector may play a crucial role in the growth of such a society by opening banking, insurance, and credit to a wider range of people. The government, regulators, and banking industry are given guidance by the financial inclusion policy on the three pillars that should be prioritized in order to achieve sustainable financial inclusion:

- Promote greater individual financial inclusion by improving account usage, payment infrastructure, and take up and use of insurance, savings, and productive credit.
- Increase SMMEs access by increasing credit take up for SMMEs and
- Increase competition by utilizing a more diversified base of providers and distributors, creating a more equitable regulatory environment, permitting the employment of fintech disruptors and agents in the financial distribution process.

4.1.3 Usage and penetration of financial service in South Africa

Usage refers to both utilizing the acquired services and utilizing the relevant and necessary products and services. According to Figure 2 of appendix 2, the majority of South African people have a bank account, use and digital payments are substantially lower. According to a Finscope Consumer Survey 2021, people from low-income households held 40% of the dormant accounts, while 19% immediately withdrew all of the money that was placed and another 19% are still unbanked. 46% of adult population have some formal insurance, 61% borrow from formal credit provider, while 16% of people save informally and 25% do so through a formal institution. Some usage issues mentioned on the financial inclusion strategy by FSCA are lack of trust of the formal banking sector, perceived high bank charges, inappropriate use of bank account (one deposit, one withdrawal), high levels of indebtedness, and limited financial resources.

As one of its financial inclusion strategic pillars, FSCA has committed to provide financial education programs to existing and potential financial service customers with the aim to improve and remove obstacles the prevent effective financial inclusion because of lack of knowledge and literacy.

4.1.4 Access and usage of financial products and service by small, micro and medium enterprises (SMMEs)

Small businesses have been identified as potential key drivers of economic growth and development. According to the SMME Finscope Survey (2020) as shown in figure 3-5 of appendix 2, SMMEs contribute (on average) 87%% of employment and 40% of GDP and contribute significantly to poverty reduction. The South African government strategy is to curb unemployment by cultivating SMMEs to create more jobs, alleviate poverty and redistribution of wealth. The Finscope report (2020) also tells us that there are 2,615,751 Small, micro and medium enterprises in South Africa, owned by individuals who are 16 years and older, of which 1,656,223 are informal and 959,528 are formal.

Formal businesses contribute R2.9 trillion, Informal businesses contribute R147 billion, Township economy R1.5 trillion, Rural economy R139 billion of the country's income. The survey further confirmed that 84% of SMMEs are financial included and 15% are considered financially excluded. 81% is formally served while 28% is served by informal financial institutions.

From a product update point of view, 80% of business owners are banked, 30% use accounts in the name of the business, whereas 70% still use personal accounts for business transactions making it difficult to differentiate the two entities. 75% of SMMEs save through the bank, while only 4% saves informally. 33% borrow from a bank, while 64% do not borrow for various reasons (i.e., do not need funding or do not meet the requirements). 33% of SMMEs are insured and 64% are uninsured due to lack of information about business insurance or insurance products being perceived as too expensive. Out of many barriers such as loadshedding, crime and theft affecting SMMEs in South Africa, 19% is access to finance. a finding that proves that there is still room to improve financial inclusion for SMMEs.

Most respondents from the set of questionnaires are also of the reflective view that financial exclusion for individuals in the low-income segment as well as concessionary funding for start-up business and SMMEs are the biggest failures that require serious intervention from the government. They further said that government initiatives that encourage growth of entrepreneurship, the integration of the formal and informal economies, and a decrease in the use of cash can help an economy become financially inclusive by reducing the concentration of asset ownership that exists in the banking sector and fostering competition. Lack of innovation to assist potential clients to meet regulatory requirements, as well as lack of means to recognise income from informal trading was also mentioned as one of the gaps that exist in the current banking system.

The issue of high banking costs was further validated by the responses received, examples were made about exorbitant costs that are charged on unsecured loans as the gap that a state-owned bank would be expected to close. Further comments were made on the fact that commercial banks do not offer vehicle and housing finance products that are tailor made to meet the repayment abilities of individuals in the low-income segment.

In summary, financial exclusion due to high cost of capital, high transaction fees and lack of innovation seem to be the major hurdle to advance competitive funding to developments projects for entrepreneurs and meeting the needs of those in the low-income segment, which further increases their financial vulnerability, exacerbate poverty and contributing to continuing inequality and a slower economic growth. However, one respondent expressed a strong sentiment that there is no material/major gap that exist in the market, that requires the establishment of the state-owned bank. The respondent believes that the current banks are able to sufficiently cater for every need across all income and business segments. For this reason, any additional player that comes into the banking sector will struggle to survive long term and may bring with it systematic risks in the already strong and robust financial system. The respondent went on to say that the failures and gaps that exist in the market should rather be addressed by means of policies and regulatory measures, financial engineering via government guarantees. However, the respondent also went further mentioning that the rationale of a state-owned commercial bank would be to close these gaps (i.e., due the Apartheid history of South Africa's past, there are entrepreneurs looking for commercial funding, but do not have the capacity to furnish deposits, security and guarantees that are necessary to unlock the funding.

The respondent continued to say that if the establishment of state bank would help with the removal of the above-mentioned barriers, unlock the desired funding that has a very good chance of leading to jobs creation, competitiveness and innovation in the South African economy, poverty alleviation and skills development, then by all means the state can go ahead and establish a commercial bank. If not, then it is not worth allocating resources to it. All other responses were clear in their support for this intervention-i.e. establishment state bank to address economic growth and participation by all citizens.

4.2 The role that the state-owned commercial bank would be expected to play in economic development

Based on the secondary data analysed, it is apparent that the current banking system has its limitations to aggressively fund small businesses and low-income earners where there is not proven track record, no balance sheet or no security to cover loans. Therefore, private banks may not find it profitable or justifiable the deployment of capital in building more infrastructure (branches, systems, ATM machines) in other rural towns, and communities to cater for this market segment. While State would then be able to leverage on the already existing infrastructure across geographic locations where DFI's, Post Bank and other government agencies already located. While this may require additional investments in refurbishing and installing IT systems tailored for banking platforms but would cut-out bulk of the investment costs on buildings, infrastructure. Hence optimizing on already existing resources to reach out to untapped areas and make available safe and smart banking services to residents in isolated areas.

Respondents stated that the state-owned commercial bank would be expected to provide catalytic capital in market segments where private sector investment is relatively weak, thereby promoting sustainable economic development. This bank would have the ability to have product and service offering which targets the bottom of the pyramid which is normally financially excluded from the traditional private commercial banking model, A state-owned bank would promote access to financial services to all economic participants in the society through its extensive distribution channels. A state-owned commercial bank will be expected to have the capability of providing microfinance which is a key ingredient of assisting small to medium enterprises, particularly in Africa.

Some respondents said that the state-owned bank would be expected to have financial literacy programs, to educate people about the available products and services, the importance of accessing and utilisation of these products in order to create a society that better understands what is available, where and for what purpose to inform how personal or business financial needs can be met. This approach will not only lead to an improved take up and usage of financial products and services, but the population in the bottom end of the pyramid will also start to believe and trust the financial system. This bank will be expected to lower the barriers/ criteria for products such as life cover, housing, and asset finance to accommodate the financially excluded population and SMEs. Risk mitigating measures will have to be put in place to ensure consistency (and compliance) and to ensure that these policies do not in any way compromise the financial system of the country. Offer affordable and convenient banking products and services for ease of access, thereby saving time and travel costs for users in the rural areas. Have incentive campaigns to promote savings and investments in the low-income segment.

Respondents further said that the state should ideally come in and close this gap by establishing a financial entity that will provide these services and enable extension of low-cost micro-loans to potentially profitable and social investment projects in line with objectives of the National Development Plan (NDP) which is to create jobs and promote social and economic welfare of the people of South Africa. They also mentioned that it would be great to see South African Government and private-owned banks working together in broadening access to banking services and extending credit and working capital for productive investments, especially for low-income earners and small growing enterprises. In order to have a fully productive and a fruitful economy the state need to find ways of closing market failures in the financial service sector that will complement the existing commercial banks.

4.3 Restructuring of the Postbank's governance framework to becoming a full-service state-owned commercial bank

The Postbank is one of the government institutions that has been identified as being the ideal institution to take the lead in meeting the financial services demands of South Africa's rural and underprivileged areas. Given this crucial role, the government started a process to include Postbank's banking operations within the scope of the financial services industry's legislative and regulatory framework. The South African Postbank Limited Act, which aims to establish a legal framework to permit the conversion and extension of the Postbank's role to that of a full-fledged commercial bank, was written and approved as the first step in the process. The goal is to increase the Postbank's offerings, especially for low-income and rural communities that have little to no access to commercial banking services. It also aims to give every South African the opportunity to engage actively in the economy. In his State of the Nations Address (SONA 2023), the president expressed his support for the state bank and further mentioned that the process is already underway and that the Department of National Treasury together with the Banking Sector Authorities are working on making this vision a reality.

During the meeting in Parliament on Postbank financial sustainability in September 2020, the acting CFO, Ms Pule presented the financial position of Postbank which showed total assets of R11,1 billion, a 15% growth compared to 2019, suggesting a fairly strong growth despite Covid-19 challenges. The Acting CEO, Mr Van Der Merwe also mentioned during the parliament interview that the Postbank meets the capital adequacy that is required by the Reserve Bank and went on to say that the Postbank has started investing in projects that are set to offer a fully-fledged banking service, such as the revamp of its IT infrastructure with the main focus on cybersecurity and digital outlets. It was also mentioned in the discussion that the Postbank will be separated from the South African Post Office, and that a new holding company (Bank Controlling Company) will be created to ensure success of the state bank.

The idea of converting the Postbank into a full-service commercial bank seem more viable as opposed to spending resourcing to establish a new state bank from scratch. Also taking into consideration the Postbank’s infrastructure that already exist all around South Africa and in all nine provinces.

4.4 The role that the state-owned bank would play in enabling the DFIs meaningful contribution in the economy

Based on the views of well-informed respondents, Development Finance Institutions (DFIs) do not have the capacity or capabilities to accept deposits from their clients. Secondly since government no longer have enough resources to provide grants to DFIs, these institutions have over the years become self-funded. Their funding structure is such that they must raise capital by borrowing from multilateral institutions and commercial banks at exorbitant interest rates and utilise these funds to lend to their clients for developmental purposes. Therefore, the high cost of capital is considered to be a major hurdle and market failure to advance competitive funding to development projects. In pursuit of financial inclusion and support of socio-economic investments, the state-owned commercial bank should be the solution to address accessibility to affordable cost funding in order to drive economic development and not just reliance on debt funding or government grants. Some respondents said that currently DFIs have billions of ZAR that is sitting in the commercial banks earning interest and not doing the developmental work. Such moneys when DFIs now bank with state Bank then this money can be put to good use by having all the cash of DFI's now banked with the state bank amongst other funding means. This cash can used as a funding mechanism for capital required to support development, largely from profits earned and other government grants currently in circulation. State bank could also incorporate DFI's into this bank as divisional units in line with their specialization. Other strong views were raised to say the State Bank can serve as a central treasury function for all DFI's as its holding entity, with proper controls on their cash management, liquidity, and governance. Its ability to deposit taking, generating of transactional income would contribute to their funding model and grow their business operations without heavy reliance on debt capital markets. Some respondents said that there could be co-funding of projects and lending that happens between state bank and DFIs. Co-funding means sharing of risks in projects where the mainstream commercial banks are not able to lend money for such projects due to lack of appetite and high risk. Other emphasis viewpoints were expressed to say in order for the DFIs to play a role that is adequately transformative to meet the massive challenges facing the South African economy, institutions such as the IDC and DBSA and The Landbank need to be scaled up through the state-owned commercial bank, by way of issuing guarantees, and low-cost source of funding. Should there be a need to incorporate some of the existing DFIs into the State-Owned Bank these considerations may be considered as phase two of the programme for the implementation of the State-Owned Bank.

There was one respondent who said they do not see how a state-owned commercial bank will enable DFIs in the economy. In fact, the causality is the opposite way round, namely that DFIs should be unlocking commercial credit in the South African banking sector and economy. The respondent was asked to expand further; however, no response was received as at the time these results were put together.

In summary to the above, the motivation behind the establishment of the state-owned bank should not necessarily be to compete with the commercial banks as this will be ill-advised given different roles meant to be played, with already a well-functioning financial system for the established businesses and professionals, with majority of households in the medium to high income groups. Instead, it should come in as a complementary bank to close the gaps that currently exist in the market by making sure that everyone gets a fair chance of participating and contributing in the economy to cab the issues of financial exclusion, inequality, joblessness, and poverty that South Africa is facing.

4.5 Performance measures and corporate governance structures that the government can put in place to ensure the success and long-term sustainability of the state-owned commercial bank

Some respondents said that the government can measure performance by developing a balanced corporate scorecard which captures metrics such as:

- Financial Sustainability which measures how well the state bank could cover its costs if the operations where unsubsidized and if it were funding its expansion with liabilities at market prices.
- Profitability ratios-return on equity (ROE), return on assets (ROA)
- Asset quality ratios- acceptable Non-Performing Loans (NPLs), Write offs, Impairments Ratios

Other respondents also mentioned that accountability and transparency are key to the success of any business, therefore, a capable and competent Board should be appointed and given the oversight mandate, where there would be no mingling of government officials and shareholders on the day-to-day operations of the bank. The corporate governance structures should be the same as those applied in commercial banks to allow this institution to be agile to meet client service expectations. The King IV and Risk Management approach similar to that of commercial banks should be adopted with slight adjustments to allow for financial inclusion objectives. It was also said that quarterly monitoring, evaluation and impact assessment processes could play a crucial role in ensuring the success of the state bank.

CHAPTER FIVE

Conclusion and recommendations

This report investigates the market failures that exist in the South African banking sector that require government's direct intervention by way of establishing a state-owned commercial bank and whether or not there is a need for the establishment of a state-owned commercial bank. The results from the secondary data indicated that 19% of the population is living in extreme poverty. South Africa is one of the most unequal nations in the world. According to estimates from the World Bank Annual Report, 2022, the wealthiest 10% of the population produces 65% of the nation's income while the bottom 50% only contributes 5.3%, demonstrating why poverty and inequality are so pervasive in the nation. Due to their restrictive operating methods and limited funding sources, development banks are suffering with high levels of non-performing loans and significant impairments. Institutions that cater to the financial requirements of persons who are underbanked and unbanked are lacking in the South Africa.

Financial inclusion has drawn attention and acknowledgment from all around the world as a means of achieving inclusive and sustainable growth. To restructure the financial system and to better serve low-income and vulnerable households, and ultimately the country, major financial organisations must collaborate closely with government authorities and the larger South African population. The government has launched a variety of programs throughout the years to speed up financial inclusion in the nation, and these initiatives include easing of regulations to promote entry into the banking sector, improving governance of the Postbank, taking forward the financial sector charter by creating enabling frameworks for corporative banks. In addition, the banking sector has also launched several programs to take advantage of cutting-edge technology and deliver novel and more affordable products to the market.

Based on the results of the data collected, both primary and secondary, there is a gap in the market and a missed opportunity because current commercial banks do not have the appetite to provide credit facilities to start-up and small firms. Secondly, DFIs do not seem to be making enough strides to close this gap due to limitations in their funding structure and the capital raising model. Issues like these can be a factor in inequality, prolonged poverty, and slow economic growth. Inclusive financial institutions that allow for broad access to financial services without any cost barriers are likely to benefit poor and disadvantaged communities. Without access to bank account and sources of credit, poor people often have to rely on their low incomes to pay for education and small businesses cannot pursue growth prospects due to limited financial resources. South Africa lacks institutions devoted to the financial needs of the underbanked and unbanked citizens. The fact that commercial banks do not have the appetite to issue micro-loans to start-up and small businesses represent a gap and missed opportunities in the market. Issues such as these can contribute to slow economic growth, prolonged poverty, and inequality. The State Bank would have a different focus, serving different interests that are socio-economic related. While development is high risk, but if funded appropriately and optimally with adequate support mechanisms it may succeed. Most big businesses also have their own humble beginnings but succeeded because someone gave them a chance through optimal funding support amongst others. Looking at the changes (i.e, upgrading of the IT infrastructure and the application of a full-service banking licence) and developments that The Postbank has gone through over the past few years, it is becoming clear that the government is forging ahead with the establishment of the state-owned bank through the conversion of The Postbank.

However, if not implemented and managed appropriately, the state commercial bank may pose serious threats on the current financial system, which is why factors such as good corporate governance structures and success measures cannot be ignored. The respondents are of the view that the motivation behind the establishment of a state-owned bank should not necessarily be to compete with the privately owned commercial banks, as this will be ill-advised given the different roles that are meant to be played, with already a well-functioning financial system for established businesses and professionals in the medium to high income groups. Instead, the state-owned commercial bank should come in as complementary with the objective to close the gaps that exist in the market in making sure that every citizen has a fair chance of participating and contributing in the economy to cab the issues of financial exclusion, joblessness, inequality, and poverty that South Africa is currently facing.

CHAPTER SIX

Limitations and recommendations for future research

There is limited literature on state-owned commercial banks in the South African context. Therefore, the literature reviewed was limited to the financial inclusion status of South Africa, an overview of the banking sector, the DFIs, as well as the South African banking sector regulatory bodies and frameworks. However, The Bank of China was also used as the example of a successful state-owned commercial bank.

Amongst the many key Development Financial institutions in South Africa, we decided to include the Land Bank, the Industrial Development Corporation (IDC) and the Development Bank of South Africa (DBSA), which in our opinion are key and relevant for our study.

Subsequent research would look at the implementation process of the state-owned South Africa commercial bank.

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APPENDICES

Appendix 1

1.1 Ethics Clearance Certificate

Graduate School of Business Administration
University of the Witwatersrand, Johannesburg

Wits Business School Ethics Committee
Constituted under the University Human Research Ethics Committee (Non-Medical)

Ethics Clearance Certificate

Ethics protocol number: WBS/BA2498970/470
This certificate is only valid with a legitimate ethics protocol number and signed by the Researcher (below).

Project title	The establishment of a state-owned commercial bank and its impact on the South African economy
Investigator / Researcher	Mrs Zandile Diza
Nature of Project	MBA (Research Article)
Decision of the Committee	Approved, provided stakeholders and participants are guaranteed confidentiality.
Issue Date of Certificate	16 09 2022
Expiry date	Date of submission of the project / research report
Chairperson	Prof Anthony Stacey ☎ +27 11 717 3587 +27 82 880 4531 anthony.stacey@wits.ac.za

Declaration by Researcher

One copy must be signed by the Researcher and returned to the Chairperson of the Wits Business School Ethics Committee.

I fully understand the conditions under which I am authorized to carry out the abovementioned research and I guarantee to ensure compliance with these conditions. Should any departure to be contemplated from the research procedure as approved I undertake to resubmit the protocol to the Committee.

Signature

27 September 2022
Date:

1.2

Master of Business Administration

Participant Information Sheet

Title: The Establishment of a state-owned commercial bank and the impact on South African Economic Development

By Zandile Diza

Wits Business School – University of The Witwatersrand, Johannesburg.

I would like to invite you to participate in the above-mentioned research study. Before you make a decision whether or not to take part, it is important for you to understand what the study is about and what it is hoping to achieve. Please take time to read the information below and feel free to ask questions should you require clarity.

The purpose of this study is

1. To investigate the factors that necessitate the establishment of a new state-owned bank.
2. Examine the expected contribution of the new state bank in enabling the Development Financial Institution's role and performance in economic development.
3. Establish if the state bank would be able to address the needs of those outside the current banking system, who are under-funded, including those who have limited banking access due to low-income levels and geographic locations.
4. To explore corporate government structures that the government could have in place to ensure the success of the new state bank.

Participation in this study is voluntary. Should you wish to participate you will be required to complete a set of six open ended questionnaires in your personal capacity where you will provide me with your opinions and views around the expected objectives of a state-owned bank and what performance measures would have to be put in place to ensure its success.

It will take you approximately 10 minutes to complete the questions. The Questionnaires are in a word document attached to the email and you will be required to complete your answers on the fields provided.

Copies of completed questionnaires will be stored in a password locked computer. I will maintain confidentiality of all research data and all participants will remain anonymous in the publication of this study.

I will inform you by email once the research project is completed and provide you with information on how you can access the full report and the findings. You are also welcome to contact me on the details provided for any enquiries related to this research.

Details of the researcher:

Zandile Diza, 2498970@students.wits.ac.za/ zdiza0415@gmail.com, 071 894 4855

Supervised by:

Prof Eric Schaling and Dr Jacques Totowa. Eric.schaling@wits.ac.za and Jacques.totowa@wits.co.za. 011 717 8885/ 011 717 3660

1.3

Master of Business Administration

Participant Consent Form

For the Managers of the Development Financial Institutions: The Land Bank, IDC, DBSA

Title of the study:

The Establishment of a state-owned commercial bank and the impact on South African Economic Development

I can confirm that I have read and understood the contents of the study as stipulated in the participant information sheet.

I understand that my participation is voluntary and that I am free to withdraw any time without providing any reason or facing any consequences.

I also understand that I can withdraw my data at anytime

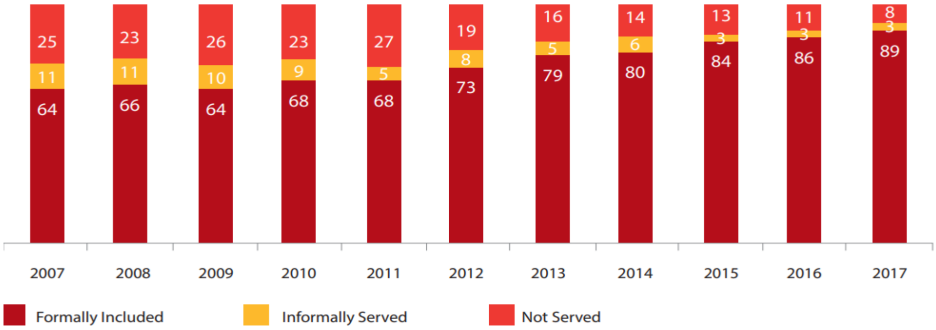
I understand that the information and data collected will be kept confidential and the identity information will not be disclosed publicly

I hereby consent to the use of the data that I have shared in the form of answering the set of questionnaires as provided by the researcher.

Name of Participant	Date	Signature
Researcher	Date	Signature

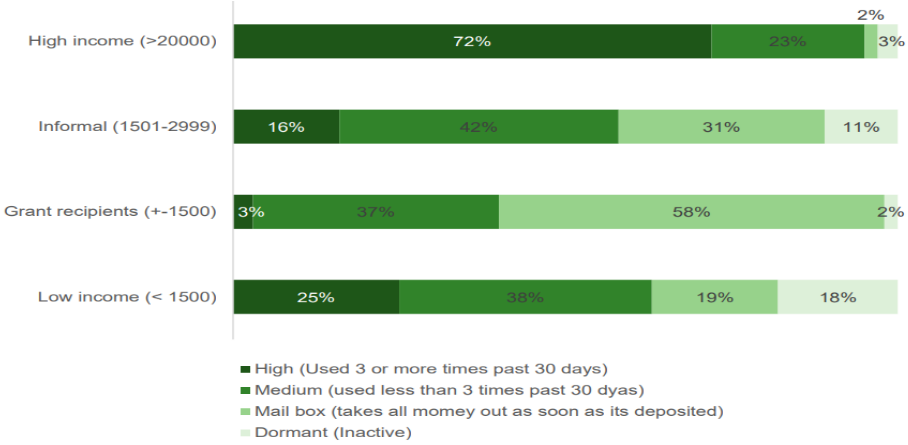
Appendix 2 Secondary data research instruments

Figure 1. South Africa Financial Inclusion Landscape



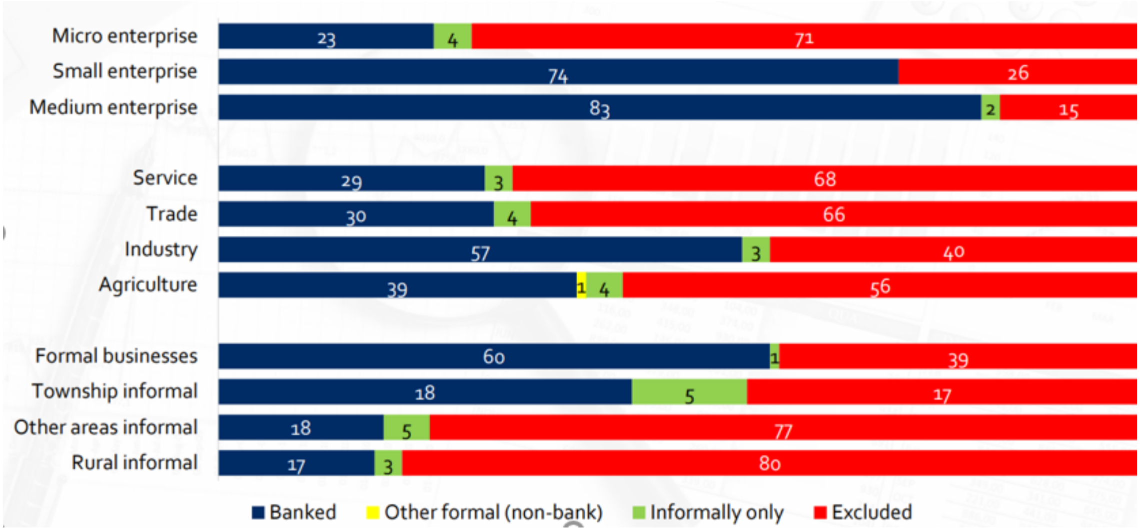
Source: Department of National Treasury (SA), 2020

Figure 2. Frequency of bank account usage by income group



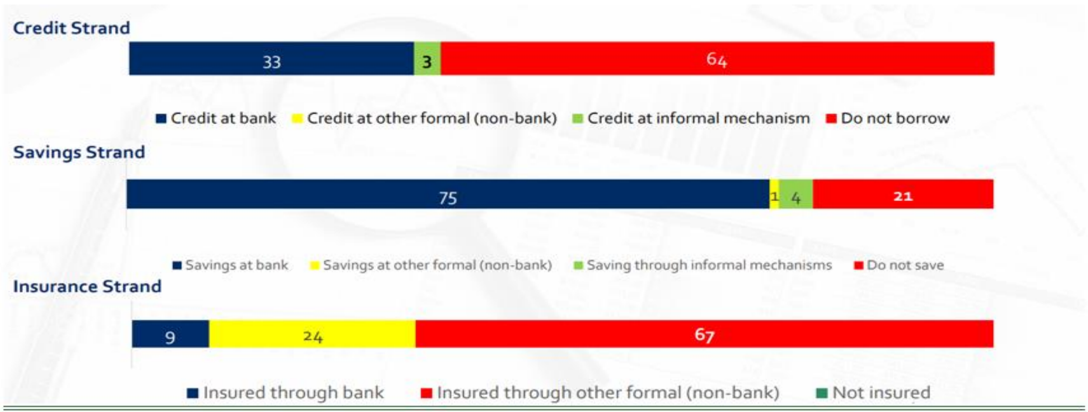
Source: FSCA,2022

Figure 3. Access to credit by size of the business and sector



Source: FinScope SMMES (SA) (2020)

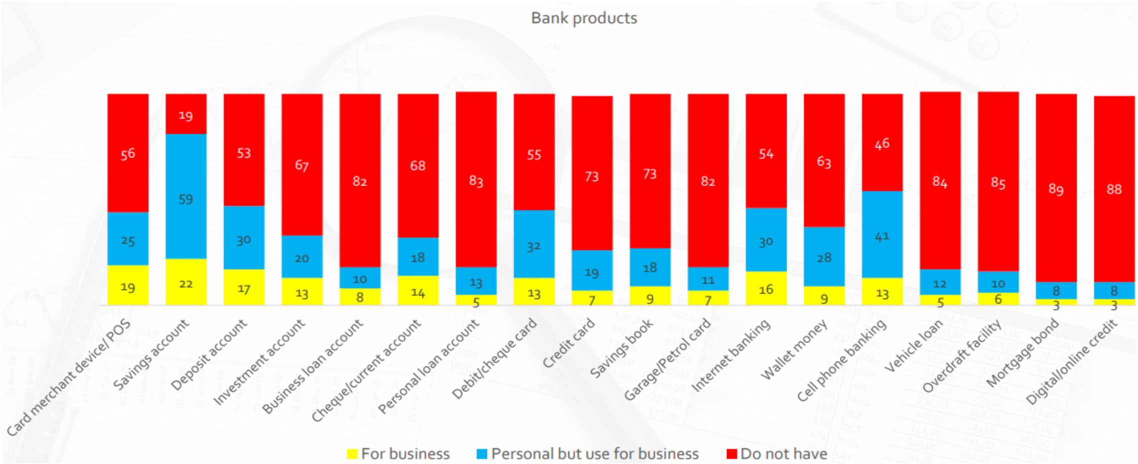
Figure 4. SMME (SA) financial inclusion by product



Source: FinScope SMME (SA),2020

Figure 5. SMME (SA) bank product penetration

o



Source: Finscope SMME (SA),2020