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Class of Business Training

Module 2 (B): Deposit taking fundamentals

Class 5: Short-term and Long-term Deposits

Class 6: Structured Deposits

Written by: Anna Bouhail

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INTRODUCTION

The participant must have completed and passed the COB Module 1 (A) - Overview of the financial services sector first before undertaking this module.

This module forms part of the Class of Business Training for Business Class 5 & 6: Short-term and long-term deposits | Structured deposits

It is a prerequisite to complete and pass this module before completing one or all of the following modules:

- COB Module 3 (5) – Short-term and long-term deposits: Class 5
- COB Module 3 (6) – Structured deposits: Class 6

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For permission request write to the author at the address below:

1 Bracken Lodge

10 Roy Campbell Street

Brackenhurst

Alberton

1449

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TOPIC 1 OVERVIEW OF THE DEPOSIT TAKING INDUSTRY

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Outline the different types of deposit taking institutions and their regulatory framework.
- Describe the South African banking system.
- Describe the key role of banks.

1.1 INTRODUCTION

A deposit is an amount of money paid by one person to another, subject to an agreement that an equal amount, with or without interest, will subsequently be repaid to the person making the payment on demand or at a specified or unspecified date.

In South Africa there is several deposit taking institutions and several type of deposits. Regulation in South Africa has mainly differentiated between three broad types of deposits:

- **Short-term deposit:** A deposit including a foreign currency deposit with a maturity not exceeding 12 months but excluding a structured deposit.
- **Long-term deposit:** A deposit including a foreign currency deposit with a maturity exceeding 12 months but excluding a structured deposit.
- **Structured deposit:** A structured deposit is defined in the Financial Advisory and Intermediary Services Act as one of the following:
 - Combination of a short-term deposit or a long-term deposit or any tier 1 financial product.
 - A short-term or long-term deposit where the return or value is dependent on the performance of or is derived from the return or value of one or more underlying financial product, asset, rate or index, on a measure of economic value or on a default event.

The South African Reserve Bank (SARB) oversees the prudential regulation of deposit taking institutions and divide deposit taking institutions into 4 broad categories:

- Banks
- Co-operative banks
- Co-operative financial institutions
- Mutual banks

Other institutions that perform deposit taking activities but that is not directly regulated by SARB includes the following:

- Stokvels
- Ithala Development Finance Corporation
- Postbank

The sections following will consider each of these deposit taking institutions, with banks being the most important in terms of market size and regulation.

1.2 BANKS

Banks accept deposits from the general public, provide payment services such as cheques and electronic transfers, and make available credit such as overdrafts, home, term or asset-backed loans. Banks offer additional services to their clients such as trust and custody services

Banks make a critical contribution to economic performance in the following manner:

- Taking deposits and extending loans.
- Facilitating transactions and providing payment, clearing and settlement services.
- Providing a variety of financial products that enable the corporate sector and households to cope with economic uncertainties by hedging, pooling, sharing and pricing risks.
- Reducing the cost and risk of investment, and of producing and trading goods and services.

The first of these points relates to the familiar role of banks as financial intermediaries (taking deposits from individuals and corporates with surplus funds and lending them to those who require such funds). In doing so, they are uniquely able to create money through the fractional reserve system.

Banks are for-profit institutions and must be legally incorporated as public company with the shareholders as owners.

1.2.1 The South African Banking system

Despite recent credit-ratings downgrades, South Africa still has a well-developed banking system which resembles the United Kingdom' system. It consists of three key elements:

- The South African Reserve Bank (the country's central bank).
- Private sector banks (commercial banks, merchant banks, and general banks).
- Mutual banks.

The South African banking system weathered the recent global financial crisis relatively well and remains relatively stable and the South African Reserve Bank reported that banks were adequately capitalized. South African banks hold the first six places among the top 100 banks on the African continent. Four large banks dominate, with Standard Bank of South Africa, Nedbank, ABSA and FirstRand Bank collectively accounting for around 85% of banking services in South Africa. A new banking entity, Capitec, has made significant inroads into the unbanked and entry-level banking segment.

In total, there are approximately 70 foreign banks operating in South Africa, either via representative offices, branches, subsidiaries or joint ventures with local companies.

International banks in the country have focused on offshore lending (where they have a competitive advantage as a result of their low overheads and their ability to raise funds at comparatively favorable rates), as well as treasury activities for corporate clients and government.

All banks offer a comprehensive range of products and services through extensive branch and electronic banking infrastructures, serve a wide client base, and have the characteristics of universal banks.

Based on population numbers, South Africa does not appear to be over-banked, as one branch exists for approximately every 9,500 persons. However, a large portion of the population does not have access to normal banking services and uses only a few products. Many Black South Africans tend to save outside the formal banking sectors and choose to save in cooperative savings institutions called stokvels. Excluding the non-banked segment of the population, it is estimated that there is one branch for every 3,200 persons.

Electronic banking has become commonplace. The banking sector is overshadowed by the four largest retail banks that set cost and service standards. Attempts by authorities to make the banking sector more cost-effective and service orientated, especially to new entry-level clients, have met with limited success.

1.2.2 The key role of banks

Although financial institutions can do some of what banks do without being registered as banks – such as offering loans and facilitating transactions – banks are unique in certain key aspects. It is their ability to influence the rate of investment through financial provision that gives them a key role in the economy.

The two aspects that enable banks to influence the rate of investment are as follows

- The ability to create money.
- The ability to raise funds for investment projects.

These two aspects are considered in the subsections following.

1) Money creation

Money is commonly defined according to its functional roles. These are money as a measure of value (also referred to as a unit of account), a medium of exchange, a store of value, and a standard of deferred payments.

Modern money consists primarily of two types of monetary instruments (Denoted by M1).

The first is the notes and coins issued by central banks (This is known as currency – denoted by C).

The second type is composed of bank liabilities, also referred to as deposits, credit money or bank money (This is denoted by D).

The measurement of money supply in modern economies therefore includes measures of both the amount of cash money and bank money, therefore $M1 = C + D$

Bank money is a record of debt-credit relations. The creation of this type of money has been understood to be the result of an inter-temporal exchange transaction between parties since the earliest influential discussions on modern bank money.

The supply of currency

Nobody but the central bank (or those to whom it grants authority, such as the South African Mint Company and the SA Banknote Company) is allowed to print notes or to mint coins.

The central bank, however, needs to take into account the number of coins and banknotes that the system requires. Hence, while the central bank is proximately responsible for the supply of currency, the amount provided is essentially determined by the needs of trade. In supplying coins and banknotes, the central bank is simply accommodating the needs of trade. If consumers decide that as from tomorrow they wish to increase the number of coins and banknotes they use in transactions (and correspondingly decrease the transactions financed by cheques and Internet transfers), the central bank would (over time) sense the need to feed more coins and banknotes into the system.

From this point of view, the supply of coins and banknotes is not something determined from outside the system (i.e. it is not exogenous) but from within the system (i.e. it is endogenous).

So, when we say that banks can create money, we do not have in mind the creation of coins and banknotes. In South Africa, demand deposits are by far the largest component of M1 (more than 90%). From this point of view, coins and banknotes represent the small change of the economic system and if we talk about banks creating money, we must be talking about the non-currency part of the money supply.

The supply of deposits

The most notable feature of a bank is that their clients can open demand deposits. Demand deposits are characterised by the fact that the bank is obliged to pay out the deposit in cash or transfer it immediately on demand to another bank or account holder. A demand deposit can therefore be treated as money.

A demand deposit can be created in two ways.

Firstly, a demand deposit can be created if the person deposits money into the account or by transferring money from another account. In this instance the bank did not “create” any money as a decrease in currency was reflected in the increase in deposits. A change in the money supply can be expressed as follows:

$$\Delta M = \Delta C + \Delta D$$

Let say a person deposit R1 000 into a saving account, the formula will be affected as follows

$$\begin{aligned}\Delta M &= -R1\ 000 + R1\ 000 \\ &= R0\end{aligned}$$

Secondly, a demand deposit can be created by an overdraft facility. In this case the role of the bank is more active. The money has deliberately lent money and thus created credit. As a result, the money supply in the country has been increased. If a R1 000 overdraft will be extended to a client, the change in money supply will be affected as follows:

$$\begin{aligned}\Delta M &= \Delta C + \Delta D \\ \Delta M &= R0 + R1\ 000 \\ &= R1\ 000\end{aligned}$$

Although banks can create credit, as illustrated above, there are definite limits to the amount that can be created. It must be kept in mind that deposits can be withdrawn at any time. Cash and demand deposits can be arbitrarily substituted for each other. Each bank must therefore ensure that it always has sufficient cash reserves available to provide for cash withdrawals or transfers to other banks.

Therefore, a bank must set out aside a percentage of total deposits received for this purpose in the form of cash reserves. To maintain confidence in the banking system the South African Reserve Bank lays down legal requirements, stipulating the amount of cash reserves to be held against the total liabilities (demand deposits) of a bank. This percentage is called the reserve requirement. The supply of bank deposits is also further constrained by the capital adequacy requirements. South Africa's current minimum reserve requirement of 2,5 % of total bank liabilities, excluding issued capital and reserves, is broadly similar to that of G7 countries.

The required increase in cash reserves (R) as a result of an increase in demand deposits (ΔD) can be calculated as follows:

$$\Delta R = b \times \Delta D$$

where b = required cash reserve ratio expressed as a percentage

Any increase in demand deposits will raise the required minimum cash reserves. For example, if the cash increase in demand deposits amounts to R2 000 it means that an additional R50 will be required as cash reserves:

$$\begin{aligned}\Delta R &= b \times \Delta D \\ &= 0.025 \times R2\,000 \\ &= R50\end{aligned}$$

Alternatively the amount of demand deposits will have to be reduced to meet the cash reserve requirement. The equation can be rewritten to express the change in demand deposits as a function of the change in required reserves:

$$\begin{aligned}\Delta R &= b \times \Delta D \\ \Delta D &= \frac{1}{b} \times \Delta R \\ \text{where } \frac{1}{b} &= \text{credit multiplier}\end{aligned}$$

If $b = 2,5\%$ then $\frac{1}{b} = \frac{1}{0,025} = 40$. This means that if the banks receive an additional amount in cash, they can create an amount of demand deposits equal to 40 times the initial increase in cash reserves.

We can also use this equation to calculate the increase in demand deposits as a result of R50 increase in cash reserves:

$$\begin{aligned}\Delta D &= \frac{1}{b} \times R \\ &= 40 \times 50 \\ &= R2\,000\end{aligned}$$

An increase in the cash reserve requirement of banks will reduce the credit multiplier. To meet the new requirement, the banks will have to keep more cash reserves with the central bank or alternatively, reduce the amount of demand deposits by for example, requiring clients to pay of their overdraft facilities.

For example, if the cash reserve requirement (b) is double from 2,5% to 5%, the credit multiplier will be halved from 40 to 20 and required cash reserves will double.

Although variations in the cash reserve requirement may be used occasionally when structural changes in the financial sector occur, these variations are not an essential part of the present monetary control system in South Africa. The South African Reserve Bank seeks to control the amount of demand deposits by influencing the cost of demand deposits (the repo rate) rather than by variations in the cash reserve requirement.

This will be discussed in more detail under monetary policy.

II) Raising funds for investment projects

Commercial banking typically refers to the process of deposit taking with a view to on-lending such funds. By contrast, investment banking (also sometimes referred to as merchant banking) involves the activities required to raise funds so that third parties can undertake projects. Traditionally, different types of banks conducted these functions, although many banks now perform both.

The activity of investment banking enables a firm to undertake investment. In raising funds for investing entities, banks can access funds in the capital market or via private equity. Capital market funds can be raised through sale to the public of the investing entity's shares or other securities such as bonds through the securities exchange. Private equity or venture capital is raised directly from funds and individuals by offering them a stake in the investment. To fulfil the function required to raise funds, a bank typically acts as an underwriter and agent for the investing entity. Underwriting involves evaluating the investment or entity and bearing the risk of selling the securities and the cost of holding them – until they are sold.

As an agent, the bank is required to promote the securities. Sometimes these activities are described as sell-side activities, or activities associated with meeting the needs of suppliers of investment projects. However, banks also need to deal with the demand side – i.e. the buyers of these investment projects. Demand comes from pension funds, mutual funds and hedge funds, and also from the public. In providing these services, banks act as consultants to non-bank firms and funds, offering research and advice services.

1.2.3 The bank as intermediary

Apart from the money creating function, banks also an intermediary, channelling funds from surplus to deficit units. On the one hand there are individuals and entities who have surplus funds at their disposal, and on the other, there are individuals and entities who require loans

To appreciate the role of banks as payment service providers, we have to take into account that a substantial number of the payments made by bank clients will be payments to clients of a different bank. Such payments will involve interbank transfers.

When a client of Bank A writes out a cheque to another client of Bank A, the transaction is an intra bank one; the bank will neither accumulate nor loose reserves. Somebody's account at Bank A is being debited while the account of somebody else at the same bank is being credited. If, however, an interbank transaction is involved, the process is more complicated. In effect the person making out the cheque is instructing Bank A to pay another bank the amount of the transaction, and in the process Bank A loses reserves. Such interbank transactions are usually settled via the accounts that banks hold at the central bank.

During the trading day, of course, clients at other banks will be making payments to Bank A clients, in which case Bank A accumulates assets in the form of increased clearing account balances, and liabilities in the form of increased deposits.

At the end of the trading day it is the net amount that banks owe each other that is important. The term clearing bank arose from the idea that at the end of a trading day, banks would net out the amounts that they owed each other. Such a clearing process would take place through the books of the central bank, at which institution the banks themselves held accounts. Different processes may be used by banks for settling the net amounts owed. If Bank A owes Bank B R7 million and Bank B owes Bank A R5 million, the two transactions can be resolved by Bank A paying Bank B R2 million – we can call this the net method. Alternatively, Bank A can pay Bank B R7 million and Bank B can pay Bank A R5 million – we can refer to this as the gross settlement method, which is the one used in South Africa.

As intermediary, the bank will pay interest on positive balances (referred to as the interest expense of the bank) and will charge a higher interest rate for the funds they lend (interest income). From their intermediation services, then, banks earn what is referred to as interest margin (interest income less interest expenses), also known as net interest income.

Banks also provide services for which they charge fees. These include the following:

- Transactions for payment services – such as for processing a debit order or drawing cash at an ATM, or for current account facilities and Internet banking.
- Investment- and trading-related activities.
- Financial advice.
- The management of investment funds.

The income earned from these services is typically referred to as non-interest income. When operating expenses are deducted from this, we have net non-interest income. Together, net interest and net non-interest income constitute the total revenue for banks. Over time, non-interest income for banks has become an increasingly important part of the income of banks. This is a consequence of other financial intermediaries providing competition in investment and loan products – and hence eroding the interest margin – as well as the increasing tendency for banks to charge explicitly for each service provided.

As intermediary, the bank generally borrows funds from individuals and entities that may have to be repaid at short notice but the lend to individuals and entities over a longer term. The loans that banks make represent assets to the bank and the deposits that they receive represent liabilities. This means that the bank is taking a risk. This, of course, is how it generates profits, because the interest rate it pays out to short-term lenders will invariably be lower than the interest rate it earns on the funds it lends out to borrowers.

There are several types of risk involved, one of which is the risk of default – certain borrowers will be unable to service the debt owed to the bank. To guard against this risk, banks may require some sort of collateral. The other types of risk have to do with the possibility that those who have deposits at the bank will, from time to time, want to liquidate them.

Should all clients want to liquidate their assets (deposits) at the same time, the bank will be in trouble. In such a case, the bank will simply not have enough cash and other liquid assets to repay all the deposits, since it has borrowed short term and lent long term. When this happens, we have a run on a bank, which may well lead to the closure of the bank. Fortunately, this happens rarely. This risk is called funding liquidity risk and lies at the heart of banking.

To deal with the fact that consumers will be withdrawing deposits from time to time, banks have to keep a portion of their assets in the form of currency. However, what is prudent to keep in the form of reserves today may not be considered prudent enough tomorrow. What really worries regulators is when the funding liquidity risk is transmitted to more than one bank, i.e. when liquidity risk becomes systemic. In this situation, a run on a single bank serves as a signal for depositors of other banks to withdraw, thus triggering the collapse of the entire banking system.

Because of the risks involved in banking, banks impose prudential behaviour on themselves. Over and above this, we may identify the requirements imposed on them by the regulatory authorities.

1.2.4 Regulatory framework

The banking system have a number of characteristics that motivate and direct regulation. Such characteristics are related to the following:

- The roles that money plays and the essential requirement for confidence therein.
- The distinct nature of financial contracts.
- The potential for pervasive private and social costs where market failures occur.

Matters of confidence are intertwined with all three characteristics. Market participants need to have confidence in money as a means of payment, a unit of account and a store of value. The regulatory role of the government has to do with maintaining public confidence in the ability of money to play these roles.

The evaluation of financial contracts and the relative value of financial goods and services are complicated because of the nature of such goods and services. The quality of a financial contract can be ascertained only after a significant delay, if ever (this is known as credence goods).

An extreme form of this would be a long-term investment product where the quality of the product may never be fully ascertained. Consumer decisions to purchase credence goods and services from financial entities speak of a confidence in the regulatory structures that afford them a critical element of protection. We can see that if consumers are to purchase financial services, market participants need to have confidence in the conduct of individual firms, and in the integrity of the system as a whole.

The failure of one bank should not lead market participants to believe that the entire system will be threatened. Confidence in a system that protects against externalities and systemic risk is crucial. Systemic risk is the risk of a sudden unexpected collapse of a significant portion of the financial sector so that economic activity in the wider economy suffers. A functionally efficient financial system requires confidence at both the micro- (or institutional) and macro- (or system) levels.

The supervisory framework has to adapt continuously to changing (and demanding) banking and financial conditions. The Registrar of Banks, who is appointed by the South African Reserve Bank (SARB), subject to the approval of the Minister of Finance, is responsible for the regulation and supervision of banks under the auspices of the SARB's Prudential Authority.

1.3 CO-OPERATIVE BANKS

A cooperative bank is a cooperative that provides its members with a range of banking and financial services. The members are both the owners and the clients of the bank. The members of cooperative banks must comply with one of the following:

- Are employed by a common employer.
- Are employed within the same business district.
- Have common membership in an association or organisation, including a religious, social, cooperative, labour or educational group.
- Reside within the same defined community or geographical area.

Cooperative banks potentially include credit unions where members contribute to the communal deposits and allow for loans from this communal funding.

The features of cooperative banks are as follows:

- **Cooperative banks are client-owned entities:** As a result, the strategic objective of a cooperative bank is not to maximise profit, but to provide the best possible products and services to its members.
- **Cooperative banks are under democratic member control:** Cooperative banks are owned and controlled by their members, who democratically elect the board of directors. Members usually have equal voting rights, i.e. one person, one vote.
- **Cooperative banks allocate net profit to members:** In a cooperative bank, a significant part of the annual surplus is usually allocated to reserves. However, a part of this profit may be distributed to members through interest or dividends related to the number of shares subscribed to by each member.
- **Cooperative banks are deeply rooted in their communities:** The members and management board of a cooperative bank belong to the community in which the cooperative bank undertakes its activities. As a result, cooperative banks are typically involved in and contribute to the sustainable development of their communities by increasing financial access in areas where commercial banks are absent. For example, cooperative banks provide banking and other financial services to micro-, small and medium enterprises in the community, farmers in rural areas, and middle- or low-income households in urban areas.

Although the institutional structure of a cooperative bank differs from that of a shareholder bank (i.e. cooperative banks are owned by their members while shareholder banks are owned by their shareholders), cooperative banks are on par with shareholder banks in that they are supervised and overseen by regulatory authorities and must comply with prudential banking regulations.

In terms of the Cooperative Banks Act 40 of 2007, there are four types of cooperative bank:

- Primary savings cooperative bank.
- Primary savings and loans cooperative bank.
- Secondary cooperative bank, which may be established by two or more primary cooperative banks.
- Tertiary cooperative bank, which may be established by two or more secondary cooperative banks.

The Prudential Authority is responsible for the supervision of all registered co-operative banks, whilst the Co-operative Bank Development Agency (CBDA) is responsible for training needs of the sector.

1.4 COOPERATIVE FINANCIAL INSTITUTIONS

According to the International Cooperative Alliance, a cooperative is an autonomous association of persons who unite voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise.

The International Cooperative Alliance's Statement on the Cooperative Identity sets out the values upon which cooperatives are based and specifies seven principles by which cooperatives put these values into practice. The values are self-help, self-responsibility, democracy, equality, equity and solidarity, and a belief in the ethical values of honesty, openness, social responsibility and caring for others.

The principles are as follows:

1. Voluntary, open and non-discriminatory membership.
2. Democratic member control.
3. Member economic participation.
4. Autonomous, independent, self-help organisation.
5. Education and training for the members, elected representatives, managers and employees of cooperatives, as well as the provision of information to the public about the nature and benefits of cooperation.
6. Cooperation among cooperatives to strengthen the cooperative movement by working together through local, national, regional and international structures.
7. Concern for the community.

There are a number of types of cooperative, such as agricultural, housing, marketing, building and construction, financial, savings and credit cooperatives (also called credit unions), and financial services cooperatives (also called village banks). Financial cooperatives, savings and credit cooperatives and financial services cooperatives – collectively termed cooperative financial institutions – are considered further in this subsection.

Cooperative financial institutions are closed cooperatives that offer banking-related services to their members and receive funds from members against the issue of shares or by the subscriptions of members. They also accept savings from their members and provide them with credit facilities.

Cooperative financial institutions, as financial intermediaries, adopt additional principles besides the seven principles contained in the Statement on the Cooperative Identity. These are as follows:

- **Mutual aid:** Cooperative financial institutions combine the financial resources of their members and accept the reciprocal guarantees of members for loans.
- **Margin management:** Cooperative financial institutions operate and compete within the financial sector of the economy. This implies that their interest rates should be market orientated. In addition, margin management will be required, as the margin between the interest rate paid on deposits and that received on loans will need to be sufficient to cover expenses and build up capital and reserves.
- **Risk management:** Since cooperative financial institutions operate as financial intermediaries, sound risk management principles should be applied.
- **Savings mobilisation:** Cooperative financial institutions attach a high priority to savings mobilisation, as savings constitute the major (if not only) source of funding for member loans.

1.4.1 Regulation

Cooperative financial institutions conduct the business of banks and, provided certain conditions are met, are exempt from the provisions of the Banks Act. The conditions attached to this exemption are set out in the common-bond exemption notice.

The exemption notices place a limit on the total amount of funds solicited or managed by cooperative financial institutions. If a cooperative financial institution holds contributions from members of more than R30 million, it would be required to register as a bank most probably a cooperative bank. If a cooperative financial institution does not comply with the requirements of the exemption notice, its deposit-taking activities fall within the definition of the business of a bank, and it must apply for a bank, mutual bank or cooperative bank licence.

According to the common-bond exemption notice, a common bond exists between members of a cooperative financial institution if the members-

- Have a common employer or are employed within the same business district.
- Have common membership of an association or organisation, including a religious, social, cooperative, labour or educational group.
- Reside within the same defined community, or rural or urban district.

The conditions outlined in the common-bond exemption notice as applicable to savings and credit cooperatives include the following:

- Cooperative financial institutions must subject themselves to the supervision and regulation of the Cooperative Banks Development Agency (CBDA). The CBDA is established in terms of the Cooperative Banks Act 40 of 2007 to support, promote and develop cooperative banking in South Africa.
- Cooperative financial institutions may not undertake the activities of pension fund organisations as defined in the Pension Funds Act.
- The rules of a cooperative financial institution must not allow a member to withdraw his or her contribution at any time.
- The benefits of the members of the cooperative financial institution must not be provided exclusively by way of loans that must be repaid.
- A cooperative financial institution must keep accounting records that reflect its state of affairs and business and explain its transactions and financial position.
- A cooperative financial institution must produce annual financial statements within 120 days of the end of its financial year.
- If a cooperative financial institution holds subscriptions from members in excess of R3 million, but not more than R30 million, the annual financial statements must be accompanied by a report by an accountant and auditor. Within 60 days of completion, the audit report must be presented to the members and the CBDA.

The Financial Sector Regulation Act (FSRA) 2017 amends the Co-operatives Banks Act to include the supervision and regulation of Co-operative Financial Institutions (CFI) within the Prudential Authority (PA). Co-operative financial institutions must apply to the Prudential Authority for registration.

The Cooperative Banks Act 40 of 2007 requires cooperatives that provide services falling within the definition of the business of a bank to register as cooperative banks if they have 200 members or more and hold member deposits to the value of R1 million or more.

If a cooperative financial institution provides credit to its members and has 100 or more credit agreements or an outstanding loan book of more than R500 000, it must register as a credit provider with the National Credit Regulator and comply with the National Credit Act and any regulations issued in terms thereof. Of importance for cooperative financial institutions is that the National Credit Act contemplates developmental credit agreements that enjoy certain exemptions from the Act.

In terms of the Cooperatives Act 14 of 2005, a cooperative financial institution must register with the Registrar of Cooperatives at the Companies and Intellectual Property Commission in order to operate legally.

1.5 MUTUAL BANKS

As with banks, mutual banks accept deposits from the general public, provide payment services such as cheques and electronic transfers, and make available credit such as overdrafts, home, term or asset-backed loans. Mutual banks differ from banks on the following important points.

- **Ownership:** A mutual bank is not required to be a public company as is a bank. Members of mutual banks receive returns on their investments in the form of interest payable on the specific type of share in which they have invested. There are different types of share issued by mutual banks, but only the permanent interest-bearing ones are freely transferable. However, these shares may not be listed or traded on a stock exchange.
- **Minimum capital requirement:** The minimum capital requirement for a mutual bank is the greater of R10 million (compared with R250 million for a bank) or 10% of the bank's assets and other risk exposures (as adjusted through the application of the prescribed risk weightings).

It was criticism of the restrictive nature of the Banks Act that led to the promulgation of the Mutual Banks Act. The Mutual Banks Act was intended to create a second tier of banking and add greater depth to the South African banking industry. However, the capital and reporting requirements for mutual banks are regarded as so onerous that the second tier has failed to materialise in significant numbers.

In addition, mutual banks have limited potential for growth as they cannot mobilise external capital because of their cooperative structure and share capital that cannot trade on the Johannesburg Stock Exchange. At present, there are three mutual banks in South Africa: GBS Mutual Bank, VBS Mutual Bank (place under curatorship), and FinBond Mutual Bank.

1.5.1 Regulatory framework

A mutual bank is registered in terms of and administered under the Mutual Banks Act. To register as a mutual bank, an entity needs to comply with certain statutory requirements regulating the application for registration, its ongoing operations and its prudential requirements. Briefly, it would be obliged to do the following:

- Meet certain capital adequacy requirements, which effectively means that the bank must maintain issued primary and secondary share capital, as well as primary and secondary unimpaired reserve funds, to an amount of at least R10 million or up to 10% of its risk exposure.
- Maintain a minimum reserve balance of approximately 2,5% of its liabilities to the public in an account with the SARB.
- Hold liquid assets of not less than 5% of its liabilities to the public.
- Carry on its business subject to certain restrictions; for example, it may not be exposed to any individual person in excess of 10% of qualifying capital and reserves without board approval, and in excess of 25% without approval of the Registrar of Banks.
- Give detailed monthly and quarterly returns, showing its various risk exposures and the manner in which, it is complying with capital adequacy and liquid asset requirements.

1.6 STOKVELS

A stokvel is a group or association of individuals who make regular contributions to a pool of savings or common fund, generally on a weekly, fortnightly or monthly basis. Each member can draw from the fund, usually for a specific purpose. In many stokvels, the pool is given in total or in part to each contributor on a strictly rotational basis. Stokvels have the following major features:

- The arrangement between the members of a stokvel is rarely formalised; instead the business of the stokvel is directed by the common bond that exists between members.
- While there are frequently strong social motives to participate in a stokvel (such as establishing a social network of trusted acquaintances), the key economic reason for participation is to accumulate cash and obtain access to credit.
- Members of a stokvel who receive the pool of funds early in the stokvel cycle are in the position of borrowers. Members who receive contributions at the end of the cycle are in the position of savers. Thus, receiving the pool at a stage when other members have to wait until later in the cycle requires reciprocal saving, not only to remain part of the saving cycle, but to have access to future credit through the stokvel.

The following are types of stokvels that exist:

- **Traditional stokvels:** These are the earliest form of stokvels and are general savings clubs that rotate pooled funds to members on a mutually agreed basis. There are a number of variations of the traditional stokvel – women’s stokvels, where women pool their savings to buy groceries in bulk at reduced prices; and party stokvels, where members take turns to organise parties at which food and liquor are sold and the host takes the profits.
- **Burial societies:** These are dedicated stokvels established to assist members with funeral costs. They are formed between people with a common bond (such as membership of the same church) to provide a way for members to save for and insure themselves against the costs associated with the death of a family member.
- **Investment stokvels:** These are stokvels that save or bank the pool of savings with the objective of carrying out capital projects or investing in a business venture, property or shares. The accumulated funds of an investment stokvel may be used as a source of credit to members to enable them to purchase an expensive item such as a car or taxi, or as seed capital for a small business.

Because of the nature of their business operations, stokvels accept deposits in the same way as banks. In recognition of their social and economic upliftment role, stokvels, like cooperative financial institutions are exempted from the Banks Act if they comply with the scope and conditions of the common-bond exemption notice.

The conditions that apply include the following:

- For purposes of self-regulation, a stokvel must be a member of or affiliated to a representative body such as the National Stokvels Association of South Africa, the National Stokvel Body of South Africa or any other similar representative self-regulatory body, approved by the Registrar of Banks in writing.
- Stokvels may not undertake the activities of pension fund organisations as defined in the Pension Funds Act. The rules of a stokvel must not allow a member to withdraw his or her contribution.
- The benefits for the members of the stokvel must not be provided exclusively by way of loans that must be repaid.
- A stokvel must keep accounting records that reflect the state of affairs and business of the stokvel and explain its transactions and financial position.
- A stokvel must produce annual financial statements within 120 days of its financial year end.
- If a stokvel holds subscriptions from members in excess of R3 million, but not more than R30 million, its annual financial statements must be accompanied by a report by an accountant and auditor. Within 60 days of completion, the audit report must be presented to the members and the self-regulatory body.

The common-bond exemption notice places a limit on the total amount of funds that may be solicited or managed by stokvels. The intention is that if the subscriptions of any stokvel exceed R30 million, it would be required to register as a bank – most probably a cooperative bank.

If a stokvel does not comply with the requirements of the common-bond exemption notice, its deposit-taking activities fall within the definition of the business of a bank and it must apply for a banking licence.

In terms of the National Credit Act, an agreement between a stokvel and one of its members made in accordance with the rules of that stokvel is not a credit agreement and is therefore not covered by the Act.

1.7 ITHALA DEVELOPMENT FINANCE CORPORATION

KwaZulu-Natal's provincial development finance agency is the Ithala Development Finance Corporation (IDFC). It accepts, holds and invests deposits received from the general public. It conducts the business of a bank in South Africa in terms of an exemption from the provisions of the Banks Act.

1.8 POSTBANK

Postbank, a division of the South African Post Office, conducts deposit taking in terms of an exclusion from the provisions of the Banks Act. The South African Postbank Limited Act provides for the incorporation of Postbank and thereby cleared the way for it to apply for a banking licence in terms of the Banks Act. Postbank is ideally suited to meet the financial services needs of rural and poor communities in South Africa as it has access points in practically every village, town and city in South Africa. It does not currently offer lending products.

TOPIC 2 REGULATORY FRAMEWORK

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Describe the main considerations of the key legislation governing the banking and deposit taking industry.

2.1 INTRODUCTION

The sections following consider the key legislation governing the banking and deposit taking industry. These key pieces of legislation, together with their associated regulations, provide a distinct framework for the regulation of deposit taking entities in South Africa.

2.2 THE BANKS ACT (ACT 94 OF 1990)

This is the most significant piece of legislation for South African banks. The key objective is to regulate and supervise the taking of deposits from the general public. The focus of the Banks Act is prudential regulation, or the financial soundness of banks.

Subject to certain exceptions, no person may conduct the business of a bank in South Africa unless such a person is registered as a bank in terms of the Banks Act, or as a mutual bank in terms of the Mutual Banks Act 124 of 1993. The business of a bank involves, inter alia, the acceptance of deposits from the general public as a regular feature of business.

Regulations to ensure financial soundness embrace a number of aspects. In the first instance, a firm must meet minimum capital requirements (such as shareholder or Tier 1 capital).

The international guidelines for other aspects of soundness that are set by the Bank for International Settlements (BIS) were until recently captured in a document known as the Basel Capital Accord.

Since 1988, the Basel I framework has been introduced progressively into more than 100 countries, not only in member countries of the Basel Committee, but also in virtually all other countries with active international banks. The principles of Basel II – the updated Accord – became effective in South Africa in 2008 through amendments to the Banks Act in 2007. Following the great financial crisis of 2007/08, the Basel Committee of the BIS introduced a comprehensive set of measures to enhance the Basel II framework by further strengthening the regulation, supervision and risk management of banks. These measures are known as Basel III.

2.3 THE SOUTH AFRICAN RESERVE BANK ACT (ACT 90 OF 1989)

The South African Reserve Bank Act consolidates the laws relating to the South African Reserve Bank (SARB) and the monetary system of the country. It sets the framework for the minimum reserve requirement, also called the cash reserve requirement.

2.4 THE MUTUAL BANKS ACT (ACT 124 OF 1993)

The Mutual Banks Act allows for the regulation of mutual banks. The Mutual Banks Act effectively replaced the legislation for building societies.

2.5 THE COOPERATIVE BANKS ACT (ACT 40 OF 2007)

The Cooperative Banks Act seeks to improve access to banking services through sound, sustainable cooperative banks. It provides a formal regulatory and supervisory framework for cooperative banks.

In addition, it protects members of such banks through, among others, the provision of depositor protection and lender-of last-resort facilities.

Cooperative banks must maintain and meet a number of prudential requirements in respect of capital adequacy, asset quality, liquidity, surplus reserves and large exposures.

2.6 THE NATIONAL PAYMENT SYSTEM OF SOUTH AFRICA ACT (ACT 78 OF 1998)

This legislation allows for the management, administration, operation, regulation and supervision of the payment, clearing and settlement systems in South Africa, and affects banks in so far as they are clearing and settlement participants and offer payment services to their clients.

2.7 THE NATIONAL CREDIT (ACT 34 OF 2005)

The National Credit Act regulates all credit providers, including deposit taking entities such as banks and cooperatives that extend credit. Such entities must register as a credit provider with the National Credit Regulatory and comply with the National Credit Act and the regulations issued in terms thereof.

The National Credit Act focuses on consumer protection, as well as on the disclosure and fairness of terms.

2.8 THE FINANCIAL INTELLIGENCE CENTRE ACT (ACT 38 OF 2001)

This Act (generally referred to as FICA) requires that banks and other financial institutions obtain and retain appropriate information about each client, with the primary motivation of combating money laundering and financial terrorism.

2.9 THE FINANCIAL ADVISORY AND INTERMEDIARY SERVICES ACT (ACT 37 OF 2002)

The Financial Advisory and Intermediary Services (FAIS) Act promotes consumer protection through the regulation of certain advisory and intermediary services to clients by financial firms, including banks.

In terms of the FAIS Act, all financial services providers (FSPs) must adhere to the General Code of Conduct (considered in the generic module 1) and the code of conduct specific to their industry.

The Code of Conduct for banks as financial services providers conducting short-term deposit taking business has been developed. Most specific codes of conduct need to be considered with the General Code of conduct. However, this code stands alone and applies to banks when rendering the service of short-term deposits i.e. deposits not exceeding 12 months. The subsections following consider the duties to be performed under this code.

2.9.1 General duties

The financial services provider (FSP) must act fairly and reasonably with uncompromising integrity to promote trust and confidence. The FSP must assist the client in selecting a deposit that meets the client's needs.

Information must be made available in plain language and where appropriate in other official languages. The FSP must ensure that the client understands the financial implications of the deposit selected.

Clients may not be requested to sign blank forms. Clients must be made aware if services are offered in a different way, for example, electronically.

The FSP must advise clients how to obtain more information in that regard. The FSP (must also make copies of the Code available to clients. Adequate internal complaints procedures must be maintained.

The FSP must ensure that contractual terms and conditions are fair in substance and distinguishable from promotional material. Reasonable enquiries must be made to establish the client's needs and objectives.

2.9.2 Unsolicited contacting of a client

At the commencement of an unsolicited contact of a client by way of a visit or call, the purpose must be explained. In all communications, an FSP must act honorably, professionally and with due regard to the convenience of the client.

2.9.3 Information to be provided

An FSP must ensure that contractual terms and conditions are fair in substance and clearly distinguishable from marketing or promotional material and clearly set out the rights and responsibilities of the client.

When furnishing advice, an FSP must make reasonable enquiries to establish the client's needs and objectives, taking into consideration the client's circumstances and the type of deposit on which advice is being given.

The FSP must provide the following information before the transaction or at the same time or any time at the request of the client or if urgent, orally: –

- Key features of the deposit to enable the client to make an informed choice, including applicable cooling-off periods.
- How the account will operate including information about withdrawal, earning and payment of interest, difference between stop orders and debit orders and special procedures and safeguards to ensure safe business.
- Full details about fees and charges and whether they are negotiable, including additional interest or charges in case of early withdrawals or cancellations.
- Full details on the applicable interest rates, including deduction or payment of interest and methods of calculation and possible changes thereto.
- Possible later changes to terms and conditions and how that may affect the deposit adversely.
- How funds may be dealt with on maturity.
- Clients' rights to access personal information held by the bank.
- Required client identification when opening an account and the use of PINS and passwords.
- When account details may be passed to or checks made with credit reference agencies, fraud prevention agencies and other entities.
- Closing of branches, outlets or ATM's.
- Any possible set-off between a deposit and other business debt in its capacity as a bank.
- Closing of deposit accounts of clients after reasonable notice to the last address without prejudice to the client's rights.

2.9.4 Account operations

An FSP must provide statements to the client in the manner agreed i.e. orally, in writing, or through electronic banking and must inform the client as to the charges to be levied for such statements.

The client must also be made aware as to what procedure to follow when there are statement errors or where an automatic rollover of a deposit may take place against the wishes of the client.

The client must also be informed regarding the procedure to be followed when changes in personal identification take place and safeguards to be followed regarding telephone and electronic banking.

2.9.5 Confidentiality and privacy

An FSP may not disclose a client's personal information to a third person except when required by law, if it is in the public interest or in the interest of the FSP or if made with the client's written consent.

An FSP may not bring other deposit-taking services to the client's attention unless the client has consented thereto. Pressure on the client is also prohibited.

If telephone conversations are recorded, the client must be informed, and reasons provided.

2.9.6 Advertising

The same rules relating to these aspects apply as the rules set out in the General Code of Conduct.

2.9.7 Complaints

Complaints must be submitted in writing and promptly responded to and investigated. The complaints must be handled in a timely and fair manner.

The FSP must keep record of complaints for five years.

Where a complaint is not resolved to a client's satisfaction, the client must be advised of further steps available in terms of the FAIS Act or the law.

An FSP must maintain an internal complaint resolution system based on a comprehensive complaints policy, transparency and visibility, accessibility of facilities and fairness.

1) Resolution of complaints

The internal complaints resolution system and procedures of the FSP must be designed to ensure the existence and maintenance of the following:

- Availability of adequate manpower and other resources.
- Adequate training of all relevant staff, including knowledge of the FAIS legislation,
- Ensuring that responsibilities and mandates are delegated to facilitate complaints resolution of a routine nature.
- Ensuring that there is provision for the escalation of non-routine serious complaints and the handling thereof by staff with adequate expertise.
- Internal follow-ups to avoid occurrences giving rise to complaints or improve services
- No charging of fees for making use of the internal complaint resolution system and procedures or for facilitating and resolving a complaint.

II) Specific obligations

The internal complaints resolution system, including any updates or upgrades, must be in writing. Clients must have access to the complaints policy at every branch or electronically and clients must be made aware of the procedures by public press, electronic announcements or client communications.

The complaints policy must contain the duties of the FSP and the rights of the client. A clear summary of the FAIS Act pertaining to the pursuance of a claim through the Ombud after dismissal of a claim by the FSP must also be included as well as the contact details of the Ombud.

The internal complaints resolution system and procedures must stipulate the following:

- Complaints should, if possible be in writing and copies of relevant documentation should be attached thereto.
- The FSP must provide acknowledgement of receipt of complaints in writing. Such acknowledgement must include the details of staff dealing with complaints.
- Complaints must be properly internally recorded.
- After receiving and recording the complaint, the complaint must be forwarded to the relevant staff member,
- The complaint must receive proper consideration.
- The consideration process must effectively be controlled.
- The client must be informed of the results of the consideration.
- Where the outcome is not favorable to the client, full reasons must be provided, and the client advised that the complaint may be pursued through the Ombud within six months and the Ombud's details must be provided.

Where a complaint is resolved in favour of a client, redress should be offered to the client without delay.

2.9.8 Waiver of rights

No financial services provider (FSP) may request a client to waive any right or benefit described to a client under the General Code of Conduct. Any such waiver is considered null and void.

2.10 THE CODE OF BANKING PRACTICE

The fundamental principles of the Code of Banking Practice (COBP) cover the following aspects, which primarily relate to how banks deal with their clients. Banks must produce policies and procedures that staff have to comply with, and which are aligned with the Code of Banking Practice.

Under this code, banks undertake the following:

- To act fairly, reasonably and with transparency.
- To ensure that products and services comply with this Code, applicable laws and regulations.
- To explain the financial impact of products and services.
- To have a safe, secure and reliable banking and payment service.
- To ensure that staff follow the procedures as set out in this Code.
- To correct errors and handle complaints speedily.
- To understand the financial difficulties of clients.
- To act with uncompromising integrity and fairness so as to promote complete trust and confidence between individuals and the industry.
- To ensure that there will be no discrimination of any sort and that decisions made by the bank are based on commercial principles.
- To disclose specific information depending on the type of product.

The subsections following consider stipulation regarding aspects to be adhered to by banks.

2.10.1 Terms and conditions

All written terms and conditions must be fair and will set out the rights and responsibilities of the client in plain language, with legal and technical language used only where necessary (and where it does occur, an explanation will be provided).

Changes to the terms and conditions (including changes in the interest rates) will be made with reasonable notice, providing clients with an opportunity to decide if they will continue with the product or service, and a copy of the new terms and conditions will be provided to the client.

2.10.2 Marketing

Clients must receive marketing information that is understandable, clear and not misleading. Clients, however, can choose not to receive it.

The banks may give certain clients' information out to other business units of the same banking group and the bank may use its marketing distribution channels to make banking clients aware of products offered by other businesses.

New clients of the bank will need to give their consent to the above, while existing clients shall be treated as though their consent was given. This consent can, however, be withdrawn in writing.

The ongoing marketing and sale of credit products shall be done responsibly in an attempt to ensure that clients are not financially extended beyond their means. There is, however, a requirement from the clients' point of view that they keep the banks informed of their financial position.

2.10.3 Savings and investment accounts

The banks must give their clients clear and appropriate information on the different types of investment accounts that are available, how these accounts work and the charges applicable to them (for example, early withdrawal costs). The responsibility lies with the clients to manage their own financial affairs as far as liquidity and tax are concerned.

2.10.4 Running client accounts

Bank statements must be made available to clients as and when required and depending on the type of product used. If the statement contains an error, the banks request that their clients report this error within thirty days.

The bank will explain to the client the operation of a cheque account with specific reference to the following:

- When the client can dispute a debit from the account.
- The procedure when the cheque deposited by the client is returned as unpaid.
- The procedure to follow when a cheque is lost, stolen or damaged.
- The procedure to stop the payment in terms of an issued cheque.
- Information on how clients' accounts work, with emphasis on stopping payments, withdrawals, interest and deposit information.
- Full details of any charges.
- Changes made to ATM charges.
- Special procedures or safeguards required of the client to ensure safer banking.
- Information on any additional charges and interest when accounts become overdrawn without prior agreement, or loans fall into arrears.

2.10.5 Circumstances under which an account may be closed

Accounts will not be closed without reasonable notice, but may be summarily closed where:

- The bank is compelled to do so by law.
- The account has not been used for a significant period of time.
- The bank has reason to believe that the account is being used for fraudulent purposes.

2.10.6 Notification to clients

When a client wants to open an account, the bank must inform the client of the basic operation of the product, the transaction fees, the rules surrounding PIN numbers and cards, and the circumstances under which the bank may close such an account.

2.11 THE OMBUDSMAN FOR BANKING SERVICES (OBS)

The Ombudsman for Banking Services (OBS) resolves individual complaints about banking services and products in an impartial, quick and confidential way.

Any bank client who has a complaint against his bank may approach the OBS for assistance. The service is free and the only requirements that must be met are that:

- The complaint must be within their jurisdiction.
- The client must have followed the bank's complaint-handling procedures before approaching the scheme for assistance.

The Ombud resolve complaints by investigating matters according to the rules of the scheme. If the matter has not been resolved by negotiation after investigation, a formal decision may be taken. The decision may be in the form of a determination that is binding on the bank or a recommendation that is not.

The OBS is an independent and impartial body that consists of eight board members: a current or retired judge (the Chairperson), three directors (representatives of the banking sector) and four independent directors of the banking sector. They cannot make rules for the banking industry, deal with policy issues, or give general advice about banking or financial matters. Commercial decisions taken by banks regarding fees or the granting of credit are out of their jurisdiction, unless maladministration has occurred. As such, they cannot assist in getting the bank to approve credit or alter terms of repayment on a loan.

2.12 THE BANKING ASSOCIATION SOUTH AFRICA

The Banking Association South Africa is an industry body representing all registered banks in South Africa. This includes both South African and international banks. The Main Board of the Association comprises the Chief Executives of the five largest South African banks, two Chief Executives representing international banks and two Chief Executives representing the other South African banks.

The broad role of the Banking Association South Africa is to establish and maintain the best possible platform on which banks can do responsible, competitive and profitable banking, by way of abiding by the Code of Banking Practice (COBP). A critical role of the Banking Association South Africa is to work with its members to enable this role within the context of the transformation challenges our country is addressing.

The Banking Association South Africa manages numerous committees that advise the executive on issues pertinent to the sector.

TOPIC 3 CONCEPTS RELATING TO DEPOSIT TAKING

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Describe the concepts related to deposit taking.

3.1 ECONOMIC POLICY

Recognition that market forces alone cannot ensure that an economy will achieve the economic objectives has resulted in state intervention occurring to some degree in all countries. The intervention can take the form of fiscal policy, monetary policy and /or direct controls, collectively economic policy.

Economic policy of a county has an effect on the interest rate applicable to certain deposits.

3.1.1 Fiscal policy

Fiscal policy is the use of government spending and taxation policies to influence the overall level of economic activity.

Fiscal policy is said to be loosening if tax rates are lowered or public expenditure is increased – inject income into the circular flow and stimulate aggregate demand.

Fiscal policy is said to be tightening if tax rates are increased or public expenditure is reduced – weaken aggregate demand.

In South Africa National Treasury is responsible for the execution of fiscal policy.

Taxation and government spending are linked in the government's overall fiscal or budget position. A budget surplus exists when taxation and other receipts of the government exceed its payments for goods and services and debt interest. A budget deficit arises when public-sector expenditure exceeds public-sector receipts. A budget deficit is financed by borrowing.

Expansionary fiscal policy is usually associated with a budget deficit and contractionary fiscal policy with a budget surplus.

The public or national debt is the total sum of all budget deficits less all budget surpluses over time. National debt incurs interest costs and must be paid back. It is financed by taxpayers and is a transfer between generations.

3.1.2 Monetary policy

Monetary policy regulates the economy by influencing the monetary variables such as the following:

- **The rate of interest:** Lowering interest rates encourages (i) companies to invest in capital as the cost of borrowing falls and (ii) households to increase consumption as disposable incomes rise on the back of lower mortgage and overdraft rates. Rising interest rates will typically have the opposite effect
- **The money supply (notes, coins, bank deposits):** If the money supply is increased, interest rates tend to fall.

The most important tools of monetary policy are as follows:

1. Reserve requirements
2. Open-market operations
3. Bank or discount rate policy.

I) Reserve requirements

The central bank requires banks to hold a specified proportion of their assets as cash reserves - typically against their depositors' funds. By changing the reserve requirement, the central bank can influence the money supply and credit extension. For example, if the central bank lowers the cash reserve requirement the money supply will increase as banks extend additional credit on the back of their increased lending capacity.

II) Open market operations

Open market operations involve the purchase and sale of government and other securities by the central bank to influence the supply of money in the economy and thereby interest rates and the volume of credit.

A purchase of securities – expansionary monetary policy – injects reserves into the banking system and stimulates growth of money supply and credit extension.

A sale of securities – contractionary monetary policy – drains reserves into the banking system and weakens money supply and credit extension.

III) Bank or discount rate policy

The bank or discount rate is the interest rate at which the central bank lends funds to the banking system. In South Africa this rate is called the repurchase rate (repo rate). Banks borrow from the central bank primarily to meet temporary shortfalls of reserves.

By varying the interest rate on these loans, the central bank can affect market interest rates e.g. increasing the bank rate raises the cost of borrowing from the central bank and banks will tend to build up reserves. This will decrease the money supply and reduce credit extension.

An accommodative or expansionary monetary policy reduces the bank (or repo) rate at which the central bank provides credit to the banks.

Monetary policy is restrictive or contractionary when the central bank increases the bank (or repo) rate.

The South African Reserve Bank (SARB) is the central bank of South Africa. The SARB applies monetary policy in South Africa within an inflation targeting framework. An inflation targeting framework has the following four elements:

- A monetary policy goal of price stability
- A numerical inflation targets to make the price-stability objective operational
- A time horizon to attain or return to the inflation target
- Ongoing review as to whether the inflation target will or has been met.

IV) Direct controls

Examples of direct controls are as follows:

- Prices and incomes policies attempt to control inflationary pressures by restraining price and wages increases
- Import controls endeavour to correct balance of payment deficits by placing restrictions such as quotas and tariffs on the importation of products into the country.

3.2 INTEREST RATES

An interest rate is the price, levied as a percentage, paid by borrowers for the use of money they do not own and received by lenders for deferring consumption or giving up liquidity.

Factors affecting the supply and demand for money and hence the interest rate includes the following:

- **Production opportunities:** Potential returns within an economy from investing in productive, cash-generating assets.
- **Liquidity:** Lenders demand compensation for loss of liquidity. A security is liquid if it can be converted into cash at short notice at a reasonable price.
- **Time preference:** Lenders require compensation for saving money for use in the future rather than spending it in the present.
- **Risk:** Lenders charge a premium if investment returns are uncertain i.e., if there is a risk that the borrower will default. The risk premium increases as the borrowers' creditworthiness decreases. Sovereign (government) debt generally has no risk premium within a country and therefore pays a risk-free rate. A country risk premium may apply outside a country's borders.
- **Inflation:** Lenders require a premium equal to the expected inflation rate over the life of the security.

The South African Reserve Bank (Reserve Bank, or SARB) plays an important role in determining the level of short-term interest rates as discussed under economic policy.

3.2.1 Interest rate calculations

There are two basic types of interest, simple and compound.

I) Simple interest

Simple interest is also referred to as interest at the end of the term. It assumes that interest earned on an investment is not reinvested.

The basic formula to calculate simple interest is:

$$\text{Interest} = \text{Present value} \times \text{interest rate} \times \text{time}$$

For example, R1 000 invested for 1 year at 14% p.a. will earn R140 interest (i.e., $1\,000 \times 0.14 \times 1$) at the end of the year.

R1 000 invested for 2 years at 14% p.a. will earn R280 interest (i.e., $1\,000 \times 0.14 \times 2$) at the end of the term.

The basic formula can be expanded to determine the future value of the principal at maturity i.e., to what amount the money will grow at the end of the term.

$$\text{Future value} = \text{Present value} (1 + \text{interest rate} \times \text{time})$$

For example, R1 000 invested for 1 year at 14% p.a. will have a value of R1 140 (i.e., $1\,000 \times (1 + 0.14 \times 1)$) at the end of the year.

R1 000 invested for 2 years at 14% p.a. will have a value of R1 280 (i.e., $1\,000 \times (1 + 0.14 \times 2)$) at the end of the term.

The present value formula can be obtained from the future value formula:

$$\text{Present value} = \text{Futures value} / (1 + \text{interest rate} \times \text{time})$$

For example, a loan with a maturity value of R120 000 and interest rate of 15% p.a. has a present value of R115 662.65 (i.e., $120\,000 / (1 + 0.15 \times 3/12)$) 3 months prior to its maturity.

II) Compound interest

Compound interest adds the simple interest paid on the investment in the first period to the principal amount and, in subsequent periods, calculates interest on the principal plus the interest earned in earlier periods. It assumes reinvestment at the same interest rate.

The future value formula for compound interest is:

$$\text{Future value} = \text{Present value} (1 + (\text{interest rate}/\text{compounding}))^{\text{time} \times \text{compounding}}$$

Compounding period is determined as follows:

- Annually (NACA) = 1
- Semi-annually (NACS) = 2
- Quarterly (NACQ) = 4
- Monthly (NACM) = 12

For example, R2 000 invested at 15% p.a. for 3 years will have one of the following future values depending on whether interest is paid:

Annually:	R3 041.75	$= R2\ 000 \times (1 + 0.15)^3$
Semi-annually	R3 086.60	$= R2\ 000 \times (1 + \frac{0.15}{2})^{3 \times 2}$
Quarterly:	R3 110.91	$= R2\ 000 \times (1 + \frac{0.15}{4})^{3 \times 4}$
Monthly:	R3 127.89	$= R2\ 000 \times (1 + \frac{0.15}{12})^{3 \times 12}$

The present value formula can be obtained from the future value formula:

$$\text{Present value} = \text{Future value} / (1 + (\text{interest rate}/\text{compounding})^{\text{time} \times \text{compounding}}$$

For example, the following amounts must be invested now to accrue to R10 000 in 5 years' time at p.a. compounded:

Annually:	R4 971.77	$= R10\ 000 / (1 + 0.15)^5$
Semi-annually	R4 851.94	$= R10\ 000 / (1 + \frac{0.15}{2})^{5 \times 2}$
Quarterly:	R4 788.92	$= R10\ 000 / (1 + \frac{0.15}{4})^{5 \times 4}$
Monthly:	R4 745.68	$= R10\ 000 / (1 + \frac{0.15}{12})^{5 \times 12}$

III) Nominal versus effective rates

The nominal rate is the quoted annual rate. Some indication is usually given of compounding intervals:

- Nacm: nominal annual compounded monthly
- Nacq: Nominal annual compounded quarterly
- Nacs: Nominal annual compounded semi-annually
- Naca: Nominal annual compounded annually

The effective rate is the equivalent annual interest rate that would apply if interest were compounded annually. The effective rate increases as the number of compounding periods' increases. By definition, there is no difference between a naca rate and the effective rate.

The formula to convert a nominal rate to an effective rate is:

$$\text{Effective rate} = [(1 + \text{nominal rate} / \text{compounding})^{\text{compounding}} - 1]$$

For example:

15% NACM rate implies and effective rate of-	16.08%	$= (1 + \frac{0.15}{12})^{12} - 1$
15% NACQ rate implies and effective rate of-	15.87%	$= (1 + \frac{0.15}{4})^4 - 1$
15% NACS rate implies and effective rate of-	15.56%	$= (1 + \frac{0.15}{2})^2 - 1$
15% NACA rate implies and effective rate of-	15.00%	

3.2.2 Interest rate options

Deposits can pay interest either at a fixed or variable rate. Furthermore, interest can be calculated on a tiered basis.

I) Fixed interest rate

A fixed rate is a set rate and cannot be changed for the full term of the deposit.. This type of option provides -

- Certainty regarding a client's interest earnings for a specified period.
- Protection against the upward or downwards movement of the prime rate (fluctuation of interest rates).
- An alternative to the variable interest rate for clients who hold the view that the rates might increase or decrease in the near future.

At the end of the term, a new agreement will have to be entered into which means that a new rate would apply.

II) Variable interest rate

With a variable interest rate, the rate is usually linked to the prime rate of interest or another variable rate. This means that interest earned may fluctuate as this rate moves up or down.

Clients who believe that interest rates are likely to drop in the short term or who have sufficient capital to withstand an increase in the interest rate, would generally prefer this option. The benefit of choosing this option is that interest rates could change, lowering the repayment amount of the loan and increasing disposable income, or the client has the option to continue paying the same amount on the loan thus decreasing the loan period and saving the client money in the long term.

III) Tiered interest rates

Tiered interest rates refer to a rate of interest scaled according to the amount invested in the account. Typically, the higher the balance in the account, the higher the rate. Savings or investment accounts with longer terms generally pay higher rates than accounts with shorter terms.

This option is beneficial to clients who intend to save continuously and increase the balance on their account. The more money the client saves, the higher the interest rate paid for the money; and, if the interest is capitalised, the balance will increase even further, and the client will earn interest on the interest.

Each deposit taking institution has its own process in place for accessing interest rates. Interest rates for most products are usually advertised on bank websites and employees can access interest-rate information electronically or manually.

3.3 INFLATION

Inflation is the persistent increase in the general level of prices and is devaluing of the worth of money.

Inflation has the following three main negative effects:

- Distorting the behaviour of households and firms because it obscures relative price signals, i.e. it is difficult to differentiate changes in relative prices and changes in the general price level.
- Creating uncertainty and consequently discourages investment because it is not precisely predictable.
- Redistributing income from creditors to debtors and fixed-income earners to variable-income earners.

In South Africa, the inflation target has been specified as achieving a twelve-month rate of increase in the CPI, excluding mortgage interest costs, called the CPIX, of 3-6%.

Real interest rate is the actual or real amount of interest a client can earn, which has been adjusted for inflation. The real interest rate is the stated or nominal interest rate minus the inflation rate. If the real interest rate is negative, it means that the inflation rate is higher than the interest rate earned on an investment, and vice versa.

3.3.1 Price indexes.

There are two price indexes: the consumer price index and the producer price index.

Both indicators are presented as monthly index numbers.

Both also focus on percentage changes and distinguish between the level of prices and the rate of increase. If the rate of increase declines but remains positive, prices are still increasing.

The price indexes are likely to have the following impact on economic element:

- **Interest rate:** Larger than expected increases or an increasing trend is considered inflationary. Interest rates will tend to rise.
- **Bond prices:** Higher interest rates mean falling bond prices.
- **Share prices:** Higher than expected price inflation should negatively impact share prices as higher inflation lead to higher interest rates.
- **Exchange rate:** The effect is uncertain. The exchange rate may weaken as higher prices lead to lower competitiveness. However, higher inflation typically leads to tighter monetary policy and higher interest rates, which leads to appreciation.

I) Consumer Price Index (CPI)

The Consumer Price Index (CPI) is a weighted average of the prices of a representative group of goods and services purchased by households.

The CPI is used to calculate and monitor inflation.

II) Producer Price Index

The Producer Price Index (PPI) tracks prices at the first stage of distribution or at the point of the first commercial transaction. Prices of domestically produced goods | imported goods are measured when they leave the factory | arrive in the country and not when they are sold to consumers.

The PPI measures the cost of production and as such reveals cost pressures affecting production.

3.4 THE DIFFERENCE BETWEEN SAVING AND INVESTMENT

The difference between saving and investment lies in the aim and time period. Savings are meant to be liquid (easy to convert into cash) and the client should have the ability to withdraw this money immediately or within a short notice period. The returns on savings are usually quite small. Investments tend to be less liquid (depending on the type of investment) and usually have a longer time period. Investment accounts offer higher interest rates.

In a deposit taking context standard investment accounts are considered low risk, as the capital amount deposited is not at risk compared to other types of investments, such as investing on the stock market or investing in property.

3.5 DEMAND DEPOSIT

A bank account, such as a cheque account, that allows the holder to withdraw funds or use funds for payment upon demand.

3.6 FIXED DEPOSIT

A fixed deposit is an investment of a lump sum of money for a fixed period, at a fixed rate of interest.

3.7 TRANSACTIONAL ACCOUNTS

Transactional accounts are generally not interest-bearing accounts and clients can deposit or withdraw any amount of money any number of times, subject to availability of funds.

3.8 TRUST ACCOUNT

A trust account is a legal arrangement through which funds or assets are held by a third party (the trustee) for the benefit of another party (the beneficiary), which may be an individual or a group. The creator of the trust is known as a grantor or settlor.

A trust account may also be useful when a minor inherits property from a will or receives a life insurance payout. In this instance, the trust account—managed by the trustee—holds the trust assets for the education, medical care, and general support of the minor until the age of majority, after which he would inherit the assets directly as a beneficiary.

3.9 TAX FREE INVESTMENT ACCOUNT

A maximum of R33 000 per tax year (annual limit) can be invested in a tax-free investment account (the amount increased from R30 000 to R33 000 as of 1 March 2017).

More than one such investment account can be held at different institutions, as long as the annual limit is not exceeded.

There is a lifetime deposit limit allowed of R500 000 per person. If a person exceeds the limit, a penalty of 40% on the excess amount will be payable. This will be payable as a tax, together with the normal annual tax payable by the investor.

From 1 March 2018, funds may be transferred between different service providers, by the service providers, without affecting investors' annual or lifetime limits.

Any returns (interest or dividends) on such investments that are capitalised on the accounts do not affect the annual or lifetime limit. No penalties will be paid on the excess amounts, due to the capitalised interest.

These accounts cannot be used as transactional accounts.

3.10 FOREIGN CURRENCY DEPOSIT ACCOUNT

A foreign currency deposit account is a locally held account that can be used to invest funds in a range of foreign currencies. The main currencies are the United States Dollar (USD), the British Pound (GBP) and the Euro (EUR).

This type of investment is used by investors who want to save in order to purchase overseas products and services at a later stage (for example, an overseas holiday), but do not want to be exposed to foreign currency fluctuation risk.

3.11 TERM TO MATURITY

Term to maturity indicates the set period for which the cash is to be invested. The longer the term to maturity, the higher the interest rate.

3.12 PERIOD OF NOTICE

Period of notice is the amount of time that must be given by investors to withdraw the invested funds in an account. Some accounts can be withdrawn on demand; others require a notice period for example 30 days' notice.

3.13 DORMANT ACCOUNTS

If an account becomes dormant, i.e. it has not been operated on for a specific period of time, e.g. six months, the deposit taking institution has the right to close the account after attempting to notify the client and following the process for dormancy.

If the bank cannot contact the client and the specified dormancy period has elapsed, the bank will close the account. If the account is in credit the bank will transfer the amount to a holding account for safekeeping. No interest is earned on the credit balance from the time that the account is closed.

3.14 AUTOMATED TELL MACHINE (ATM)

Automated teller machines are electronic banking outlets that allow people to complete transactions without the help of a bank representative or teller. ATM transactions can be as simple as a deposit or balance inquiry, or more complex like a balance transfer or bill payment.

In order to use an ATM, consumers need to have a debit or credit card, and a personal identification number.

ATMs are convenient, allowing consumers to perform quick, self-serve transactions from everyday banking like deposits and withdrawals to more complex transactions like bill payments and transfers.

There are two primary types of ATMs. Basic units only allow clients to withdraw cash and receive updated account balances. The more complex machines accept deposits, facilitate line-of-credit payments, transfers, and report account information. To access the advanced features of the complex units, a user must be an account holder at the bank that operates the machine.

Although the design of each ATM may be different, they all contain the same basic parts:

- **Card reader:** This part reads the chip on the front or the magnetic stripe on the back of the card.
- **Keypad:** The keypad allows the consumer to input information like the PIN, the type of transaction he or she intends to do, and the amount of the transaction.
- **Cash dispenser:** Bills are dispensed through a slot in the machine, which is connected to a safe at the bottom of the machine.
- **Printer:** If required, consumers can request receipts which are printed here. The receipt records the type of transaction, the amount, and the account balance.
- **Screen:** The ATM issues prompts that guide the consumer through the process of executing the transaction. Information is also transmitted on the screen such as account information and balances.

TOPIC 4 ADVISING CLIENTS ON A SUITABLE PRODUCT

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Describe cash as an asset class
- Factors to considered when conducting a need analysis with regard to a deposit taking account.

4.1 CASH AS AN ASSET CLASS

Cash can be held as notes and coins or deposited with a bank.

Holding cash has the advantage of immediate liquidity. However, there are two problems with holding cash. Firstly, cash earns no or little interest and its real value will be eroded by inflation and secondly large cash holdings may attract criminals.

4.1.1 Returns on cash

Returns from assets in cash instruments are received in the form of interest, which is generally paid in line with prevailing interest rates. The interest is simply added to a bank deposit which can then either be drawn as income or be re-invested in the underlying investment fund.

4.1.2 Tax implications of cash

Interest earned (or income distributions received) on cash/ fixed-interest investments is fully taxable, less the general annual interest exemption. Note that on investments into tax-free investment products investors are exempt from paying tax on the interest earned within the fund – terms and limitations apply. At the moment (2018), the tax-free investment threshold is R33 000 per year.

4.1.3 Volatility of cash

Cash instruments typically come with a guarantee on the capital and a fixed interest rate; therefore, they are seen as safe investments with limited volatility. They are generally considered to be low-risk investments.

4.1.4 Inflation and cash

There is no real growth on capital invested in cash over the longer term, as the net after-tax returns on fixed-interest investments are historically below inflation or just a few basis points above inflation.

4.1.5 Accessing cash investments

Cash deposited with a bank will be held in non-interest-bearing or interest-bearing accounts.

Non-interest-bearing accounts such as cheque accounts are used to meet immediate expenditure requirements. Cash can be withdrawn by cash or cheque at any time without notice. Since cheque accounts generally do not pay interest they are not strictly-speaking investments. Rather they are a convenient way to store cash and make transactions.

4.2 FACTORS OF CONSIDERATION WHEN CONDUCTION A NEEDS ANALYSIS

Transactional, savings and investment needs need to be considered when establishing a suitable deposit for an individual or entity.

- Information must be gathered from the client to establish the following the following:
- **Aim of the account:** The purpose of the account must be identified whether it is for transactional purposes, savings or investments or a combination of these.
- **Financial position:** The financial positions will be able to establish if the client can meet minimum balance requirements and the rate of interest that can be awarded for the amount of money to be deposited into an account.
- **Risk appetite:** The risk appetite is the amount of risk that the investor is willing to accept in order to meet his goals and objectives.

To choose an interest-bearing account such as a demand deposit, fixed deposit, money market account or notice deposit account, an investor should consider the following factors:

- **Interest rate:** Interest rates may be fixed or variable and may be paid at different times e.g. monthly, quarterly, semi-annually or annually. Investors should ensure that when evaluating interest rates offered, these are comparable.
- **Term to maturity:** Term to maturity indicates the set period for which the cash is to be invested. The longer the term to maturity, the higher the interest rate.
- **Restrictions and penalties:** Restriction and penalties on deposit account vary from deposit taking institutions. It is important that the restriction on a deposit account is understood.
- **Period of notice (liquidity):** Period of notice is the amount of time that must be given by investors to withdraw the invested funds in an account. Some accounts can be withdrawn on demand; others require a notice period for example 30 days' notice.
- **Cost:** Some accounts attract fees such as monthly maintenance fees. Since these eat into the return and perhaps capital of the deposit, investors should ensure they are receiving value for money.

- **Security:** Security relates to the risk of default by the bank. Investors should consider the financial strength of the bank before placing their funds with it. In addition, they should consider diversifying i.e., having accounts with several different banks. Some countries have deposit insurance, which provides compensation to small retail depositors in the event of a bank failing. Deposit insurance has been proposed in South Africa but has not yet been introduced.

Some of the factors will be considered in the subsections following.

4.2.1 Term to maturity

The term to maturity is the minimum length of time the funds are locked in before the holder can access them. This is also referred to as the investment period.

The various deposits that a bank accepts for savings and investments have specific time periods attached. Usually the longer money is committed for investment purposes, the higher the interest rate paid on this type of investment.

By establishing the client's financial profile, one can determine what investment period might best suit his needs.

Demand deposits such as savings accounts, call deposit accounts and money market accounts are suitable for the management of short-term cash flows as these accounts provide immediate access to the funds.

Notice deposits are short-term investments aimed at clients who would like a high return but with the option of accessing their funds at short notice. The investment period for this type of account relates to the notice period. The client is required to give notice before he can access his money. The categories of notice periods are usually 32 days, 60 days and 88 days; however, some financial institutions offer longer periods such as 185 days and the funds are available on the expiry of the notice period.

Fixed deposits accounts have a specified investment period attached to the agreement. In some banks the period can be as short as one month and as long as five years. The maturity date is agreed to on the date of the deposit and cannot be changed. Usually, the longer the period the client is prepared to invest for, the higher the interest rates. If the money is withdrawn before the maturity date, the client will have to pay an early withdrawal penalty.

4.2.2 Restrictions and penalties

Restrictions and penalties must be understood before advising a client on a deposit account. The types of restriction on deposit accounts include the following:

- **Minimum and maximum balance requirements:** Some accounts stipulate a minimum or a maximum amount to be invested. For example, some money market transaction accounts have to maintain a minimum balance of R20 000. A debit order must also be in place to transfer a minimum amount of R1 000 into this account at a time. If these rules are not adhered to and the account falls below the R20 000 balance, the account is closed.

- **Notice periods:** It must be established if the holder needs to give the bank notice before being able to withdraw funds. Penalty fees for early redemption of deposit and penalties when no notice has been given. These penalties differ from bank to bank.
- **Age restrictions:** The bank provides specifically tailored products to suit the needs of their diverse client base, for example, products for minors, students and senior citizens with specific benefits such as higher interest rates on investment products or special service fees on cheque accounts.
- **Deposit and withdrawal limitations**

4.2.3 Period of notice (liquidity)

The period of notice must be considered according to the purpose of the funds. People who save for a 'rainy day' for a deposit on a house or a car, or in case of emergencies, are likely to need access to their funds in a relatively short period. Individuals and businesses occasionally have funds available that they do not need to use immediately, but they would like to earn some interest on the money until they do – these clients are also likely to want easy access to their funds and would probably choose a call or notice deposit account depending on their specific financial context.

The following accounts allow immediate access to funds:

- Savings account
- Cheque accounts
- Transmission accounts
- Money market accounts

The following accounts require notice before funds can be released:

- 32-day, 60-day, 88-day notice
- Call accounts with 24-hour notice requirements.

Generally, a fixed deposit cannot be accessed prior to maturity, however the client's request can be processed subject to penalties.