Setting the scene

Learning from the informal sector

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Understanding the context

In recent years, there have been commendable efforts to improve access to formal financial services and products such as banking, credit, insurance and contractual savings to South Africa's poor. Extending the benefits of South Africa's fairly developed financial industry to millions of South Africans who were previously excluded from it during apartheid has been a task taken up jointly by government, the financial sector and others to improve economic participation and integration. But it is becoming apparent that in spite of these efforts, South Africans from all walks of life continue to use, if not in some cases prefer, the services made available by the informal financial sector. **To date, as many as 52% of adult South Africans employ informal sector financial products in some form**[1]. What makes the informal sector noteworthy is that it has attracted enough acceptance by regulators that they are not only recognised but actually exempted from certain requirements by the Financial Services Board.

What is it exactly that continues to attract investors to informal sector products? Are there compelling aspects to these products that might help us better address some of the challenges posed by formal sector products?

The formal and the informal: financial inclusion in South Africa

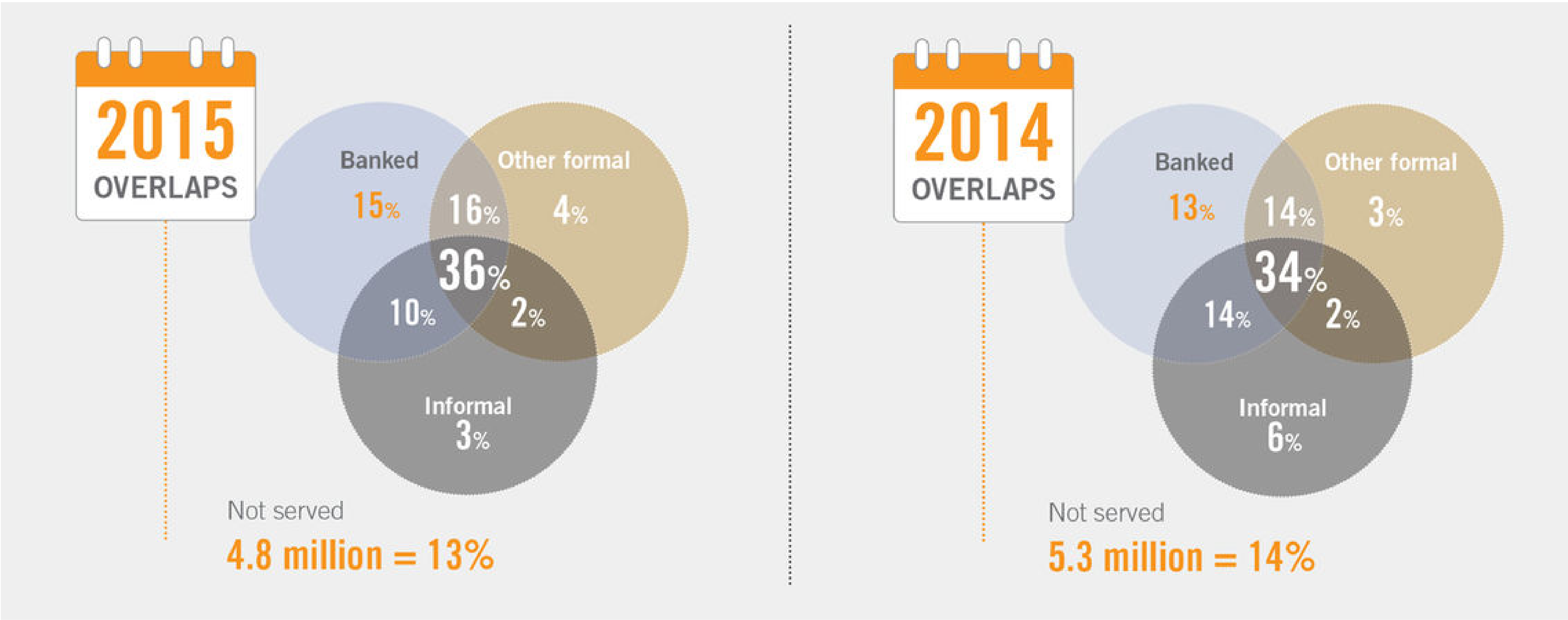
What do we mean when we use the term ‘formal', or for that matter, ‘informal' in conjunction with financial services? The informal financial sector can be described as financial services and activities that are conducted apart from formal institutions, like microcredit lenders and banks, or those that are either unregulated or less strictly regulated. But perhaps the most informative definition is a more colloquial one: informal financial activities are those whose “proper functioning relies at least as much on the establishment of personal relationships as on formal rules and procedures”[2] . As such, informal products and activities include:

- stokvels
- burial societies
- informal borrowing from family, neighbours or other members of the community.

In practical terms, and for this discussion, products and activities included in the formal sector include bank accounts with registered banks, risk insurance products, life cover, retirement annuities, pensions, provident funds or contractual savings such as life cover facilitated through a formal contact with a regulated financial services provider.The FinScope Consumer Survey looks at the extent of financial inclusion in the country– the extent to which people have access to and use formal products. The general trend has been that of increasing inclusion. About 84% of adult South Africans in 2015 were formally served with at least one formal financial product. In most cases, this was a bank account. Still, according to the survey, 36% of South Africans used some combination of formal and informal financial products.

Financial inclusion, and formal or informal product usage

Case study/Lesson



Source: FinScope South Africa Consumer Survey

Informal financial product usage

Source: FinScope South Africa Consumer Survey

Understanding the informal financial market

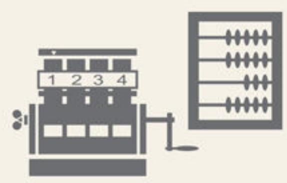
The two dominant savings and investment vehicles in the informal sector are stokvels and burial societies.

The term 'stokvel' is a century-old term referring to a variety of savings and investment clubs that involve regular monetary contributions from a fairly small number of club members, with rotating turns of which member takes the lump sum. The National Stokvel Association of South Africa (NASASA) estimates that there are about 800 000 stokvel groups in South Africa, with about 11.5 million individuals who participate in this R45.1 billion rand industry.

By contrast, burial societies or funeral schemes are usually much larger, often involving tens or even hundreds of thousands of people. Instead of rotational contributions and payouts, burial societies pay out at the time of need, that all-important requirement to provide one's loved ones with a proper send-off. In 2013, self-administered friendly societies had a total of R796 million in net assets. 80% of these friendly societies were funeral societies that paid out R48 083 000 in funeral benefits[3].

These two informal vehicles are also recognised and exempt from certain requirements by the Financial Services Board.

Informal savings by numbers



800 000[4]
Stokvel groups in South Africa

11.5 million[5]
Number of individuals

R45.1 billion[6]
Total value of the stokvel industry

518 322[7]
Number of individuals in burial societies and other friendly societies

Note: Based on friendly societies that submitted returns to the Financial Services Board. Most friendly societies are burial societies.

Types of stokvels

Why has the formal financial sector failed to penetrate the mass market

Formal financial services have tried for some time to find ways to extend their penetration into this sizeable market segment. In late 2005, the four major retail banks and Postbank launched a low-income transactional banking 'Mzansi' account. By the end of 2008, the Mzansi effort had given as many as six million people access to a bank account, but the impact was shallow: many users either never activated their accounts or converted back to cash[8]. Long-term contractual savings products (with a term of longer than five years), savings for education and old age, and life cover products have also had little success with consumers at the lower end of the income spectrum.

Roth, Rusconi and Shand's 2007 study on the challenges of financial inclusion found that the penetration failure was less about consumer reluctance to take up such offerings and more about subsequent consumer dissatisfaction with how the products were conceptualised and serviced[9]. In the case of the Mzansi bank initiative, for example, the authors of the Bankseta 2012 *Investigating vehicles for banking the unbanked* report suggested that the initiative seemed to focus more on distribution and less on meeting the end users' most pressing needs[10]. The Roth, Rusconi and Shand study concluded that dissatisfaction with voluntary long-term contractual savings products stemmed from such things as: lack of full, clear and simple disclosure about what one is buying, early termination penalties and poor after-sales service[11].

Recent years have brought in tighter regulations, such as the *National Credit Act and Financial Intelligence Centre Act (FICA)* requirements, as sensible steps towards protecting vulnerable consumers. But these necessary but burdensome governance and compliance requirements also play a role in deterring consumers from using formal products in the less formal space. A simple FICA-type requirement of proof of residency, for example, can become an almost impossible requirement to fulfil. As South Africa's Independent Electoral Commission recently found, verifying proof of one's residence is hampered by the reality that many of those in what counts as formal employment live in informal settlements with no marked street or house numbers. Credit assessment requirements can mean that many intended transactions are simply non-starters. Time constraints around transactions and access to funds are similarly problematic. **And last but not least, formal product forays into the informal sector have generally failed to grasp the most compelling aspect of informal product offerings: the power of community and peer group to reinforce responsible fiscal behaviour and promote greater financial understanding and insight.**

What drives people to save in the informal sector?

One way to tackle the question is to first understand the general drivers of household savings. Economists De Clerq and others provide an intuitive hierarchy of motives[12].

Level 1: **The cash management motive**
Involving short-term financial issues, such as direct payments for transactions

Level 2: **The precautionary motive**
Developing a financial reserve for unexpected household expenditures

Level 3: **The down-payment motive**
Accumulating financial deposits for buying a house, car or durables

Level 4: **Wealth management motive**
Incorporating enterprise and investing assets

Households with little disposable income, either because they have little income to start with or because their income has to stretch across many needs, will often choose flexible savings products to meet their short-term financial needs. Importantly, a household need not be poor or have a low income to be dominated by short-term financial needs. This can occur when there is a need to distribute income to other members of the extended family who may have very different and more immediate agendas for that income. The magic of informal products is they have a high degree of flexibility and low degree of regulatory or administrative complexity. When flexibility is of paramount concern, these products fill this gap handily for a number of South Africans. However, the flip side of this lack of compliance safeguards is that these investments cannot be used for security. Nor do investors have any form of recourse aside from community moral suasion should any product problems arise.

But there is more. Trust, peer pressure, status, communal pooling of risk and the accumulation of social capital play a critical role in the operational strategies of the informal sector. In addition, because of the community's role in the governance of these products, the informal sector can impose heavy fines for withdrawal, being late, not assisting in funeral planning, or even being drunk – effectively a degree of behavioural control that formal products would find particularly hard to replicate. That means that informal sector products are significantly more effective at addressing the next level of savings motives: the precautionary motive that allows individuals to create emergency savings.

Finally, community and peer support has been shown to be particularly effective in providing an all-important, ongoing coaching and prodding mechanism that ensures people stay on target with longer-term asset accumulation and wealth management. This means that the social aspect of stokvels strengthens social relations.

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In summary, financial products in the informal sector provide participants with these benefits:

- **Diverse applications:** Stokvels are simple and can be used for any number of purposes.
- **Low transaction costs:** Formal products, by contrast, can introduce a host of fees and bank charges for on-boarding, transactions, withdrawal fees and termination.

- **Tangible value with targeted outcomes:** Stokvels make the value of the financial behaviour tangible. Stokvels further encourage better financial behaviour through regular contact with club members and reminders of their financial goals.
- **Financial education:** Stokvels and burial schemes involve open discussions about how the money is going to be used. This is a valuable opportunity to learn with peers about topics that are usually daunting and laden with technical jargon when handled by formal sector professionals. This also creates the space to reflect on and learn from different members' financial journeys, building solidarity and empathetic appreciation of the challenges each member faces, which differs from the impersonal model of formal institutions.
- **Control over terms and regulations:** Stokvels are governed by a stokvel constitution that is adopted by the members as a collective and may be amended by a simple majority vote. This means that if the users have particularly unpredictable and fluid financial lives and needs, it is not an onerous process to amend the terms to suit the circumstances.

We have discussed some of the shortcomings of the formal financial sector, and how those shortcomings often feed into the pull factors that lead consumers to employ the services of the informal financial sector. But what lessons can and should the former learn from the latter? The following section discusses some of these lessons and provides some recommendations on how these learnings can assist the formal sector in rethinking its offering.

How could we better integrate these informal attributes into our workplace

The power of pooling

As stokvels can eliminate unwieldy administrative compliance and administration functions by treating their pool of investors as one entity, they can easily use this lump-sum investment to secure favourable discounts for fees and costs. Grocery stokvels, for example, already enable a community or a company group to buy food stuffs in bulk.

This means the stokvel model could have particular applicability when it comes to initiatives around housing. In the formal sector, the relevance here could be either for pension-backed housing loans or employer-sponsored housing grants and subsidies. The power of pooled resources from members can be applied to the negotiation of favourable deals on construction materials, specialist services, and land rights or purchase of existing assets.

More importantly, the stokvel model can provide a platform for members to share ideas, find educational material, recommend service providers and share best practices. These functions can be invaluable services for the self-build market at the lower end of the housing market in helping people save their time and money – both valuable resources on anyone's financial journey.

> **Stokvel = Power of pooling+ Favourable discounts +Power of the peer group**

The power of peer pressure in debt management and credit rehabilitation

Debt and managing financial crises present pervasive threats to the financial well-being of many South Africans. Both can be accompanied with feelings of guilt and shame and powerlessness that drain people's ability to get out of a downward spiral. But this again is where the power of the group can help individuals overcome that sense of alienation and find the type of ongoing support that can provide that day-to-day guidance. In this regard, the stokvel-type model could be particularly useful in the workplace, where the employer has a decided interest in helping employees cope with debt issues. A savings club aimed at healthy fiscal responsibility could have a number of benefits:

- A platform for emotional support, professional counselling and financial education.
- Peer support helps to overcome debt through pooled funds.
- More favourable interest rates are determined by club members according to the needs of the indebted person.

If a stokvel is a member of an appropriate industry body, such as NASASA, it is allowed to use the accumulated capital from contributions to lend out money to members. The stokvel constitution determines the repayment terms. This means that a workplace debt management stokvel could be created that uses the regular contributions from group members to facilitate emergency group savings. The stokvel would set rules about how to prioritise debt and could settle it on behalf of members. It could also offer favourable interest rates for those assisted, if any at all.

Of course, the key to success in these arrangements is that they are voluntary and that there's trust and familiarity between the individuals. That means that **these concepts are most powerful when they are employee led and managed rather than employer led. But employers can lend support by taking an interest in these activities and making time, facilities and other resources available to help employees as and when they are requested.**

> **The key to success in these arrangements is that they are voluntary and that there's trust and familiarity between the individuals.**

Concluding thoughts

Much of the strategy of engaging with the informal savings space has been from a top-down approach and the two worlds have roughly carried on independently from each other. But when we reflect on the qualities of these informal savings products and why they are so persistent, we can see how necessary it might become to modify formal sector products and services to solve more effectively for social protection.

So what can the formal sector learn from the informal sector? The overall lesson is that people use the informal sector not exclusively because of necessity or lack of access. People often find using informal arrangements much simpler and more versatile to their needs. The shared risk, peer pressure, flexibility of terms and rules and the opportunity to add social aspects such as education and encouragement show that formal sector products may benefit from offering their products with these features. The formal sector as a whole and particular stakeholders like employers have an interest in incorporating these innovations and benefits into their own formal structures as a supplement to products and programmes meant to take care of financial well-being.

The most important reason for finding a way to bridge these two worlds comes out clearly in Part 2: 'Fleshing out the vision a better model' where we ask our members: What do you want? South Africans want the value they see in both worlds and any attempt to keep them separate could lead to inefficiencies in an optimal savings model. We will need to ensure we can integrate the constructive aspects and minimise the destructive ones from both systems in our model. This would enable us to deliver a model that more effectively satisfies the unique needs of South African savers.

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