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**THE MICRO FINANCE SECTOR INTERNATIONALLY
AND IN SOUTH AFRICA**

Sharda Naidoo*

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* Sharda Naidoo is based in Johannesburg South Africa and works as an independent consultant.

This paper¹ discusses the history of financial sector development internationally and locates the South African context in that process.

Roots of micro finance on the international scale date back to the 1970s. At that time, the idea of growing the “informal sector”, now known as the micro enterprise sector, gained popularity as one of the means to expand economy and reduce poverty by inclusion of entrepreneurs on the margins. It was assumed, then that access to financial capital was one of the means to grow this emerging sector. Furthermore, it was proposed that credit should be subsidised as the poor would not be able to afford cost recovery rates of financing. Simultaneously, in Asia and Latin America, innovators were developing new products and methods for providing credit to the poor. By the 1980s, it became evident that subsidised credit was dependent on “political fashion” and that it was possible for agencies providing credit to the poor to become financially sustainable. Further research showed that that the poor needed access to savings as much as they needed credit. Given that asset building is a key feature of poverty reduction, this is not surprising. As a result,, there was a shift from micro credit to micro finance, based on the recognition that the poor (read un-banked) required the same set of financial services as the rest of society². Invention of micro insurance intermediaries as providers of safety nets for the poor is a relatively recent advent in micro finance sector.

By the 1990s an international movement³ on providing financial services to the poor had grown. The core philosophy of this movement is reflected in the vision statement of Women’s World Banking, “Building financial systems that work for the majority.” The basic tenets of this movement are:

- Provision of financial services to the poor is both desirable and necessary;
- Availability of credit to the poor can contribute to poverty reduction when businesses realize good returns on investment. Profitability is, however, dependent on market structures and institutions where businesses operate;
- Despite the fact that credit provision in itself does not reduce poverty, provision of safety nets through savings and economic opportunities are essential;
- The poor can afford to pay cost recovery rates for credit as return on investment is deemed to be more important than the cost of capital;
- While setting financing rates at cost recovery levels is possible, it is still important to build efficiency and scale;
- Efficiency is built by increasing the case loads of staff, reducing transaction costs borne by lender, and achieving and maintaining high recovery rates and scale by expanding the number of clients served by the lending institution;

¹ As the primary focus of this study is the role of private sector in poverty reduction, this section considers financial services for micro and very small businesses (MSEs). This view challenges the widely used definitions of small and medium businesses (SMEs).

² This view is further articulated in the *New World of Micro Enterprise Finance* edited by Elizabeth Rhyne and Maria Otero, Kumarian Press, 1994. A new methodology was devised known as the Financial Systems Approach, which recognises that the financial system needs to be expanded to include the poor and unbanked.

³ In addition to the types of products and systems discussed here, there is widespread recognition for credit unions, village banks and other types of financial institutions, which can and do service the micro market efficiently and sustainably.

- Sustainability becomes viable through a continuous increase in efficiency levels and outreach efforts as lending institutions become profitable by reaching large numbers of clients at the lowest possible cost; and
- As the poor often do not have marketable assets, collateral substitutes are necessary. These may take the form of group guarantees, peer pressure, community standing or other means.

The experiences of a number of institutions achieving the conditions outlined above, have led to a new movement, which focuses on the commercialization of micro finance. In India, SEWA and SHARE and in Latin America, especially in Colombia and Bolivia a number of institutions are trading on money markets to access funds from private investors to re-lend. These institutions can now be evaluated by market ratings agencies, which provide necessary transparency and information disclosure to attract private investors.

This international movement has been predicated on policy innovations and institutional frameworks that were conducive to the development of a viable micro finance sector. At the policy level, it is recognised that there is a need for a regulatory framework, which allows for the development of various microlending services. One of the features of such liberalized financial structures is unregulated interest rate regimes that would allow at the minimum cost recovery, with profitability being the optimal outcome. These frameworks also allow for a variety of lending institutions such as credit only NGOs, private financiers, credit and savings cooperatives, village banks, commercial banks, business NGOs, and grassroots savings groups (roscas). The extent of regulation of such institutions depends on the risk factors of the products they offer.

In the late 1980s and early 1990s success of PKSF in Bangladesh and the Sri Lanka National Development Bank created powerful impetus for wholesale financiers to serve micro finance institutions. As South Africa had started moving towards democracy in the early 1990s, policymakers were persuaded to adopt the wholesale or apex model to stimulate microfinance sector with capacity building and financing capital. Although economic feasibility of such institutions has since been challenged internationally South African policy still applies this model to housing and enterprise wholesalers.

Another anomaly is that South African policy still emphasises credit and not savings, despite the fact that it has been recognized internationally that savings and credit are both equally important in serving financial needs of the poor. Development finance has now been extended to include savings to build assets, insurance to provide safety nets and credit used for asset building and productive purposes such as housing, agriculture, and enterprise development.

CONSTRAINTS FACING MICRO FINANCE SECTOR IN SOUTH AFRICA

- While the principles outlined above may appear simple achieving the goals of sustainable micro finance in practice has proven very elusive. Major successes are recorded in Asia and Latin America but success in Africa (except Kenya and Uganda), especially in South Africa, has been limited. This is due to a number of factors:

- Population concentration and therefore enterprise activity is higher in Asia and Latin America thus increasing the scale in small geographic areas;
- Leaders who established micro finance institutions in Asia and Latin America had more management and finance skills;
- In Africa, South Africa in particular, government corruption makes it easier for people from business and finance sectors to get highly paid jobs who have fewer incentives to be concerned about poverty reduction;
- Distances between settled groups, cities and rural areas increase transaction costs for micro financiers;
- In South Africa the economy is dominated by large conglomerates making it very difficult for smaller enterprises to compete;
- Although micro enterprise sector has burgeoned in the last ten years, it has not achieved much recognition or state support in the post apartheid era;
- Micro finance policy initiatives in South Africa have focused on provision of wholesale finance for credit only (not savings) at the expense of much-needed capacity building support to the entire sector;
- Despite the growth of a highly profitable consumer lending sector in South Africa, extension of credit for productive purposes is still in early stages of development and is, therefore, scarce; and
- The importance of savings as a means for the poor to build safety nets and accumulate assets is still not on the official policy agenda.

In the face of these conditions, micro finance as a development tool is still in short supply and is poorly distributed in South Africa. Nonetheless, due to significant government and donor investment, there are several institutions (e.g. SEF and Marang) that are surviving and expanding. The information above has been provided as a basis for understanding the complexities and challenges of growing micro finance sector that can provide range of services required by the poor. In addition, it may be useful to gain some insights into the process of how micro lenders relate to their clients in delivery of financial products. These are described below.

GROUP LENDING

Institutions that lend to groups, expect that potential clients would be willing to join a group and undergo necessary business training which covers group rules, lending conditions, of how loans are structured and disbursements and repayments are made. The preference for lending to groups is due to efficiency of dealing with groups rather than individuals. Moreover, members of the group are often expected to provide guarantees for the loans of other members in the group. Peer pressure thus becomes a collateral substitute. It must be expected that training in a group takes time before the members of the group qualify for and receive loans.

It is also common that clients start with smaller loans than they initially require and only receive larger loans once they have proven their reliability and have built up a repayment history. This lowers risk of default shouldered by micro lenders. Therefore, clients should expect to start with small loan amounts.

In some cases, preference is given to clients who already have some business experience. This is another risk mitigation technique. With group lending this is less common, but it is still possible. It is also customary for lenders to select their staff from the area they serve. This is done to ensure that local staff has some knowledge of their potential clients. As borrower reputation is another key factor in assessing credit worthiness, this is a further risk reduction mechanism. Potential clients who live in proximity to micro financier are more likely to receive credit.

INDIVIDUAL LENDING

In lending to individuals two methodologies are usually employed. First, if a loan is more than a few thousand rand and the client does not have credit history with a lender, it can be assumed that some form of collateral will be required. Second, a lender is likely to start the client with a very small loan amount and increase the loan size as the client proves their repayment ability.

Where collateral is required it can take a number of forms. Clients may have to take out a specific insurance policy simply to cover the loan and cede the policy to a lender. In addition, clients may have existing policies of which part of the payment may be ceded to a lender. Other forms of collateral could be bonds on property (housing or land) or any other assets, which the lender considers marketable. External guarantees can be regarded as a form of collateral and are accepted by some lenders.

In addition to these conditions, clients should expect that lenders of larger loans would require detailed business plans. These plans will have to demonstrate future viability of a proposed enterprise. In summary, clients of micro financiers should expect a number of different lending conditions to be applied throughout the loan process. The conditions become more rigorous as the size of the loan increases.

SOUTH AFRICA VS. THE WORLD IN MICRO FINANCE

As pointed out above, South Africa has not been very successful in growing the development finance sector. Despite the availability of substantial funds for wholesale and retail financing, development finance sector is characterized by limited outreach, high losses in some cases, large unused reserves, low capacity levels and closures among retail intermediaries, lack of suitable financial products for clients and lack of investment in growing capacity and developing products among institutions. Limited number of institutions is clearly visible in Khula's declining client base. In 1994, Khula was re-lending to 38 retail financial intermediaries. By 2003 their client base was reduced to 16 and it was predicted that only six of these were likely to survive and achieve sustainability.

In contrast to the development finance sector, a massive consumer lending sector has burgeoned in the wake of the Usury Act Exemption of 1994 that was amended in 1999. Proliferation of this sector is evident by the large numbers of consumer lenders that have been listed on the JSE in recent years. So large is the influence of this sector that the South African Reserve Bank has expressed concern about the potential for systemic risk, which could follow from instability in

this sector. As the consumer lending sector that lends only to employed people grew so fast during the 1990s, it has been feared in recent years that it may have reached its peak. While this may be true, which is evident by significant consolidation trend in the sector, a number of small lenders still survive, suggesting that competitive forces have not crowded out smaller players. Given that most consumer lenders charge interest rates of 25-30 percent per month proliferation of this form of lending has a significant impact on further impoverishment of the waged poor in South Africa, those who earn R2000-4000 per month.

While the MFRC was established to regulate policy implementation of the Usury Act Exemption, there has not been a holistic policy framework that focuses on financial sector development. Access to financial services is still polarized across departments lines, e.g. DTI and enterprise finance, housing with housing finance and agriculture with the land bank, etc.

Due to many frustrations of trying to grow the development finance sector, a number of academics and donor agencies are looking to the commercial lending sector (e.g. DFID's Finmark programme to be housed in the Banking Council) to diversify into micro enterprise, savings programs for the poor, and other forms of productive financial services. There are several ongoing dynamic efforts such as Credit Indemnity and African Bank's Small Contractor Lending. To achieve success in reaching the poor commercial sector would need to diversify its loan recovery systems, conduct market research, invest in product development and staff training.

The table below illustrates the extensive financial infrastructure, which exists in South Africa. Evidence suggests that the potential to extend savings and credit facilities to MSEs already exists. Major constraint, however, is the capacity and know how in the finance sector. Current investments have neither been methodically evaluated and carefully, timed, nor has there been a record of improved performance. Khula, for example has spent in excess of R26m on capacity building over the last six years and its client pool has shrunk from 38 to 16 institutions. The reasons for this less than stellar performance go beyond lack of institutional capacity, though the estimate that only 6 out of 16 are likely to survive or reach sustainability indicates severe lack of capacity in the sector at large.

INSTITUTIONAL TYPES IN SOUTH AFRICAN MICRO (AND SME) FINANCE

Wholesalers	Khula, NHFC
Development Banks	DBSA, Land Bank, IDC
Provincial Corporations	MDC, ECDA, Nkwe
Micro Finance Institutions	Clients of Khula and NHFC offering loans < R10 000 and members of MEA
Village Level Savings Cooperatives	Village Banks
Roscas	Members of NASASA
Commercial Banks	Members of the Banking Council
Savings and Credit Associations	FinaSol Network Burial Societies
Commercial / Consumer Lenders	Members of MLA
Private Lenders	TEBA, Furniture and Clothing Retailers, Pawnbrokers
Credit Unions	Members of SACCOL

This lack of institutional capacity was officially acknowledged by the Reference Group on Access to Finance, convened by the DTI from November 2000. This group, which represented the interests of government departments, business groups, micro financiers, banks and regulators, had agreed to an action plan. The plan earmarked eight key benchmarks needed to reach the overall goal of improving access to financial capital for SMMEs:

1. Removal of price barriers to lending to SMMEs will stimulate investment in SMME lending (i.e. lifting the ceiling on the exemption to the Usury Act) – **High Priority, quick to implement**
2. Improved market information (i.e. baseline studies, demand surveys) – **Secondary Priority, quick to implement, on-going**
3. Development of cost effective debt recovery mechanisms (i.e. legislative changes) – **High Priority, more difficult to implement**
4. Increased involvement of venture capital (i.e. tax incentives to attract more stakeholders and stimulate investment) **Secondary Priority, difficult to implement**
5. Adoption of an application scoring system by financial institutions (especially towards start-ups), **Priority for Banks, but slow to implement**
6. Creation of a homogenous government policy framework. **High Priority, ongoing**
7. Improved access to capital for non-banks (involvement of non-traditional role players), **High priority, long-term ongoing effort**
8. Development of institutional capacity building (SMMEs and financial institutions), **High Priority, long term ongoing effort**

The proposed benchmarks stressed the need for regulatory reform, market information and incentives for stronger private sector participation. The action plan itself proposes an innovative classification of institutions providing a range of lending services such as, Urban SMEs, Rural MSEs, and Urban MSEs. Such distinction based on rural-urban disparities is long overdue. This new approach is likely to yield a set of products and institutions that focus on the poor and the under-serviced MSE market. Given the current state of the sector many challenges still remain. Considerable organizational efforts and dedicated financial capacity will be required to achieve the goals set by the action plan.

Major challenges for the Reference Group were:

- a. Devise a homogenous policy and regulatory framework that focuses on financial sector development;
- b. Build an institutional capacity that extends product range and outreach;
- c. Reduce the degree of centralization in current programs to increase MSE finance; and
- d. Build commitment to realistic time frames in achieving eight key goals of the plan.

The Reference group however was dissolved by the middle of 2001 in the expectation that the Department of Trade and Industry would adopt its principles and implement its recommendations. However, in January 2002, the Director General of the Department of Trade and Industry invited micro-enterprise financiers to a panel discussion about the establishment of a new microfinance apex. These discussions continued intermittently until the launch of the Apex, called SAMAF (South African Microfinance Apex Fund) in December 2004. Since

SAMAF was created, Khula Enterprise Finance ceased disbursements to MFIs in March 2005. Despite the official launch of SAMAF, it is still not a registered entity and therefore is precluded from disbursing funds to MFIs. Its ending model appears to be slightly different from that of Khula. Whereas there was an expectation that every MFI could become fully financially sustainable, the new Apex consists of two funds – enterprise loans for MFIs fund to be capped at 60% p.a. and a poverty lending fund to be capped at 36% p.a.

In some cases the lack of disbursement is causing discomfort among smaller MFIs dependent on government assistance for operational and overhead costs. Larger MFIs claim they have adopted not to rely on any single source of funds.

It is still too soon to determine whether the new entity is the long-awaited solution to extending outreach of financial services in South Africa. There has been some recognition in the South African Treasury with the introduction of Draft Bills towards registration of Cooperative Banks and Dedicated Banks. It would be reasonable to argue in favour of a more integrated and cohesive approach in place of these rather disjointed policies. The important issue is, however, to provide vital financial services that will enable the unbanked to build assets and safety nets.

ABOUT THE AUTHOR

SHARDA NAIDOO based in Johannesburg South Africa works as independent consultant. She has been working in small and micro enterprise development, policy development, advocacy and micro finance development since the mid-eighties. In the 1992-1994 period as part of her function as consultant at the Friedrich Ebert Foundation, she was member of a team that drafted the first white paper on small business development for the new democratic government.

She headed up the Micro Enterprise Alliance from 1996-2001, where she established the organisation as the strongest micro enterprise network in Africa. During her time there, she led the Alliance into achieving a change in the Usury Act and created a qualification in micro finance.

As an independent consultant, she has conducted assignments for DfID, Sida, SEEP Network and the National Housing Finance Corporation, among others. She recently completed institutional assessments of four South African micro finance institutions leading to significant donor investment in the sector and has been appointed technical advisor to the Ubutyebi Trust, a housing finance trust working in the Eastern Cape area of South Africa.