

BANKING FOR THE POOR: THE SUCCESSES AND FAILURES OF SOUTH AFRICAN BANKS

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1. INTRODUCTION

Since the democratisation of South Africa in 1994 increasing pressure has been brought to assist the development of the disadvantaged majority of the community living in poverty. The formal financial sector has a critically important role to play in this process. It must somehow open up traditional banking services - deposit and credit facilities - to the poor. In this paper, a selection of the initiatives taken by the four big banking groups (Absa, First National Bank, Nedcor and Standard Bank), whose assets constitute 72 per cent of total bank assets and who operate more than 3000 branches country wide, to engage the poor are analysed. The focus falls on deposit facilities and credit facilities for entrepreneurial purposes. This inquiry is done against the background of the reasons why banks are wary of serving the poor and how these problems may be overcome. The role of government to solve this market failure is addressed in the final instance.

But what does poverty in South Africa look like? Though there is no uniformly agreed poverty line in South Africa, this paper follows the recommendation in the analysis of poverty prepared for the South African government by the World Bank (1995). In this analysis the poor are regarded as the poorest 40 per cent of households, earning less than R5 600 (in 1999 rands) per annum, which is roughly equal to NZ\$1 700 at current exchange rates. This constitutes 53 per cent of the population of 40 million. The ultra-poor are the poorest 20 per cent of households, currently earning not more than NZ\$1 000 per annum, and it projects to 29 per cent of the population.

Poverty has a strong racial dimension. Nearly 95 per cent of the poor are blacks, 5 per cent are Coloured and less than 1 per cent are Indian or white. Unemployment also reflects this racial dimension. The unemployment rate amongst blacks is 38 per cent, and for Coloureds, Indian and whites it is 21 per cent, 11 per cent and 4 per cent respectively. Many of the unemployed turns to the informal sector as a livelihood. According to the Department of Trade and Industry (1998: pars 2.2.1 and 2.2.2) micro enterprises¹ account for 14 per cent of total private sector employment. Poverty, furthermore, has a definite rural and regional dimension. Nearly 75 per cent of the poor live in rural areas, and 66 per cent in three of the nine provinces of South Africa. Poverty also shows a distinct gender and age dimension. Female-headed households have a 50 per cent higher poverty rate than those households led by males. Children below 16 years of age constitute 45 per cent of the poor in South Africa (World Bank, 1995).

2. BANKS DO GENERALLY NOT SERVE THE POOR: WHY THIS MARKET FAILURE AND HOW CAN IT BE OVERCOME?

South Africa has, for a developing country, a well-developed and sophisticated formal financial sector. In comparison to 22 other middle income countries in 1990, South Africa's commercial bank assets constituted 87 per cent of GDP against the average of 68 per cent (Demirgüç-Kunt & Ross, 1996; South African Reserve Bank, 1995). However, the unemployed and those active in the informal sector of the economy, who are in dire need to escape poverty, do not directly benefit as the formal financial sector has very little dealings with them. The South African Reserve Bank estimated in 1996 that 60 per cent of the South African population remains unbanked (Wiese, 1996).

South Africa's experience in this regard is not unique. Throughout the world there is very little contact between formal financial institutions and the poor. Why is this the case? The failure of

¹ Micro enterprises are classified as those enterprises that have the following characteristics: annual turnover of less than R500 000 (NZ\$155 000), one to five employees, and loan requirements of less than R50 000 (NZ\$15 500). They typically operate in the informal sector of the economy.

formal banks to serve the poor is due to a combination of high risks, high costs and low returns associated with such business.

Banks are cautious in supplying credit, because the delay involved before the debt obligation is repaid, subjects the credit transaction to great risk. To offset this risk, bankers screen potential borrowers to ascertain the risk of default; devise incentives for borrowers to fulfil their promises; and develop various enforcement actions to make sure those who are able to repay, do so (Hoff and Stiglitz, 1990: 237). In the case of the poor, these actions are difficult and costly to undertake. Scarcity of information results in information asymmetries between poor borrowers and formal sector lenders.

To side step these asymmetries, which could lead to the poor defaulting on the capital amount, banks require collateral. Unfortunately, the poor seldom have sufficient forms of conventional title to submit as collateral. There is the further risk that the loan may not generate an adequate and sustainable flow of income to service the all-inclusive cost thereof. To ensure a satisfactory and sustained flow of income necessitates a viable business and a sustainable loan.

In addition to informational problems, high operating costs (e.g. salaries for highly skilled personnel, standardised procedures for transactions) relative to the size of transactions with the poor inhibit banks from serving them. Moreover the banks are not alone in facing high costs. Their poor clients also encounter substantial transaction costs (e.g. time and transportation costs) in dealing with them, *inter alia* because formal banks are often not conveniently located.

South African banks experience problems in all of the abovementioned regards. Conventional forms of collateral - the most common being title over fixed property - are, due to South Africa's political past, not available in adequate numbers to blacks. Banks also experience problems in finding viable micro enterprises to lend to. They are, for various reasons, in short supply. The lack of managerial skills is an acute problem. It can be solved by mentoring the entrepreneur, but the costs involved are normally too high for the micro entrepreneur. The high costs also discourage individual banks to undertake this function.

The lack of adequate risk capital (owners and venture capital) in micro enterprises is a further factor that leads to the conclusion that many such enterprises are regarded as non-viable. Banks are not prepared to lend to enterprises that have no or very little risk capital. The danger of the cash flow of a business not being sufficient to meet the regular interest payments in times of adverse business conditions, and there not being any risk capital to act as a cushion, scares off the banks.

It is not only a viable business that is required to achieve a sustained flow of revenue sufficient to service the all-inclusive cost of a loan. The return on the loan itself should cover the costs involved, namely (i) the interest payable to depositors, as well as the opportunity cost of having to hold reserves against deposits in terms of the legal reserve requirements; (ii) an acceptable rate of return to the shareholders of the bank; (iii) the transaction costs involved in granting, administering, monitoring and recovering the loan; (iv) mentoring costs, if applicable; and (v) a provision for loan losses (Tucker 2000: 11-13).

When lending to micro enterprises, it is the transaction and mentoring costs and the provision for loan losses that are inordinately high per unit of funds lent. If banks are serious in their efforts to lend to these enterprises, they need to somehow curtail these costs and/or receive grant funding to cover some of the costs. Grant funding by government to cover mentoring costs can be motivated on the grounds of the positive externalities flowing from such expenditures.

Even if banks do succeed in reducing the risks and costs involved in lending to micro enterprises, it has to be accepted that such lending will inevitably be more costly than lending to the average bank customer. Banks should not be constrained in any way to charge at least cost-covering interest rates. This is currently not the case in South Africa. Only loans of less than R10 000 (NZ\$3 100) are at this point in time exempted from the stipulations of the Usury Act. South Africa appears to be an exception in this regard. In a study of 17 commercial banks involved in micro finance in South America, Asia and Africa (Baydas *et al.* 1997), South Africa was the only country where interest rates had not been fully deregulated.

Is it possible for South African banks to supply loans to micro enterprises? It can be done. More and more examples of banks in developing and emerging market economies are coming forth that have succeeded in supplying loans to these enterprises in a profitable and thus sustainable manner.²

Internationally, three strategies have evolved of how banks can supply loans to micro enterprises in a sustainable manner. Two of these strategies involve banks emulating the way in which informal financial intermediaries solve the high risk, high cost and low return problems banks are confronted with when serving these enterprises. How do informal lenders achieve this?

Informal lenders have developed innovative forms of collateral. One of the best examples is found in the practices of Roscas, informal group-based rotating savings and credit associations, known in South Africa as stokvels. Rosca members have a strong commitment to save, because future borrowing depends centrally on members' past savings record. This incentive disciplines them, and provides a useful instrument to measure a member's commitment to repay future borrowings.

The commitment to repay loans is often not as strong as the commitment to save. Roscas have succeeded in solving this enforcement problem in various ways: strict screening of members (they are usually well-known to each other), the strong incentive to honour commitments (the possibility of being ostracised from the social group, never to qualify for membership of a Rosca again), and members monitoring each other (if one member defaults the group suffers). Although enforcement in the conventional sense is thus not possible, social collateral may prove just as significant and reliable a measure of creditworthiness.

Informal financial intermediaries have also succeeded in lowering the high unit costs associated with administering small savings or loan accounts. In the case of Roscas, social collateral mechanisms have been used to decrease the information costs associated with screening potential loan applicants: groups choose their own members, and their previous savings and loan repayment history is known. The costly access for the poor to formal banks is considerably decreased by informal intermediaries, both by locating close to their clients, and by speedier loan approvals.

The third strategy for banks to serve the poor is where banks link with informal financial intermediaries. The advantage of this strategy is that it can overcome the problems and the costs involved when banks try to replicate the techniques of their informal counterparts (Schoombie, 1999), the essence of the other two strategies.

3. INITIATIVES OF SOUTH AFRICAN BANKS

It has been indicated above that three strategies have evolved internationally of how banks can serve the poor in a sustainable manner. The first strategy is where specialised banks are established that serve the poor exclusively. The Grameen Bank of Bangladesh and BancoSol of Bolivia are of the best known. In South Africa, the establishment of the Community Bank in the mid 1990s was an

² BancoSol in Bolivia and Bank Rakyat Indonesia are only two examples.

attempt in this direction. It was set up in terms of the Mutual Banks Act - with support from Absa, Nedcor, Standard Bank and the Development Bank of Southern Africa - to encourage an alternative approach to supplying banking services for the poor. However, the Community Bank failed, as did this Act to attract a number of new entrants to serve low-income people.

Community Bank replicated to an extent the manner in which informal financial intermediaries successfully transact with the poor (cf. Schoombee, 1996). But it appears the reason for its failure should not be sought in this direction. Rather, the too rapid opening up of new branches - 16 in less than two years - and the high establishment costs associated with it, resulted in liquidity problems. In this regard, note what Gonzalez-Vega et al. (1996: 18) had to say on the experience of BancoSol: "...if learning effects are important in microfinance, it may not be advisable to be born large. Gradual growth from small origins may be a preferred strategy. This may allow for experimentation by trial and error while ensuring that mistakes are not extremely costly and that corrections are possible without leading to disintegration of the organization."

The second strategy is for banks to create specialised divisions/programmes exclusively to serve the poor. The most well known example is Bank Rakyat Indonesia (BRI). It operates the Unit Desa (Village Unit) system and has achieved remarkable success. In the last decade, all of the four big banking groups in South Africa created divisions to serve the unbanked in the economy. These initiatives can be divided into two groups: those that aim to serve low income but salaried individuals, mostly blacks; and those that aim to provide loans to micro entrepreneurs. While all four banking groups were involved in the first category, there was far less interest in serving micro enterprises. It has to be noted as well, as has been indicated in section 1, that the poverty in South Africa has a strong rural focus. Serving salaried individuals, who are employed in the formal sector of the economy, thus excludes the majority of the poor.

The most successful venture to serve the low income salaried blacks is Standard Bank's E Plan. E Plan commenced operations in 1993 with the aim to provide basic banking services to urban individuals who earn less than R3 500 (NZ\$1 085) per month. It currently has in the region of 2,6 million clients.

Standard Bank was of the opinion that it could provide a package of deposit and withdrawal facilities that would be in large demand and at the same time keep the high costs involved in serving low-income clients in check by making use of automated teller machines (ATMs). The package consists of a single deposit account sub-divided in two purses with card-based access at ATMs and point-of-sale devices. The one purse is a cash account and funds can be withdrawn on demand at an ATM. The other purse is a savings account where the client does not have direct access to the savings. Interest is earned at 1 per cent per annum (calculated daily) on a minimum balance of R400 (NZ\$124). An additional 3 per cent per annum is paid if a minimum balance of R250 (NZ\$78) is maintained for more than six consecutive months.

Two further services are also provided by E Plan. Funds can be withdrawn by card by a nominated third party, usually a family member residing in a different area. Third party cheques can be issued at ATMs.

But how does Standard Bank succeed in selling a card-based service to clients who are used to book-based accounts and who are furthermore not technology literate? E Plan branches are conveniently located, friendly (the inside is brightly coloured and a variety of music, sport and educational videos are shown) and user-friendly (ATMs have a simplified screen that utilises both graphics and text; three to four assistants, usually able to communicate in a variety of the local languages, are available to help clients who are not familiar with ATMs).

Standard Bank has not only succeeded in developing a service that is in big demand, but taking a leaf from the experiences of their informal counterparts, also curtails the high unit costs involved in serving low income clients. Fixed costs are kept under control by operating from branches that are far smaller than usual bank branches, not having to install safes (all cash is in the ATMs) and lower security and insurance costs due to the absence of large amounts of cash. Variable costs are kept low because personnel do not require the same amount of training and thus are not paid as much as normal bank personnel. The paper work attached to book-based accounts is eliminated. Opening E Plan branches where it is accessible to large numbers of clients further lowers the average cost per transaction.

Although South African banks are prepared to provide low-income clients with deposit and withdrawal services, very little has been done by them to accede to the large demand for credit facilities. The fast growth in the formal moneylender industry in the last number of years sufficiently proves this point.³ The formal money lending industry was established after certain money lending transactions were freed from the provisions in the Usury Act in December 1992. By 1997, in excess of 5 500 moneylender offices had already been opened country wide with an estimated turnover of R8,6 billion (NZ\$2,67 billion) per annum (Du Plessis, 1998). The typical client is a 35 year old black male. To qualify for a loan, the client has to be able to prove that he has been gainfully employed for at least the last three months, and until very recently, had to have an active bank account and bank card.

The fact that a client of a bank with stable employment in the formal sector of the economy has to approach a moneylender for a loan does not reflect favourably on banks' commitment to serve this section of the community. In defence of the banks, it should be noted that the majority of these loans are required to refinance existing consumer debt, business banks will not normally undertake. Nevertheless, the success achieved by the formal moneylenders has not gone unnoticed by the big four. They are today all somehow involved with formal moneylenders, some via a shareholding and others in partnerships.

Only two banks have specifically focused on serving micro entrepreneurs. Standard Bank's Business Growth Plan, which was introduced as a pilot project in 4 black townships in April 1993, granted loans between R1 000 (NZ\$310) and R6 000 (NZ\$1 860) to micro entrepreneurs without requiring conventional forms of collateral. Although Standard succeeded in keeping bad debts below 4 per cent of the portfolio, in part by adopting some proven informal procedures, the project was terminated at the end of 1996. The major reasons for the decision to withdraw was the high level of operating costs (e.g. relatively high South African wage rates, security costs for staff operating in areas with a high incidence of violence); the unwillingness to charge full-cost and consequently very high interest rates, because of concern for the image that could be created of a powerful bank charging excessive rates to their poor clients; and the low loan level at which the Usury Act became applicable.

The second initiative to serve micro entrepreneurs falls under the third category of how banks can tend to the poor, namely linkage banking. First National Bank's People Benefit Scheme linked the bank to informal financial intermediaries, in this instance to stokvels. In addition to the institutional linkage, lending over the range R1 500 (NZ\$465) to R20 000 (NZ\$6 200) was also linked to borrower savings. Savings were used for both screening purposes (minimum of 6 months saving with no withdrawals before lending was allowed) and for collateral purposes (loans limited to a maximum of 150 per cent of pledged savings). This scheme was operational for approximately 5 years. It was shelved in 1997, due to a lack of demand for loans. Members used the scheme near-exclusively for savings purposes, which in itself is also important, but the scheme was primarily

³ Informal moneylenders have always been prevalent in the informal communities in South Africa.

implemented with the intention to create an opportunity for members to gain access to loans. The latter was accomplished, though to no avail. Why it failed to reach its target market, poor borrowers, is not immediately apparent. The scheme was implemented in accordance with the accepted principles for successful linkages between banks and Roscas (linking with existing Roscas; using savings for screening and collateral purposes). The fact that a non-governmental organisation (NGO) was not involved in this initiative, which is relatively uncommon in linkage schemes (Seibel, 1993: 20), could explain the failure to identify prospective borrowers. NGOs are normally involved in linkage schemes since they are closer to the target market than the banks, and therefore in a better position to identify prospective clients.

A fairly recent development is the formal linking of village financial service co-operatives (hereafter referred to as village banks, their generic name) and formal banks. Village banks are community-managed credit and savings associations that aim to improve their members' access to financial services, to build a community self-help group, and to assist their members in accumulating savings. There are currently 22 village banks with a total membership in the order of 6 000 operational in South Africa. Members' savings and payment for shares are deposited in the linked bank and may serve as collateral for a loan from the linked bank to the village bank, subsequently to be retailed to individual members by a loan committee. Lending is only allowed after a period of savings mobilisation. Lending has recently commenced, but on a small scale.

Informal pressure from the community and the government compelled banks to again seriously consider how they can serve micro entrepreneurs. The banks are adamant that it is not profitable for them to lend less than R10 000 (NZ\$3 100) to this market segment and they will thus not consider granting such small loans (Banking Council, 1998: 27). The Banking Council though, representing 41 banks operating in South Africa, committed themselves in 1998 to undertake an initiative in conjunction with the four big banks to supply loans ranging from R10 000 (NZ\$3 100) to R50 000 (NZ\$15 500) to micro entrepreneurs.

According to the Banking Council, the major problem banks face when trying to engage micro enterprises is the lack of viable enterprises. As was pointed out in section 2, the lack of managerial skills is regarded as probably the most important reason why there are so few viable micro enterprises. The Banking Council therefore decided to include mentoring as a crucial element in the joint project to supply loans to micro enterprises. In terms of this venture, Sizanani Advisory Services (a not-for-profit company) was set up by interest free loans contributed by the four big banking groups. Sizanani contracts mentors who help entrepreneurs in drawing up their business plans when applying for loans and then supervises the business for a maximum of two years. The training of mentors is outsourced and is financed by a substantial grant received from the WK Kellogg Foundation. Interest rates on the loans provided by the banks are levied at the banks' prime overdraft rate plus 6 per cent per annum; three years is the maximum repayment period.

At the same time, Sizabantu Guarantee Company was established to provide participating banks with loan-loss guarantees up to 95 per cent of the value of a loan for a period of two years. Khula Enterprise Finance, a government agency (see section 4.2), underwrites 80 per cent of Sizabantu's exposure.

Although this joint venture has only been in operation for 18 months, the results look promising (Johnstone, 2000). A loan approval rate of 10 per cent has been achieved. Considering the fact that banks are normally not interested in lending less than R50 000 (NZ\$15 500), this is progress. A small number of problems have been experienced with loan repayments. A longer period, though, is required to assess the repayment performance.

4. WHAT ROLE FOR GOVERNMENT IN GETTING BANKS TO SERVE THE POOR?

In the last couple of months, the Minister of Trade and Industry has on more than one occasion expressed his dismay at the slow pace at which banks are entering the market for loans to micro enterprises. Taking into consideration that many of the poor rely on the informal sector to survive and that one of the most important impediments micro entrepreneurs face is a lack of access to capital, the government needs to seriously reconsider the options it has to get banks to serve the poor.

In practice, governments have three policy options to channel capital to specific sectors of the economy, namely state ownership of assets, control of pricing, and the redirection of capital through legislation and government programmes or government-owned specialised institutions. Although state ownership of financial sector assets is a corner stone of the ANC's Freedom Charter, the current ANC government has clearly distanced itself from this option. It furthermore does not fit into the generally accepted current orthodoxy of a market-oriented approach to economic policy.

4.1 Direct control of pricing

Direct control of interest rates, to make credit available at a reasonable cost for specific sectors of the economy, was part and parcel of the non-market oriented monetary and financial policy regime of the 1960s and 1970s. It was believed that governments could stimulate investment and economic growth through direct intervention in the financial markets, e.g. by directing financial markets to allocate funds for specific purposes, by determining the maximum level of certain rates of interest and subsidising others, by fixing exchange rates, and by controlling the in- and outflow of foreign currency. McKinnon (1973) and Shaw (1973) were of the first to argue that such interventions inhibit the development of the financial system, which they regarded as an integral part of the economic development process. This results in the suboptimal accumulation and allocation of capital, consequently constraining investment and finally also economic growth. These authors coined the term 'financial repression' and rather proposed a policy of financial liberalisation, where financial prices are determined by demand and supply leading to the efficient accumulation and allocation of financial resources. This policy approach has been widely accepted and implemented by both developed and developing countries since the 1980s and is currently the ruling orthodoxy, also in South Africa.

South Africa's support of financial liberalisation is evidenced by the shift from a non-market to a market oriented approach to monetary and financial policies in the early eighties. Nonetheless, there still remains one piece of legislation that directly controls lending rates namely the Usury Act of 1968. The intention with this act is to protect unsophisticated consumers from moneylenders who charge excessive rates of interest. Placing a ceiling on the price that may be charged by lenders for personal loans to natural persons does this.

The Usury Act places the government in an unenviable position. On the one hand it wants to protect naïve consumers from exploitative rates of interest on personal loans, and on the other hand the government wants to encourage lenders to supply credit to micro enterprises. The latter will only be undertaken if the return on such loans exceeds the high costs involved, necessarily implying high interest rates. The government has tried to reconcile the two issues by exempting loans up to R10 000 (NZ\$3 100) from the provisions of the Usury Act, thus creating the opportunity for lenders to supply micro enterprise loans at a profit, but at the same time proposed capping the rates on these loans at ten times the prime overdraft rate (prime is currently 14,5 per annum). The ceiling in question (currently 145 per cent per annum) should be liberal enough for any efficient lender to obtain an acceptable rate of return on micro enterprise loans, but at the same time it is substantially lower than the average rate of 360 per cent per annum (quoted by du Plessis, 1998) formal

moneylenders charge.

However, what is at issue here is if sufficient opportunity is created for lenders to supply micro enterprise loans at a profit. The return on loans to natural persons up to R10 000 (NZ\$3 100) is in the hands of each lender. The interest rates on other loans, nevertheless, are still regulated by the Usury Act. Currently the maximum rates are 25 per cent per annum on loans up to R6 000 (NZ\$1 860) and 22 per cent per annum on loans above this amount and up to R500 000 (NZ\$155 000). With the high risks involved in lending to small enterprises, the government should seriously consider increasing the maximum rates on loans above R6 000 (NZ\$1 860) substantially.

4.2 Redirection of capital

The redirection of capital can be achieved through (i) legislation and (ii) government-owned financial institutions or government programmes. Implementing the former option will, as in the case of the direct control of pricing, also be at odds with the ruling orthodoxy in South Africa. As it will result in inefficiencies in the financial markets, ultimately restricting economic growth, the perceived benefits flowing from following this route should be cautiously investigated.

Redirection through legislation

It is not uncommon to find developing countries where banks are committed to direct a certain percentage of their loan portfolios to particular sectors of the economy. In a recent study (McGuire et al., 1998) on policy and regulation of finance for the poor in nine Asian countries (Bangladesh, India, Indonesia, Malaysia, Nepal, Pakistan, Philippines, Sri Lanka and Thailand), it was pointed out that only Bangladesh and Sri Lanka had done away with all directed lending stipulations. The researchers found that although those banks subject to directed credit schemes tend to lend more to the poor than they would otherwise have, such schemes are for various reasons inefficient.

South Africa presently does not have legislation that directs private sector financial institutions to fund specific sectors of the economy or sections of the community. However, the Promotion of Equality and Prevention of Unfair Discrimination Act (Republic of South Africa, 2000) has implications in this regard. This act, whilst intent to prevent and eliminate unfair discrimination generally, nevertheless specifically focuses on discrimination relating to race and gender. It also highlights discrimination in certain sectors of the economy, amongst others the services sector, which includes services relating to banking and the provision of grants, loans, credit or finance. Prohibiting discrimination in bank lending may lead to the redesign of banks' existing creditworthiness assessments because it favours their traditional customers. This act may thus, in an indirect manner, redirect bank funds to *inter alia* micro enterprises.

It has often been mooted that South Africa should implement legislation along the lines of the laws in the USA that forbids banks from discriminating against borrowers on the basis of race. Although the Promotion of Equality and Prevention of Unfair Discrimination Act does address this aspect, it is in essence an act dealing with unfair discrimination throughout the economy.

The relevant USA legislation, consisting of four laws, deals only with financial sector lending. Whereas the Community Reinvestment Act primarily focuses on geographic discrimination (banks not serving the credit needs of the local community), the fair lending laws, i.e. the Fair Housing Act and the Equal Credit Opportunity Act (ECOA), address lending discrimination based on the inherent attributes of borrowers (race, gender, etc.). The Home Mortgage Disclosure Act supports the enforcement of both the Community Reinvestment Act and the fair lending laws. It does this by requiring depository institutions to (i) provide information on various aspects of their lending, including the total number and value of mortgage loans granted in the local market, and (ii) at the

loan application level, to supply details with regard to race, gender, income and disposition of the application (deny/accept/withdraw, reason for denial, etc.). Banks have to make this information publicly available, placing them under the close scrutiny of the public at large.

ECOA, the act most relevant to the issue at question, forbids discrimination in regard to any aspect of a credit transaction (consumer, commercial or real estate loan) based on race, colour, religion, ethnic origin, gender, marital status, age, and receipt of public assistance. Has it been successful? Fairly recent studies by two Federal Reserve Banks on the effectiveness of these laws (Evanoff & Segal, 1996; Gunther et al., 1999) have been inconclusive.

Should the state subject banks to credit schemes directed to micro enterprises? The answer is no on both theoretical considerations (inefficiencies in financial markets) and practical experience (inefficient lending). Should the state implement legislation along the lines of the USA laws discussed above to put pressure on banks to supply credit to micro entrepreneurs? It is believed that the government should consider this option as a last resort only.

Redirection through government-owned financial institutions or via government programmes

Creating specialised development banks, often government-owned, was the predominant manner in which credit - mostly at subsidised rates - was directed to agriculture, small industry and housing in developing economies in the 1950s and 1960s. During the 1970s this approach came under increasing attack as the expected development had not materialised and widespread poverty was still rife. Furthermore, development banks that had directed the subsidised funds started failing due to huge loan losses. The consequence of the above was a sequence of shifts in the focus of development finance to the current focus on creating or supporting the development of commercially viable finance institutions aiming to ensure sustained access to financial services for micro entrepreneurs, known as the financial systems approach to development finance (cf. Schoombee, 1998). This support is mostly in the form of incentives the government gives to these financial institutions to enable them to overcome the problems involved in serving micro enterprises - high risks, high costs and low returns - and is in line with the accepted approach to policy intervention in general, namely a market-oriented approach. The incentives furnished to overcome these problems include credit guarantees and grant or subsidised funding for set-up costs, capacity building and mentoring entrepreneurs. The support governments provide would normally not include funding for on lending to micro enterprises at subsidised rates.

Locally, Khula Enterprise Finance (Khula), a government agency, acts as a wholesaler providing services to retail lending institutions serving micro enterprises. The loan capital Khula supplies is at subsidised rates. While a case can be made out for government supplying loans at subsidised rates to the poorest of the poor, other loans should carry market-related rates of interest. Because Khula is a wholesaler, it does not have direct control over the final allocation of its funds. To in this instance provide loans at below market rates is not good practice, unless sufficient control mechanisms are put into place to ensure that subsidised funding reaches the poorest of the poor.

Khula's portfolio guarantee scheme indemnifies banks when they lend directly to micro enterprises for up to 80 per cent of their loan losses. None have been issued. Recently Khula has also undertaken to underwrite 80 per cent of Sizabantu Guarantee Company's exposure to loans granted to micro enterprises in terms of a joint venture between the Banking Council of South Africa and the four big banking groups (see section 3). These guarantees should, in principle, provide an incentive to lenders to supply micro enterprises with loans. Khula's portfolio guarantees have not been successful in providing additionality, i.e. additional credit and/or credit supplied on less onerous conditions. What is the international experience in this regard? Little evidence of additionality is found in research on guarantee funds. Gudger (1998), in his extensive survey of

such funds in both developed and developing countries, concludes that additionality at moderate cost was only achieved in Germany and Canada. With regard to guarantee funds in Africa, Gudger quotes Meyer & Nagarajan (1996) who found very little evidence of additionality in dozens of such schemes.

Those who argue against guarantee funds offer no additionality in support of their view. There are also other reasons put forward by them (Gudger, 1998). Issuing guarantees are costly and funds seldom succeed in rapidly generating a large enough volume of business to lower the unit cost to acceptable levels. Guarantee funds in Western Europe, for instance, although being the oldest and among the largest in the world, are very subsidy dependent due to low volumes of operations and high operating costs. A good developing country example would be Indonesia. Its government supplies approximately US\$20 million per annum to support guarantees of only US\$13 million (Gudger, 1998:29).

A further argument against guarantee funds is the finding that to date no small, medium and micro enterprise guarantee fund has succeeded in pricing its guarantees to at least preserve its capital base. Finally, because lenders do not carry the risk of default, they will tend to select high-risk loans. The result is a low quality loan portfolio for the fund, which is very costly.

Given that banks have recently shown more interest in Khula's guarantees, it is proposed that the government proceeds with this incentive. The international experience, though, should temper excessive expectations in regard to the additionality that can be created in this manner.

Khula has a capacity building grant for retail lending institutions, excluding banks, that supply loan capital to micro enterprises. Khula should seriously consider making its grant funds also available to banks to retrain staff and to encourage new or novel ways to serve micro entrepreneurs. Government support in this instance can be defended on the grounds of the positive externalities flowing from these activities. Khula might also consider supplying subsidised funding for the purposes outlined above, and not only grant funding. However, if a time-path of declining subsidies is not firmly spelt out, cutting subsidies may prove to be very difficult or even impossible.

Finally, what legal impediments exist that hinder banks from providing micro enterprises with loan capital? Supervisory regulations not originally designed for banks lending small amounts, for instance having to report in detail and on a frequent basis on hundreds and even thousands of small loans, may substantially increase the cost structure of banks serving micro enterprises. Such regulations need to be identified and appropriate regulatory standards designed to lower these costs. Linked to this is the proposal to allow a further tier of banks, with less stringent regulatory requirements, to operate in South Africa. The current village banks will then be able to become fully-fledged banks and have the potential to play a significant role in opening up the financial services industry to micro enterprises, as have the Raiffeisen Banks in Germany.

5. Conclusion

South African banks have since the early 1990s given attention to serving the poor. Their focus has fallen on providing deposit and withdrawal facilities, but mainly for those who earn an income in the formal sector of the economy. Given the fact that most of the poor live in the rural areas, these initiatives have not succeeded in reaching the poor to a significant extent. The banks' limited attempts to provide loans to micro enterprises have not been a success either. The Banking Council's initiative looks promising, but it does not address the demand for loan funds under R10 000 (NZ\$3 100).

The South African government has a role to play in opening up banking services to the poor. Providing incentives to banks to enter this market segment appears to be the correct approach. It must be remembered, however, that banks will only serve the poor if it is profitable. Current legislation hinders banks in at least two ways in achieving this. The Usury Act limits the rates payable on loans above R10 000 (NZ\$3 100) and stringent regulatory requirements of both the Banks Act and the Mutual Banks Act inhibit the formation of new types of banks that are better suited to serve the poor profitably than the current banks can. These hindrances must be eliminated speedily.

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