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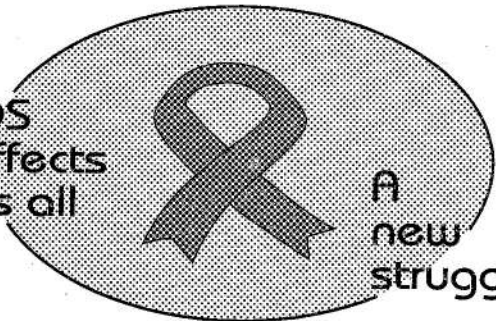
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No. 21381

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GOVERNMENT NOTICE

DEPARTMENT OF TRADE AND INDUSTRY

No. 706

21 July 2000

USURY ACT, 1968 (ACT NO 73 OF 1968)

REPORT ON COSTS AND INTEREST RATES IN THE SMALL LOANS SECTOR

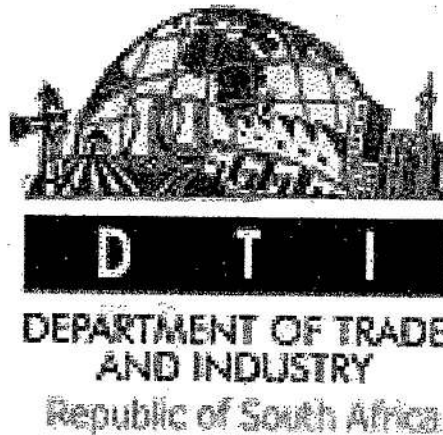
I, Alexander Erwin, Minister of Trade and Industry, do hereby publish for general comment a report titled "**Examination of Costs and Interest Rates in the Small Loans Sector.**"

Interested persons are invited to furnish written comment and representation on or before 25 August 2000 to:

The Director-General
Department of Trade and Industry
Private Bag X84
PRETORIA
0001

For attention: Ms Lizell Reinecke
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ALEXANDER ERWIN
MINISTER: TRADE AND INDUSTRY



Examination of Costs and Interest Rates in the Small Loans Sector

May 2000

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DTI Interest rate study

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List of Acronyms

AMEP	Alliance of Micro-Enterprise Practitioners
AMSA	Association of Microlenders
APR	Annual Percentage Rate
CC	Closed Corporation
DBSA	Development Bank of Southern Africa
DTI	Department of Trade and Industry
ECI	Ebony Consulting International
EU	European Union
GDP	Gross Domestic Profit
JSA	Johannesburg Stock Exchange
LSM	Living Standard Measure
M&SE	Micro & Small Enterprise
MFI	Micro Finance Institution
MFRC	Micro Finance Regulatory Council
MLA	Micro Lenders Association
NASASA	National Stokvels Association of South Africa
NBFI	Non-Bank Financial Institutions
NGO	Non Governmental Organisation
NHFC	National Housing Finance Corporation
RFI	Rural Financial Institution
RHLF	Rural Housing Loan Fund
ROA	Return on Assets
ROE	Return on Equity
ROSCA	Rotating Savings and Credit Association
SAM	South African Microlenders
SAML	South African Micro Lenders
SCF	Southern Corporate Finance
SMME	Small, Medium and Micro Enterprises
UEMOA	West – African Economic Monetary Union
USA	United States of America
USAID	United States Agency for International Development

Executive Summary

Background

The microlending industry in South Africa has veritably exploded over the past eight years since the Exemption to the Usury Act in 1992 removed interest rate ceilings on small loans under R6,000. It has been an excellent example of how a virtually non-existent financial industry can develop given the right incentives. It has been fuelled by private capital and is currently seeing large amounts of investment from the formal financial sector. The sector has seen so much growth that in June 1999, the Minister of the Department of Trade and Industry (DTI) issued a new exemption to the Usury Act which created a regulatory institution (the Micro Finance Regulatory Council - MFRC) to manage the sector, added new regulations to govern the way that microloans could be given and repayments collected, and set a ceiling on the interest rates that could be charged under the exemption.

In a law suit concluded on November 11, 1999, the Judge upheld most of the new notice for the Exemption, but struck down the interest rate ceiling, which had been set at ten times the prime rate. The DTI is concerned by a number of issues related to interest rates – the potential exploitation of borrowers by lenders, the impact of high interest rates on borrowers and potential debt spiral, and the shortage of micro-enterprise finance. It therefore commissioned this study to examine the cost of making small loans to help it to establish a new interest rate policy that would address those problems.

The study was carried out by a three person team over a ten week period from February 16 to April 25, 2000. The findings and recommendations below are the result of interviews with many of the key stakeholders in the industry, interviews with dozens of microlending institutions, review of literature on interest policy from around the world, in-depth examination of data collected by the MFRC, and analysis of data provided from the government payroll system (Persal).

Key findings

The microlending industry has entered a very dynamic stage of its growth since the creation of the MFRC. The industry has seen unprecedented investment by formal financial institutions in the sector and is being integrated into the overall financial system of South Africa. It has a very dynamic formal side, parts of which are undergoing much change, and a very large informal side, which has not changed at all.

The formal side of the industry is highly diverse. With more than 850 registered institutions comprising more than 3,500 branches, it is comprised of a range of different firms with different legal statuses (from natural persons to publicly traded commercial banks), a tremendous variation in size and outreach (from lenders with 100 clients and R50,000 in the portfolio to lenders with over a million clients and more than three billion Rand in the outstanding portfolio), and important differences in targeted term of loan (from five days to three years). Interest rates from microlenders vary greatly from effective rates of 60 percent for long term loans (up to three years) to rates that can surpass 1,000 percent for very short term loans of less than a week. But interest rates are not the main concern to the borrower, especially on the very short term loans. The borrower's main concern is getting access to the credit and on the usefulness of the money for the period that s/he has it.

The overall size of the formal industry is growing. According to the MFRC statistics, the average outstanding balance at any point in time is about R5.3 billion for about 2.5 million clients. The registered smaller, cash lenders specialising in 30 day loans account for over

400,000 clients with a current book of nearly 0.5 billion Rand. This contrasts with the 1.35 million outstanding term loans worth over 3.4 billion Rand.

On an annualised basis, however, the estimate of the turnover from the registered firms places it at about R10 billion, accounting for more than 7.6 million loans. In contrast to the snapshot view of the industry where the term lenders dominate, on an annualised basis, the short term lenders, (less than six months) account for nearly 80 percent of the loans made and 64 percent of the total value of loans made in the course of the year.

The informal side of the microlending market is comprised of traditional sources of short term money for South Africans. These include the mashonisas (or township lenders) who provide thirty day money at rates of 30-50 percent per month, the stokvels (including burial societies) that provide rotating credit and informal savings operations to their members, and pawnbrokers that function under the second hand goods act.

It is estimated that the total size of the industry between formal and informal lenders, on an annualised turnover basis, is in the range of R25 billion.

There is an increasing problem with over-indebtedness in South Africa. The data from PERSAL is quite clear that over the past eight months, there has been an increase in the number of borrowers in the government system and a substantial increase in the loan volume and number of loans per borrower. Nearly half of the clients on the PERSAL system now have loans and 15% of those are trapped in a debt spiral¹. This was also reflected by a rural survey carried out in the Northern Province, which showed that 25 percent of the borrowers borrowed to make payments on another loan.

However, the major debt problem appears to be stemming from the term lenders, who are taking salary deductions at the source, before the employee even sees his/her paycheck. Some term lenders often write irresponsible loans to salaried employees, leaving them with unacceptable net take-home portions of the salaries that are then forcing the clients to take short term debt at even higher interest rates. This is a greater cause of long term indebtedness than short-term loans from the 30 day cash lenders.

Conclusions

We therefore conclude that merely fixing an interest rate at a specific level is a naïve approach to regulating this sector. This sector is far more complex. Fixing an interest rate ceiling will not address the indebtedness of the people already trapped. It will not increase competition to the extent of driving down prices. It has not worked in other countries and it will not work in South Africa. People already in debt will suffer more, since ceilings will drive many of their providers underground, out of public scrutiny. Even if a ceiling is fixed, no amount of resources will ensure a complete monitoring of the sector. Instead, we suggest a more pragmatic approach should be pursued, based on the reality of the sector and the assumption that we do not want to stifle the sector with legislation. We also do not support unlimited freedom to microlenders as we believe in transparency and the strong vested interest that the larger lenders have in developing this into a sound, sustainable market.

The main problems fall into two arenas. First, the borrower is ultimately responsible for his/her own actions. Second, but the lending institutions also play a critical role in the problems of the sector. Therefore the solution must address both of these constituents. In addition, shortages of capital for microenterprise lending are a function of the perceptions

¹ A debt spiral is when a borrower is forced to borrow to help pay back his loans, hence driving him deeper into debt.

of high risk in the sector, poorly adapted lending technologies, and lack of incentives to invest in new product development in the sector.

The Problems and Broad Solutions

At the root of this study are three main concerns for the DTI:

❑ ***Apparent over-indebtedness of the client, causing a debt spiral***

The base cause for this condition is due to two major factors: aggressive lenders and uninformed or naïve clients. The high interest rates being charged to the clients are not the cause of the over indebtedness, but do exacerbate the problem.

❑ ***Exploitation of the clients by microlenders, leading to apparent over-indebtedness***

Exploitation can be seen either as lending a borrower more than s/he needs or wants or charging them a higher rate than they thought that they would be paying by adding on extra charges. The base cause for this condition is due to aggressive lenders, uninformed clients, and poor information flow between clients about alternative options. Exploitation can take the form of overselling the borrower on credit (i.e. lending him/her more than s/he needs), not providing accurate information to the borrower about the implications of the cost of lending and the borrower not being aware of other options.

❑ ***Insufficient small and micro-enterprise finance.***

While consumption credit is spreading like wildfire (based on payroll deductions), small and microenterprise finance (where repayment is based on cashflow not on guaranteed salary deductions, is not growing very rapidly). The commercial banking sector provides very little enterprise finance under R50,000 (its "glass floor") and the microlenders provide very little above R10,000. The fact that it is cashflow based means that the perceived risk is higher than payroll based lending.

For the first two sets of problems, there are four major categories of solutions that are appropriate to address the cause:

- Restrict or control the lenders;
- Educate and inform the borrowers and their employers of the dangers of borrowing;
- Improve information flow among borrowers and lenders; and/or
- Restrict or monitor/control borrowers access to credit.

For enterprise finance, the two main causes for the insufficient supply of small enterprise finance:

- inappropriate lending technologies which will cover risk and special characteristics of the market and
- a lack of incentives to the lenders to enter the market.

The Recommendations

Based on the analysis above and the overall shared vision of the potential of the microlending sector in the future, we propose the following recommendations:

1. *Who to try to regulate:* DTI and the MFRC should focus their efforts on those players with the greatest impact on the sector, namely the short term cash lenders and the term lenders.

2. *Restricting the lenders:* should interest rate ceilings be fixed, and if so at what level?

The analysis demonstrated that the size of the branch has a big impact on the surplus that the branch earns, but so does the age and maturity of the lending institution, the location of

the business and nature of the clientele. Setting interest rate ceilings will restrict the flow of credit into the system. This, in turn, will have the greatest impact on those who have the greatest need for short-term emergency credit, the poor. This would likely force them to go to the informal lenders who are even more expensive. Our analysis demonstrated that rural and peri-urban lenders, serving the poorest members of the community, require the highest interest rate to make a profit.

However, if the DTI decides that setting interest rates is an imperative, they should not be set based on the cost of money, but rather on the administrative costs of making the loans. In order to promote the greatest amount of transparency in the industry (in order to promote and stimulate investment in new products), while still maintaining the level of service provision, the DTI should set the interest rate ceiling as high as possible and set it as a fixed rate. Having a fixed rate of interest will allow investors to do their calculations and determine where they wish to invest their money.

The ceiling should be based on the price that has been set by the current short term market forces. This will cause the least distortion in the market and will not penalise the rural poor. Therefore, our recommendations would be to place two ceilings, one for short term cash lenders and one for term lenders, since there are significant structural differences between the two.

The effective interest rate ceiling for the cash lenders should be set at 30 percent per month. A gradual lowering of this ceiling could be planned over time, providing a sufficient delay between the reductions to allow the industry to incorporate the changes needed to bring its cost structure down. The timing and amount of the reduction should be published to allow the industry to prepare.

The effective interest rate ceiling for the term lenders should set a 10 percent per month, initially, with a gradual reduction planned over time.

3. Other restrictions on lenders need to focus on setting and enforcing prudent lending policies and procedures.

- DTI should institute a system to make the term lenders responsible for limiting the level of debt exposure that they place on borrowers through the PERSAL system. This should be based on a repayment ceiling of 25 percent of gross salary (for interest and principal repayments) which is considered to be the safe lending limit in most developed countries for term loans. This will protect the long-term integrity of the market.
- Short term loans, which respond to emergencies and which can be paid off after a month should not be subject to this ceiling. In any event, it could never be enforced.
- DTI should institute measures that will increase the risk to lenders who practice irresponsible lending practices, such as depriving them of recourse to compensation in case of default.
- DTI should motivate the large term lenders, as well as the short term cash lenders, to institute their own more stringent industry standards on lending practices for acceptable levels of debt exposure.

4. DTI should promote improved borrower education through the following methods:

- Promote the development and delivery of improved promotional and education materials by the microlenders for the industry. Since the employer is the best point of control for lenders desiring to provide services through the company, they must be included in this campaign and must insist that the microlenders provide clear, concise, and comprehensive educational material as a condition for entry into the company.

- DTI and the MFRC, in conjunction with consumer groups, should launch a national education/sensitisation programme on the risks of becoming over-indebted.

5. Improving the flow of information for borrowers as well as lenders.

Clearly, there is limited flow of information about borrowers at present, even though there are three credit bureaux that are concentrating on clients of the short term cash lenders. Therefore, the DTI should promote:

- the creation of a national loans register that will allow lenders to identify the level of debt exposure already facing an individual, either through creating a national loans register managed by the MFRC (government financed) or by the private credit bureaux (privately financed). Alternatively, the MFRC could do the R&D and then turn it over to the private operators for implementation.
- DTI should continue to require the full disclosure by lenders of all charges to the consumer and the monthly flow of payments in easily understandable language, including the annual percentage rate as calculated by the MFRC.

6. Restrict borrower access to lenders for certain categories of borrowers through

- Limiting the level of debt coverage that a user can apply for;
- Limiting the number of loans a borrower may access at a time.

Both of these can be easily bypassed by the borrower. However by making them aware of and promoting industry standards and guidelines as a form of consumer protection, this may act as a catalyst for borrowers to consider the implications of the loan.

7. Stimulating investment in SMME finance.

Stimulating investment in SMME finance remains a serious challenge. The recommendations are:

- Increase the ceiling on the exemption from SMME loans beyond R10,000 to R25,000. Increasing the ceiling will make it interesting for commercial microlenders to invest in this market, stimulating innovation in lending technologies in the market.
 - Continue to facilitate capacity building through government sponsored programmes such as Khula and promote standardised reporting to the MFRC for enterprise lenders.
8. To ensure coherent follow-up to this study, the MFRC and DTI should pursue thorough and regular monitoring and analysis of the sector by:
- its methods of data capture at the MFRC to be able to carry out regular analysis on the trends in the industry and publish those reports for the industry as a whole.
 - The DTI should carry out regular monitoring of the trends on the PERSAL system to monitor the impact of its policy initiatives on addressing the key problems of over-indebtedness.

1. Introduction

Microfunding provides access to credit to individuals who need relatively small amounts of credit at a time. By definition, these individuals represent the poorer elements in society who do not have access to formal bank loans, to credit cards or other automatic debit facilities. The development of a semi-formal or formal microfunding industry in most countries is seen as a positive element in the development of a financial system that is expanding its outreach into lesser-served segments of the economy. This results in financial system with deeper outreach, overall.

In most developing countries, there exists a very small formal sector that provides financial services to the poor or to small borrowers. In West Africa, the recent development of the savings and credit unions that have achieved significant scale has created sustainable institutions that are providing both consumer and productive finance. In East Africa, the co-operative savings systems have been very good at collecting savings (which is an important financial service for the poor), but have not been able to complement it with successfully providing small loans. In Central Africa, there are virtually no formal or semi-formal financial systems that are servicing the bottom end of the market.

South Africa is a unique case in Africa and its microfunding sector is not exception. Most of its nine million salaried employees have bank accounts, representing a large segment of the population that is linked to the formal banking system. However, most of these individuals do not benefit from access to other financial services, including credit. There has been a very heavy reliance on the informal sector to meet both short and long-term savings needs (e.g. stokvels and burial societies). For credit, the populations who cannot access formal bank finance go to informal, township-based moneylenders (mashonisas) or pawnbrokers for emergency and short term finance.

In 1992, the issuance of the Exemption to the Usury Act removed loans under R6,000 from the interest rate ceiling. This was designed to open up the market for servicing small borrowers. This created the incentive for the development of a new industry to provide credit to the large number of salaried employees with bank accounts, but who could not obtain credit. From an informal credit system carried on in the backs of shops or shebeens, a new officially sanctioned microfunding industry has grown to achieve proportions that are unparalleled in the rest of Africa. With an estimated annual turnover of between 20 and 30 billion Rand, microfunders now provide a wide variety of credit products to millions of South African consumers for a wide range of uses. This has been an extremely dynamic, demand driven industry.

But with the development of any dynamic, new industry, there are individuals and companies that abuse the system or use socially unacceptable means of doing business. This provides a need and an opportunity for government to introduce rules and regulations to govern the industry and to provide a framework for the sound growth of a socially responsible industry. This regulatory framework needs to consider how to foster the continued growth of the industry and link it to the rest of the formal financial sector without creating distortions in the market to address specific social issues. As with any other demand driven industry, the regulatory environment must be careful to not cause disinvestment in the sector, or lead to an exodus of the formal lenders towards the informal and unregulated parts of the economy where they cannot be monitored and controlled.

The Department of Trade and Industry (DTI) commissioned this study to examine the costs associated with lending and the interest rates for the small loans sector in South Africa. This study will provide the background information to the DTI to assist it to develop criteria for setting further regulations for governing the microfunding industry.

1.1 Background

The government has put in place a set of rules and regulations to govern the microlending industry, while trying to draw large semi-formal segments of the microlending industry into the formally regulated sector. The Exemption to the Usury Act, described in Annexe "A" to Government Notice 713 of 1 June 1999 lays out these rules and regulations. It successfully sets the conditions for better control and monitoring. It addresses many of the concerns about the social acceptability of the methods and practices being used by microlenders to guarantee their repayment, as well as on "acceptable" interest rates. Paragraph 3.3 of this Annexe set the maximum rate of interest² on microloans at ten times the prime rate of interest from the Reserve Bank of South Africa.

These rules affected the operating methods, practices and profitability of an important segment of industry stakeholders, the short-term cash lenders. These rules were not well received, and a number of them filed suit against the DTI. Their key practical issues were with:

- ♦ The Minister's ability to delegate his responsibilities to another institution outside of government, the Micro Finance Regulatory Council (MFRC) (paragraph 1.6 of the Notice)
- ♦ The date of commencement of the regulations (paragraph 4 of the Notice)
- ♦ The interest rate ceiling (paragraph 3.3 of the annexe)
- ♦ The use of standard approved written agreements (paragraph 2.3 of the annexe)
- ♦ Informing the clients about intended filing of credit history problems with a credit bureau 28 days before such filing (paragraph 2.11 of the annexe) and
- ♦ Restrictions on collection methods (paragraph 5.1 of the annexe).

On November 11, 1999, Judge Mynhardt ruled to set aside paragraph 3.3, governing the maximum interest rate, from the Annexe, but upheld all other elements in the Annexe. He determined that the Minister of Trade and Industry did not adequately study the issue of interest rate ceilings and their impact on the industry before arriving at the formula for a maximum interest rate. However, he ruled that none of the other key elements being contested by the applicants would be set aside.

Upholding paragraph 5.1 of the annexe, which interdicted the use of personal information such as pin codes and bank cards as security arrangements, will have an important structural impact on the industry. As the pin card has been the main source of security for the short-term cash microlenders, they maintain that this will have an important negative impact on their cost of doing business and their rate of bad debt. The removal of the bank card and pin will force the industry to invest in other risk control tools, which will take a while to develop, test, and put into application.

1.1.1 Issues leading to this study

Key concerns for the DTI

DTI is concerned with many issues relating to interest rates and the microlending sector and practices. The first is related to the exploitation of the client by the lender, either real or perceived. Money lending has long been a controversial issue. It is often cited to be the oldest profession in the world, subject to many abuses especially when servicing people who do not have much choice. Over the years, socially acceptable norms for interest rates have arisen, and if an interest rate is perceived as being too high, it brings many negative perceptions with it. The public perception of a 30 percent per month interest rate is that it is

² Said rate of interest to include all transactions costs associated with making the loan, except insurance.

very high. However this does not necessarily reflect the perception of the borrower who may not look at the interest rate as the qualifier, but on the affordability of the loan (ability to repay) and the benefit that s/he will derive from the use of the loan.

The second main concern is the impact of the interest rate on the borrower. The "debt spiral" refers to individuals who owe so much on their loans that they are caught in a trap where they must continue to borrow in order to pay off past loans. It can be demonstrated that high interest rates can more easily lead borrowers into a debt trap, from which they cannot escape. Critical questions that need to be investigated are how does it start, who is responsible (the lender or the borrower), and what exacerbates it? Clearly high interest rates can exacerbate a debt spiral.

A third concern for DTI related to interest rates, but which has less to do with consumer protection, is how to increase the investment in SMME lending. Interest rate ceilings contribute directly to creating disincentives from investing in new technologies to make loans that are perceived to be riskier. Higher interest rates can provide the necessary incentive to invest in developing those new tools and technologies, as has happened with the microlenders.

Issues surrounding determining the cost of making small loans to set interest rates

This study has been a long time coming. It was to have been one of the early endeavours of the Microfinance Regulatory Council (MFRC) that has been delegated the role of regulating the microlending industry in 1999. The DTI considered doing the study before issuing the Exemption Notice in June of 1999, but did not. As they testified in the court case, "the microlending industry contained so many diverse operations and products that research aimed at establishing objectively an appropriate interest rate for each lending product would not be feasible. This level of sophistication is only achieved in a few developed countries and the industry and its regulation has not yet developed to such a level of sophistication."

On the surface, setting interest rates appears to be quite a simple concept: identify the costs associated with providing credit services to different kinds of clients, add a "fair" profit margin, and set the interest rate cap. But in reality it is not so simple. As has been identified during this study, there are myriads of different elements that must be taken into consideration. In terms of costs, some of the issues that must be addressed include questions like what costs should be added into the calculation? Does one consider only mature companies, or also those companies that are in the start-up and investment phases?

When addressing the issue of "fair profit margin" some of the questions are: fair to whom? Is it adequate to ensure continued investment in the industry? In terms of the effects of capping interest rates, will it restrict the entry of new lenders into the market, especially in the harder to reach (and therefore more costly) small, rural, isolated markets? Will capping interest rates lead to a restriction in the supply of credit to the poorest members of the community? How will the setting of interest rates affect the overall levels of competition in the industry?

1.1.2 The Microfinance sector within the South African Economy

How big is the microfinance sector in aggregate economic terms? The microfinance sector is still quite small in comparison with the formal banking sector, but growing much more rapidly. Its contribution to the national economy is probably not accurately reflected in the national data because of the informal sector nature of many of the industry members, resulting in an under-estimate of size and contribution to GDP. The finance, insurance, real

estate and business services sector is a significant contributor to the South African economy, providing approximately 15% of total GDP in real terms in 1998. The total assets of the banking sector at the end of 1998 were R654 billion, with advances totalling R545 billion. Although the size of the microfinance industry is estimated at R10 to R15 billion with advances at R10 billion (Econometrix, 1999), we would argue that this is a gross under estimate. However, it is dependent on the definition of the sector and Econometrix focused only on the microlending component. Crude estimates of the total microfinance industry would be at least R20bn, based on an assessment of current supply of microfinance.

1.2 Methodology and key issues in the examination of the subject

1.2.1 Data gathering design and implementation

The time frame and scope of this study necessitated innovative approaches to data gathering and analysis. It was decided that the emphasis would be on secondary data and surveys would only be used to confirm and enrich secondary sources. In this regard the following secondary and primary sources were identified and exploited.

Information from the MFRC database

The complete database of applications lodged with the MFRC was the starting point of our analysis. After studying the applications' data, we focused on those applications that were successful since the MFRC captured more detailed information on these institutions, than those that were not approved. We then chose approximately 90 institutions for which we obtained the financial statements submitted by these institutions to the MFRC, to analyse their data. We captured this information from the files, since the MFRC has not yet started capturing of the content of the financial statements into a database. We chose these institutions based on a random sample of firms from within each legal category, stratified by size. Thus, we tried to obtain a spread relative to certain key variables (e.g. annual turnover, branches, clients, and term of loans) to ensure that our cost calculations covered a diagonal cross section of different microfinance institutional formats. We then interviewed a number of these institutions on the basis of a carefully structured questionnaire (Annex 8) to confirm the MFRC data and to obtain more information on risk and other product characteristics.

Submissions to DTI

The DTI supplied us with a range of submissions provided by institutions in the sector during the period before the announcement of the regulatory changes.

The November 1999 court case

A copy of the November court case was studied in detail and is discussed above, in Section 1.1.

Survey of clients of informal lenders

The University of Pretoria launched a survey amongst clients of informal lenders. The results from this survey are analysed and presented in Section 4.4.2.

Government Personnel Salary System (PERSAL)

The DTI arranged access to the PERSAL database. The Department of State Expenditure (DSE) assisted in drawing snapshot information for two time periods (July 1999 and

February 2000). Although the number of variables are quite limited on the PERSAL system analysis of their data did give us a good overview of the indebtedness, profile, and geographical spread of debtors. This is discussed in Section 4.4.3.

Interviews with stakeholders

It was decided in the beginning of the study period that the budget and time allotted to this study do not allow for a comprehensive survey of the sector. Thus, we mostly made use of secondary data as was argued earlier. However, we felt that interviews with stakeholders in the form of associations and groupings of different institutions would add tremendously to our assessment of trends and possible future happenings. This proved to be extremely worthwhile. A list of people and institutions interviewed is supplied in Annex 3. We interviewed more than 40 institutions covering several hundred branches, many of which made very comprehensive presentations to us.

1.2.2 Discussion of profitability calculations

We have already seen that there is demand for microcredit, be it from a legally registered commercial bank, a Section 21 enterprise development lender, a "cash loan" microlender, a pawnbroker, or a mashonisa. If one is to try to put a ceiling on interest rates, the issue that arises is "what is a fair profit margin?" As noted in the earlier sections on the different types of lenders, each serves a discrete market that is not being serviced by other lenders, either because of risk, lack of resources, or other factors. The costs associated with the lending will vary greatly (see below) depending on the market, the type of lender, the technologies being used, the cost of money, etc. The return to the lender from the lending operation may also be a function of the other activities in which the lender is active.

While the return to the lender may vary greatly in terms of a percentage of the amount loaned, the actual Rand return to the lender will also vary greatly based on the overall amount loaned. Is it proper to compare an individual lending 4,000 Rand of his/her own money during the month with a bank that is lending billions of Rand? The first must consider the labour and risk that the lending engenders and earns net revenue of R1,000 a month (R12,000 a year for an annualised 300% return on equity), while the latter earns net revenue of R50 million a year on an equity base of R250 million (a mere 20% return on equity). When one takes into consideration that the bank will never lend to the clients that the small lender will due to the risks, different perspectives arise. Clearly there needs to be different mechanisms and approaches for estimating a reasonable return to investment, be it based on time or money, for different kinds of lenders.

Return to Labour

Some of the research that has been carried out on microenterprise development can be very helpful in sorting through this issue. Microenterprises, by their very nature, earn very small amounts of money in absolute terms given their small scale. A microenterprise might gross R100 in a day based on R50 in inventory that it sells, for net earnings of R50. This represents a 100% return on the investment in a single day, but the actual return to the individual remains small for a full day's labour (his only equity).

To resolve this issue, leading practitioners in microenterprise development advocate using a calculation based on the return to a day's labour for the small enterprises. This allows for a more rational and realistic comparison for the microlenders on the best ways for them to earn a living wage and where their financial incentives lie.³

³ Haqqblade and Gamser, *A Field Manual for Subsector Practitioners*. November 1991, p. 33

Return on Equity (ROE)

ROE is the standard performance measure for any investor in deciding where to invest. The long-term survival of businesses requires that they earn a satisfactory and sustainable return on shareholders investment. If a business does not provide a competitive return on equity, it will lose the investment as the owners of the funds will move them to other investment opportunities that yield a higher return.

Table 1: Overall ROE and capital ratio of the major commercial banks in 1998 compared to Theta Group in 1999

Name of Bank	ROE	Inflation adjusted ROE	Capital Ratio
ABSA	18.9%	11.2%	9.1%
SBSA	18.1%	10.4%	11.2%
Nedcor Bank	23.4%	15.7%	10.7%
Theta Group	44.7%	37%	

Financial statements and Banking Council Reports

These returns on equity, illustrated in table 1, must be compared to the returns on equity from other corporations in South Africa to allow investors to determine those areas with the best potential return on investment.

Return on Assets (ROA)

ROA falls between ROE and Return to Labour in terms of measuring profitability. Where a large commercial bank can take relatively inexpensive deposits which it will on-lend, a smaller private company is lending only its own limited funds from equity or funds that it has borrowed at a significantly higher rate. The cost of the assets is significantly different. Therefore, it is best to compare like institutions with like institutions, because a microlending institution may have assets (cash to lend from borrowing) that have cost it significantly more to acquire than a commercial bank (cash to lend from deposits).

Where does the profit come from?

While all revenue for microlenders officially comes from charges to clients quoted as interest rates, not all profit in the commercial banking sector comes from interest revenue. Commercial banks are currently regulated under the Usury Act, which sets a ceiling on the interest rates that they can charge. This interest rate does not include the cost of the transaction and other charges by the banks for their services. Yet, the commercial banks earn a significant amount of their revenue from fees and the charges for these and other transactions. At the same time, micro-lending institutions are required to include all of their transactions charges in their interest rates. This can create a sizeable distortion between the rates quoted by the formal banking sector and the micro-lenders. It also has a great impact on the sources of profitability for the institution. The Banking Council submission notes that the margins in serving the lower end market are low⁴.

⁴ Banking Council Submission, p. 3.

Table 2: Proportion of transaction and other charges to total income: South Africa's major banks

Bank	Percent of Revenue from transaction charges in 1998	Percent of Revenue from transaction charges in 1999
ABSA	34.13%	38.8%
FNB	48.37%	48.48%
SBSA	45.47%	47.01%
Nedcor Bank	42.29%	44.35%

Source: KPMG Banking Survey Africa, 1998 and 1999

Conclusion on methods for determining profitability as a measure of capping interest rates.

It is virtually impossible to find one common measure against which to compare the profitability of different types of financial institutions in order to determine a "fair" profit margin for that kind of institution. Return to equity is one important way for publicly traded companies to compare their potential as investment opportunities. Return to assets is not appropriate when comparing banking institutions with microlenders.

Return to labour is the key consideration for a small lender who would prefer to earn a higher daily wage than a huge percentage on a small amount. He lives on the surplus created by his activities after costs are subtracted.

One of the concerns about using the profit margin as a way of setting appropriate interest rate ceilings is that it engenders inefficient operations. When the ideal should be to promote more efficient operations through attaining higher profit margins, an institution that is at the margin of passing the ceiling will simply increase its costs to avoid going over the profit ceiling. More efficient operations will lead to decreasing charges to the consumers through increasing competition.

1.2.3 Interest rate calculations⁵

There are several ways to calculate interest on a loan, of which two methods are most common: the declining balance method and the flat (face-value) method. Interest is generally paid over the term of the loan, although it is sometimes paid up front. These methods are discussed in detail in Annex 4.

The declining balance method

This method calculates interest as a percentage of the amount outstanding over the loan term. Interest calculated on the declining balance means that interest is charged only on the amount that the borrower still owes. The principal amount of a one-year loan, repaid weekly through payments of principal and interest, reduces or declines every week by the amount of principal that has been repaid. This means that borrowers have use of less and less of the original loan each week, until at the end of one year when they have no principal remaining and have repaid the whole loan (assuming 100 percent repayment).

⁵ Several texts exist that covers interest rate calculations. In this report we use a standard text as base and to ensure that we do not compare different methods. The text used is Ledgerwood, Joanna. (1999). *Microfinance Handbook: An institutional and a financial perspective*. Published by Sustainable Banking with the Poor Project, The World Bank, Washington DC.

The flat rate method

This method calculates interest as a percentage of the initial loan amount rather than the amount outstanding (declining) during the loan term. Using the flat rate method means that interest is always calculated on the total amount of the loan initially disbursed, even though periodic payments may cause the outstanding principal to decline. Often, but not always, a flat rate will be stated for the term of the loan rather than as a periodic (monthly or annual) rate. If the loan term is less than 12 months, it is possible to annualise the rate by multiplying it by the number of months or weeks in the loan term, divided by 12 or 52 respectively.

If a flat interest payment (fixed rate) is charged on a loan which is repaid with regular principal payments, the effective rate of interest is significantly higher than the nominal rate.

MFIs calculating interest using the on a declining balance would have to increase their *nominal* interest rate substantially to earn the same revenue as an MFI calculating interest on a flat basis.

How Do Fees or Service Charges Affect the Borrower and the MFI?

In addition to charging interest, many MFI's also charge a fee or service charge when disbursing loans. Fees or service charges increase the financial costs of the loan for the borrower and revenue to the MFI. Fees are often charged as a means of increasing the yield to the lender instead of charging nominal higher interest rates.

Fees are generally charged as a percentage of the *initial* loan amount and are collected up front rather than over the term of the loan. Because fees are not calculated on the declining balance, the effect of an increase in fees is greater than a similar increase in the nominal interest rate (if interest is calculated on the declining balance).

Calculating Effective Rates

MFIs often speak about the 'effective interest rate' on their loans. However, there are many ways in which effective rates are calculated, making it very difficult to compare institutions' rates. The effective rate of interest is a concept useful for determining whether the conditions of a loan make it more or less expensive for the borrower than another loan and whether changes in pricing policies have any effect. Because of the different loan variables and different interpretations of effective rates, a standard method of calculating the effective rate on a loan (considering all variables) is necessary to determine the true cost of borrowing for clients and the potential revenue (yield) earned by the MFI.

The effective rate of interest refers to the inclusion of all direct financial costs of a loan in one interest rate. Effective interest rates differ from nominal rates of interest by incorporating interest, fees, the interest calculation method, and other loan requirements into the financial cost of the loan. The effective rate should also include the cost of forced savings or group fund contributions by the borrower, because these are financial costs. We do not consider transaction costs (the financial and non-financial costs incurred by the borrower to access the loan, such as opening a bank account, transportation, child-care costs, or opportunity costs) in the calculation of the effective rate, because these can vary significantly depending on the specific market. However, it is important to design the delivery of credit and savings products in a way that minimises transaction costs for both the client and the MFI.

1.2.4 Factors affecting the cost of lending

We equate the cost of lending to those components that contribute to the calculation of the interest rate. We assume that we are mostly working with organisations, or sections or divisions of organisations that are entirely dedicated to microlending. This is a heroic assumption, as we know that some of the institutions are active in many markets (e.g. pawnbrokers are active in the financial market and in the second hand furniture market). Whenever we doubt the correct allocation of costs to a specific activity this will be highlighted. In our approach to calculate the cost components of the microlenders, we assume that the profit margin is also a contributor to the level of interest rate. In addition we study the administrative cost component, the risk cost component and the cost of capital component.

This approach was decided on for several reasons. In essence the DTI wants to know whether the interest rates charged by microlenders are realistic rates and that no exploitation of clients is taking place. One approach to ascertain this is to calculate the interest rates of the different products offered by the microlender and to take a view on the level of the interest rate. In this approach several problematic areas can be identified. It can be argued that we are not comparing institutions on the same basis. Some institutions provide only 30-day cash loans. Is it fair to directly equate the cost structure of such a lender with the cost structure of a lender providing only 36-month loans for housing? What about the fact that the 30-day cash lender can reuse his capital 12 times per year? On the other hand the 36-month lender has a cost of lending that is roughly multiplied by twelve, while the 36-month lender's cost structure is totally different. Some institutions set up retail networks, while others work through existing networks (like employers).

Further, only a few institutions gave us adequate information with which to do interest rate calculations. Thus, the calculations we do make are for illustrative purposes. We still emphasise the complete cost structure based on the activities of a year, rather than merely looking at interest rates. Another important consideration is that the cost components approach, include fee and other income charged to clients. The interest calculations exclude these costs to clients.

Cost of capital

We define the cost of capital as all those costs that have to do with obtaining capital. In essence it starts with interest rate costs. We add to that the payment of dividends (or withdrawals) to owners as that compensates the owners for the use of equity. We consider any cost incurred to mobilise and compensate capital used in allocation to borrowers part of the cost of capital. Changes in interest rates and risk perceptions of the sector by investors would all impact on the cost of capital. Investors in the sector would probably favour short-term investments, as it is not clear what will happen with the interest rate ceiling in the sector and that directly impact on the profitability of the investment. Bank charges will clearly form part of the cost of capital.

Administration (concept of transaction cost)

All cost incurred in running the organisation are included in the administration cost component. This includes product design and marketing costs. As the level of competition increases in the sector institutions spend more on innovative product design and marketing of these products. One of the first signs of an emphasis on marketing after ABSA took the controlling share in Unibank was the erection of massive advertising boards on key routes in the Gauteng area.

Administration (including stationery, telephone, postage, equipment rental) and office expenses (including office rental, maintenance and cleaning, depreciation, water and lights), salaries and staff benefits (including uniforms, training, entertainment, subsistence and travel, motor vehicles, pension), information technology hardware and software, consultants, accounting and audit fees are most of the costs contributing to the administrative cost component.

Risk

Although the risk component is argued on the basis of organisational and systemic risk it is quite difficult to price. We studied the expenses of microlenders and included fines, collection fees, legal costs, security costs, bad debts provision, insurance and first aid costs as the risk component. We included only realised costs. No adjustments to the risk costing were made due to interest rate increases embodying systemic risk.

Required return (profit margin)

It is difficult to ascertain what would be the "acceptable" rate of return for a microlender to determine whether they are earning more or less. Therefore, we took the difference between annual income and expenditure (before tax) as the surplus component of the total (cost) structure of the microfinance business, reported simply as "surplus".

Although the four components listed above provide a comprehensive list of issues, there are numerous issues that impact on the levels of the different components. The provision of financial services in a rural setting increase the administrative cost component as well as the risk component. Increasing the risk component would also impact on the cost of capital component (increased costs due to higher perceived risks) while all of this would decrease the surplus component.

Providing services to entrepreneurs, whose repayment is based on cash flow, would also increase the risk compared to providing service to salaried or wage earning customers. There are therefore numerous impacts on these components.

For example, offering financial services to small farmers in a remote rural arid area would impact on all aspects of cost. Very often the cost would be so high that no transactions would be made, implying that no market would exist in which financial services would be offered to small farmers. The other extreme is offering financial services to the urban employed backed by collateral in the form of a provident fund. In this scenario thousands of transactions take place and a competitive and innovative market exists that is efficient and offers the clients choice and good services.

The environment and the broader influences within which financial services are offered also play a major role. Here we refer to the legal and regulatory framework, property rights and the enforcement of contracts. Where services are provided in situations with loosely defined property rights and inadequate enforcement of contracts services will be very expensive, transaction costs will thus be high and the market will be extremely inefficient.

1.2.5 Factors affecting the risk associated with lending

The size and complexity of the South African financial environment and in particular the speed of its recent expansion (on several institutional levels) pose a challenge to the ability of the system to handle the larger risks involved. Three sources of risk should be highlighted: credit risk, market risk, and operational risk.

The World Bank (1999) indicates that there has been an increase in the non-performing loans to total loans ratio. In the general banking sector it went from a low of 3.2 percent in 1996 to 4.7 percent in 1999. In one bank this ratio is over 6 percent. This increase in non-performing loans signals an increased credit risk. Mortgage and instalment loans posing this risk, in particular. As the banks in South Africa bear very small components of interest rate risk, they pile most of it on their customers. Rate increases are then almost comprehensively for the account of the customer and many customers then find it difficult to service these loans, and as a consequence the default rate rises. Credit risks also stem from transactions between banks. The interbank market is a limited resource for funding and it increased in importance as a reaction to a decline in deposit funding. Deposits dropped from 79.3 percent of total assets in 1996 to 74 percent of total assets in 1999. The interbank loan transactions financed 3.6 percent of total assets in 1996 and 5.4 percent in 1999. This increases the covariant risk in the banking sector.

In terms of market risk the World Bank mission (1999) argues that it is not the level but the ability of banks to assess the market risk that may be a problem. Thus, the banks do not have a clear view of the size of potential losses and this increase operational risk – in that the banks have no idea whether they have adequate resources to continue operations and honour all obligations.

In this study we are not analysing the risk of commercial banks in general. We are more interested in the risk of the microlending sector, which we would like to assess in terms of risk originating in the organisation and risk originating in the system (systemic risk). Firstly, the same origins of risk apply in the microlending sector. Credit risk especially is an important consideration as (overtly) microfinanciers finance most of their activities with credit (rather than relying on deposits). Several of the bigger commercial banks are now investing in the larger term lending microfinanciers. In this way, the risk from the banks' side comes to the microfinance sector and risk from the microfinance sector is now mixed with the bank's risk. This increases the systemic risk as microfinanciers are not subject to the same stringent control as the rest of the banking sector.

In organisations (thus organisational risk) in the microfinance sector, risk originates from several sources. These are primarily client-originated risk and organisational originated risk. Client-originated risk is embodied in the provisions for bad debts and bad debt write-offs. It is essence a function of the repayment ability of the client. This ranges in terms of the sources of loan repayment of the client. Where loan repayment is based on consistent income streams and the availability of collateral the risk is inherently the risk of losing a job, or becoming unemployed. Where repayment ability is a function of an inconsistent income stream, risk is in essence higher and unfortunately, mostly not covered with any collateral security.

While microfinance institutions and commercial banks are vulnerable to liquidity problems brought on by a mismatch of maturities and term structure, the risk features of microfinance institutions, servicing the small loan market, differ significantly from institutions serving the more affluent like most commercial banks. This is primarily due to the microfinance institutions' client base and context within which they operate. The client base is normally comprised of the low-income clients, without assets, requiring small short-term loans. It also is due to the lending models (small, mostly unsecured loans) and ownership structure. In South Africa the diverse number of microfinance institutions serving the sector also differ in terms of risk exposure.

The organisation originated risk has to do with the capitalisation of the organisation, the assessment techniques of the organisation and its internal financial management and control. Many institutions lack sophisticated systems and lack internal expertise. In a

recent survey of microlenders the demand for very basic training in financial management and especially asset management was identified as very important.

Risks in the microfinance industry related to institutions serving microentrepreneurs are different than those servicing the employed.

- ❑ Some MFIs target a segment of the population that has no access to business opportunities because of a lack of markets, inputs and demand. Productive credit is of no use to such people without other inputs
- ❑ Many MFIs never reach either the minimum scale or the efficiency necessary to cover costs.
- ❑ Many MFIs face non-supportive policy frameworks and daunting physical, social and economic challenges.
- ❑ Some MFIs fail to manage their funds adequately enough to meet future cash needs, and as a result confront liquidity problems.
- ❑ Others develop neither the financial management systems nor the skills required to run a successful operation.
- ❑ Replication of successful models have at times proved to be difficult, due to differences in social contexts and lack of local adaptation.

Most of the problems of MFIs have to do with clarity of goals - does the organisation provide services to lighten the burdens of poverty, or to encourage economic growth, or does it target a specific group, like the handicapped. However, quite often the goal and the structure of the institution in terms of ownership, capitalisation, governance and management are not matched.

It is clear that institutions with different client profiles have different risk profiles. Table 3 illustrates the South African situation specific to the microfinance sector.

Table 3: South African situation specific to the microfinance sector.

Institutional type	Product and Client Profile	Specific risks	Risk level
Commercial banks	Consumer finance to the employed with collateral	Unemployment	Low to medium
Cash loan institutions	Consumer finance to the employed without collateral	Unemployment	Medium
Microfinance institutions	Housing finance to the employed	Unemployment	Low to medium
Microfinance institutions	Microentrepreneurial finance, inconsistent incomes mostly low or no collateral	Business failure, low profitability	High
Parastatal institutions	Microloans to farmers	Low profitability, little diversification of income sources	High

2. Overview of the Market for Microlending in South Africa: Demand and Supply

2.1 Introduction

The market for credit is comprised of two main functions: the demand for and the supply of credit products. Historically there has always been a demand for credit that has resulted in someone supplying the service. As there is no way to separate the supply side from the

demand side of the industry, they must be looked at together. Markets are dynamic; they can grow or shrink as different elements in the supply and demand functions evolve. The demand functions can change as consumers (buyers) become more sophisticated in the use of credit and as they understand the costs associated with borrowing or the benefits deriving from borrowing. The supply function can also evolve as the industry grows, becomes more sophisticated, develops new tools to lower costs associated with risk, develops new systems to lower administrative costs, and develops new ways of doing business.

This section will look at the elements that comprise both of those two key functions in the market for microcredit in South Africa. It will try to estimate the current level of demand for micro credit products in South Africa (expressed as the effective demand that is being currently serviced) and will also try to present an order of magnitude on the potential demand for credit. On the supply side, this chapter will look at the actual suppliers, and try to estimate the current level of supply in the country.

2.2 A brief historical perspective

Before 1992, there were few official options available to people wanting to access to small amounts of credit. Banks were not offering microcredit, so the borrowers had to resort to pawnbrokers or operators in the informal sector: the mashonisas or other informal systems such as the stokvels, burial societies and rotating savings and credit associations (ROSCAs).

As the rules governing the provision of credit evolved in 1992, a whole new industry arose. Now that it was legal to extend loans at rates greater than those capped by the Usury Act, two separate programs began to expand their operations: independent cash loan operators making one month loans and term lenders that were basing their repayments on payroll deductions.

Both segments grew significantly over the following 7 years with many of the fluctuations in the industry that could be expected in a highly dynamic growth industry. While there is very little official data collected on the sector, there have been a series of estimates published over the years, estimating the supply of microcredit to the South African market.

The Notice issued in June 1999 has had a great impact on the industry. Since June, several trends have become apparent, even in this very short time:

- ◆ Increasing formalisation of the industry (registration of previously independent operations into registered firms) ;
- ◆ Introduction of new actors (furniture traders and retail merchants)
- ◆ Increased interest of the commercial banking sector;
- ◆ Increasing formal investment in microlending (funds raised on the stock market or through private placement).
- ◆ Increasing levels of client indebtedness.

These will be reviewed further later in this chapter.

2.3 Demand for microfinance products/services

The demand for banking services by the lower income strata of the population is growing rapidly, due to a variety of factors. These include current low frequency of use of the formal banking services by the poor and M&SE market, increased income of the lower income strata, income redistribution in favour of lower income people, urbanisation, rising consumer aspirations and the rapid growth of the informal business sector. In reaction a

considerable growth is experienced in the microfinance sector, and the biggest source of growth is from the microlending sector. The formal banking sector seems inappropriately structured to satisfy this rapid growth in demand.

Financing is required for a wide variety of applications by small borrowers. The list below identifies some of them:

- ◆ Seasonal fluctuation in cash flow
- ◆ Fund or start a small income generating activity
- ◆ Consolidate other loans (actually probably means pay off other loans, not so much consolidate them)
- ◆ Access other sources of capital
- ◆ Housing improvements
- ◆ Emergencies
- ◆ Education
- ◆ Purchase consumer products
- ◆ Fund bad habits, like drinking, etc.

Provident Fund did a survey of its clients in South Africa, which revealed that 96 percent of their loans were used for productive activities with interest rates ranging between 109.99% and 277%.

A recent survey carried out by the University of Pretoria identified the following needs for microfinance in the peri-urban areas of Pietersburg in the Northern Province:

Installments:	27.8%
School Fees:	38.9%
Household Needs:	22.2%
Agriculture:	5.6%
Small Business:	5.6%

However less than 50 percent of the loans were sourced from moneylenders.

2.3.1 Potential Demand

Potential demand for microcredit refers to the maximum amount of demand that there could be for micro credit products in South Africa. In order to estimate the potential demand one could look at needs that require larger purchases. Alternatively, one could look at the current salary of the employees who are typically microlender clients and determine what level of indebtedness they could satisfactorily handle and the amount of credit that this would require.

Different estimates of the potential demand for microcredit exist. One way would be to take the number of employed people in the LSM categories and estimate either 25% of their gross salary, which would provide the "safe" level of lending for the industry. This is safe in terms of over-indebtedness for the clients as well as in capacity to repay for the MFI.

Table 4: Living standard measurement categories

LS M	Number (16+)	%	1 (%)	Unemployed (%)	Individual \$ Monthly income (R)	Saving s (%)	Biggest problem	People in t/h
1	3,738,000	15	59	80	320	4	Unemployment	3.2
2	3,560,000	15	52	74	603	7	Unemployment	3.0
3	4,294,000	18	54	72	801	7	Unemployment	2.9
4	3,314,000	14	51	65	1048	8	Unemployment	2.9
5	2,041,000	8	52	62	1421	8	Crime	2.9
6	1,888,000	8	58	61	1653	6	Crime	3.2
7	2,534,000	10	50	49	3686	5	Crime	2.5
8	3,246,000	13	49	37	5660	5	Crime	2.4

Assuming that 90 percent of the salaried individuals in the LSM 3, 4, 5, and 6 categories are the main clients for microlenders, with some additional demand coming from LSM 1 & 2 (50% of employed clients), LSM 7 (50% of earners) and a few from LSM 8 (10%) the total number of potential clients for the formal microlending sector is about 5.5 million wage earning individuals, with a gross salary of about R8.4 billion per month.

In the United States and other developed countries, bank standards for safe levels of indebtedness for the sum of all payments are pegged at 25 percent of gross salary. This amount includes both principal and interest. Extrapolating out to South African conditions, the following table presents the maximum potential demand for microloans among salaried employees, depending on the interest rate being charged.

Table 5 Potential size of microloans to salaried employees

Monthly Effic. Interest Rate	Percent of % loan to reach 25%	Potential Size of Monthly Market	Potential Size of Annual Market	% of loan to reach 50%	Potential Size of Monthly market	Potential Size of Annual Market
30%	19.2%	1,562,604,345	18,751,252,140	38.5%	3,125,208,690	37,502,504,280
25%	20.0%	1,625,108,519	19,501,302,226	40.0%	3,250,217,038	39,002,604,451
20%	20.8%	1,692,821,374	20,313,856,485	41.7%	3,385,642,748	40,627,712,970
15%	21.7%	1,766,422,303	21,197,067,637	43.5%	3,532,844,606	42,394,135,273
10%	22.7%	1,846,714,226	22,160,570,711	45.5%	3,693,428,452	44,321,141,422
5%	23.8%	1,934,652,999	23,215,835,983	47.6%	3,869,305,997	46,431,671,966

The conclusions from this table are that the potential safe size of the market is in the range of R18 to R23 billion per annum. At the much riskier levels, which are actually being practised in South Africa, this figure increases to R38 to R46 billion. Since these figures assume an even spread across the employees, with no employee borrowing more than a 25% repayment schedule would allow, the real "safe" size of the credit market would be substantially less. However we currently find that the expressed demand, see below, already surpasses the potential "safe" level of demand, indicating over indebtedness.

Another approach is to value the new housing expenditures. In March 1999 an Investment bank study⁶ estimated the overall housing market, with a backlog of 4 million units, is R180

⁶ Deutsche Morgan Grenfell, March 2, 1999

billion. Assuming that microlenders could supply 20 percent of this amount, the total potential microlending market is 36 billion. In the short term, they estimate that the housing market is 5.8 billion. However, this does not include funds that could go for housing improvements, which is reputedly the largest amount of the loans for the microlending industry.

2.3.2 Expressed or Effective Demand

Effective demand refers to the actual level of demand for credit services. This is usually a function of the cost of the services, availability of the services, and awareness of the services. In a market where supply exceeds demand, the effective demand can be simply expressed as the total supply that has been provided. In growth markets where demand has surpassed the available supply or the capacity of the institutions to provide, current levels of supply may not necessarily reflect true demand.

At the end of this section we will review the current status of the market for micro loans, which is conservatively estimated at R13 billion in current outstanding portfolio, but is probably closer to R17 billion. On an annual turnover basis, the effective demand is for about R25 billion.

2.3.3 Consumer protection and education

There are very different levels of sophistication among the clients of the microlenders. The typical clients for microloans are relatively unsophisticated. A recent survey of rural borrowers revealed that only 8.9 percent of the borrowers knew the interest rate. By contrast, all of them knew the amount that they had to repay and the cash flow to do so. But in a very dynamic market, where capturing market share is very important for the financial institutions, there can be cases of abuse of the loan process by the lending institution or its agents.

Consumer protection has taken a strong step forward in the past eight months with the creation of the MFRC, which is designed to protect the interests of the consumer and to ensure that all institutions and lenders abide by the regulations.

2.4 Supply of Microfinance: Structure of the industry

The modern microlending industry that we see in South Africa today, is a relatively recent phenomenon. It arose out of the Exemption to the Usury Act of 1992. There are many different types of individuals and companies involved in microlending. Some are in the formal sector and many are in the informal sector. This section will break out the different types of lenders, identify their specific types of products and attempt to put values next to them.

2.4.1 Size and Evolution of the industry

The microlending industry has grown steadily in terms of value of loans outstanding over the past decade and continues to grow in aggregate as new, large players enter the market. At the same time, smaller, less efficient operators are closing their doors, consolidating, or dropping out of the formal market (into the informal, unregulated sector). So the numbers of operators in different segments is evolving in different ways. The new regulations promulgated in June 1999 have been an important factor in this evolution.

As noted above there are several different segments in the industry:

- ♦ Formal registered firms, which include commercial banks, financial institutions, section 21 (not for profit) enterprise lenders, developmental lenders, and the larger short term money lenders;
- ♦ Semi-formal money lenders, which include small unregistered money lenders who are doing it as their main livelihood and the pawnbrokers, who are not formally included in the money lending statistics (yet); and
- ♦ Purely informal moneylenders such as the township moneylenders (mashonisas) and stokvels, burial societies, and ROSCAs.

The most accurate information available is on the first group, banks and formally registered money-lending firms. However this data is just becoming formally available since the creation of the MFRC. There are estimates of the roles and scale of the other two groups, but this is done through extrapolation. The sections which follow below will review the findings from the formally registered firms (which comprise the vast majority of the overall volume of transactions in the market), followed by the estimates from the semi-formal and informal financial service providers.

2.4.2 The Lenders

A wide range of firms has developed over the past 8 years to supply microfinance to the population in South Africa. The table below breaks out the formal lenders by legal category as they are registered with the MFRC.

Table 6: Formal lenders by legal category

Type of Institution	Number of Registered Firms	Number of Certificates	Outstanding Book	Number of Debtors
Section 21	7	43	29,224,477	48214
Private Company	122	1960	1,202,456,352	558961
Closed Corporation	597	1025	191,864,981	270488
Bank	7	355	3,352,586,312	1389813
Public Company	8	284	302,465,465	224218
Trust	47	110	61,175,040	41164
Natural Person	58	72	8,874,228	16167
Mutual Bank	2	8	116,403,082	14604
Co-operative	4	16	66,010,133	31137
Total Registered	852	3,873	5,331,060,070	2,594,766

Source: MFRC data collected as of February, 2000

The data above does not include those institutions that have not been registered by the MFRC. Estimates from the Credit bureau indicate that there has been a significant drop in the number of storefronts officially serving as cash lenders over the past two years. Their studies estimated 6,000 storefronts two years ago, between 3,500 and 4,000 storefronts in early 2000, and project an additional drop in storefronts to about 2,500 by the end of 2000. However, while the number of storefronts has decreased, the number of clients has remained constant or increased.

The next table presents estimated numbers of the informal lenders in the country. These figures are estimates drawn from other sources, such as associations and other research documents.

Table 7: Estimated totals for South Africa

	Lenders	Outstanding Book	No. of Clients
Mashonisas	25,000	150,000,000	500,000
Pawnbrokers	5,000	300,000,000	100,000
Stokvel/ROSCA	800,000	240,000,000	8,000,000
Sources: Du Plessis, Assn. Of Pawn Brokers, NASASA			

These different lenders can be regrouped into different categories based on the type of lending that they are involved in. The first four are focused on "consumption" lending and lend only to customers with bank accounts and regular salaries. The other lenders, either developmental or enterprise lenders, generally base their repayments on cash flow from the productive activity. The source of repayment is the main differentiating factor between the two groups of lenders.

Short Term Cash Lender

The short term cash lender focuses on loans up to 32 days, or the next pay period. On average, these lenders charge an interest rate of 30 percent per month, all fees included. They are the largest number of individual institutions, but each branch tends to be relatively small in size, with loan book of between R50,000 and R500,000. There are some large companies, like the Keynes group, which has more than 120 branches and 18 million that concentrate exclusively on this market. The 30-day cash lenders have historically been users of the bankcard and pin for security. Their target market is clients with a net income of up to R2,000 per month. The average loan for these firms is about R500, as it takes into very strict consideration the capacity of the borrower to repay at the end of the month. Capital resources come mainly from their own sources, and occasionally from illegal loans from friends (illegal because this is not allowed under South African law). Only a few of the largest companies (like Keynes) have legally raised outside sources of funds.

It is important to note that the rate charged by 30 day cash lenders applies to all loans less than that period or which are repaid on a weekly basis. This raises the effective interest rate of the loan. Very important to note that even with the bank cards and pin numbers, the default rate on loans was in the neighbourhood of 2.5 - 5 percent. Now that the use of bank cards and pin numbers have been eliminated, this rate has tended to double among the lenders.

Medium Term Cash Lenders

There is often a fair amount of overlap between firms that are lending between one and six months and the term lenders. They have a mix of products that are in majority 30-day loans, but also a range of slightly longer term loans reserved for their better clients. Average loans in the 1-6 month category can increase to a multiple of the person's actual net take home pay, as they have more time to pay it off. Historically, these lenders have also used the bank card with pin number as the repayment mechanism. With the restriction of the use of the bank card, many of these lenders are experimenting with other forms of collection.

Interest rates will vary by the term of the loan, but are usually discussed as a flat rate on a declining balance, which effectively increases the effective rate. The nominal interest rate may be between 30 percent (for 30 days) and 12.5 percent (per month for the period), but the effective interest rate is always greater than 20 percent per month. Because these

loans are made to better known clients, the default rate is generally lower, about 2.5 percent, without the bank card.

Since the short term cash lenders and the medium term cash lenders are often lumped together into the same category, since branches often do both, it is difficult to differentiate between them. Overall, the estimates from the credit bureaux specialising in cash borrowers, are that there are now roughly 3,500 – 4,000 storefronts in the country. This figure is down from an estimated 6,000 storefronts two years ago, and is expected to continue decreasing this year to a ceiling of 2,500 storefronts by the end of the year.⁷

Term Lenders

The term lenders make loans for periods between six months and 36 months. The industry started through the use of Persal, the government's central payroll system, using debit orders to get repayment at the source, before the borrower actually had a chance to see the money. Now that these lenders are saturating the market, they are branching out to the larger private companies to establish credit service relationships with them. This is the most rapidly growing segment of the industry, but which has often been restricted by cash to lend. The commercial banks are becoming increasingly involved in this segment of the market, buying up the large term microlenders to develop their access to the market, while reducing the financial constraints on their lending partners.

Housing Lenders

Housing lenders are closely associated with the term lenders. Most longer term mortgage loans are greater than the ceiling set for microloans and fall outside of the exemption. But there are a lot of microloans made in the name of housing, as it is the basis of access to a Persal code, which greatly facilitates repayment. Housing loans can also be secured by provident funds, effectively bringing the risk to near zero. Large banks are involved in housing finance, as well as small specialised lending boutiques. The National Housing Finance Corporation (NHFC) has a number of programmes to assist retail lenders to access finance to on-lend to borrowers for housing improvement.

The NHFC promotes both urban housing as well as rural housing. Lenders in the housing industry include microlenders, small banks, social housing programmes, and non-bank financial institutions (NBFI) such as NGOs. Methods of securitisation include: none (unsecured), provident fund, payroll, and mortgages. The Rural Housing Loan Fund (RHLF) programme works with microlenders doing housing in the rural areas with unsecured loans, for which interest rates of 40 percent (on a declining balance) are common. For provident backed loans, margins above the cost of money are typically between four and five percent.

Furniture/Retail Lenders

The furniture and retail store lenders are the latest entrants to the market, primarily arriving since the creation of the MFRC. The furniture industry is already a R15 billion industry per year in South Africa, with about R10 billion of that being sold on credit. Historically, furniture sales have been made under the Credit Agreements Act, which restricted interest rates to the ceiling of the usury act, while allowing the seller to retain ownership of the goods sold as collateral. However with the advent of the MFRC and a clearer more transparent regulatory environment for microlending, many of the Furniture lenders, as well as other retail stores such as Woolworths and J&D, have also entered the market. They have registered branches as microlenders and are actively promoting microloans to their

⁷ Conversations with Compuscan and MicroLenders Credit Bureau (MLCB)

regular, well known clients. These lenders have a solid credit history on their clients and rely on a credit scoring methodology to assess risk and do not require debit orders or other deductions at the source. Most of their clients are salaried employees, however.

This is still a very new segment of the microlending market and has not yet started to develop. It is expected that it will replace a lot of the furniture credit market as well as making additional small loans to their customers.

The MFRC has placed many objections to furniture lenders entering the microlending market, as they see it as a means of bypassing ceilings under the Credit Agreement Act. The argument is that since they also control the price of the items they are selling, the lender can adjust the price of the goods to cover the cost of the lending. However, the furniture lenders say that the ceiling on the credit Agreement Act does not allow them to fully recover their costs.

Enterprise Lenders

Microenterprise lenders are a special group in the micro credit industry. Around the world, microfinance is associated with enterprise development finance, though in South Africa, microenterprise finance accounts for a very small portion of the microcredit market. Though some "consumption" lending may go towards financing productive activities, Microenterprise finance comes largely from NGOs and Trusts. There is very little overt microenterprise finance from the commercial banking sector in South Africa, which has put a floor of R50,000 on enterprise lending. Khula is the major financier of enterprise finance and reports that there was R108 million outstanding among about 26 lenders, accounting for loans to 66,000 microenterprises. This is a tiny portion of the entire industry. Average loan sizes among the microenterprise lenders are generally in the R3-6,000 range.

Enterprise lenders are generally new institutions that have had to invest in all of their systems, and are restricted just to lending. By and large microenterprise lenders are still in their growth phase and are still investing in their operations. Estimates submitted by the Micro Enterprise Alliance (MEA) and verified by the team show that an effective rate of 72 percent would be a minimum to cover a steady state microlending operation in South Africa that had already achieved sustainability. Since most micro enterprise lenders are still in growth phases, and even after they reach sustainability will have to continue to grow, the 72 percent figure is well below, the limit for sustained growth and development.

Developmental Lenders

The developmental lenders are increasingly similar in their approaches to the enterprise lenders, except that they have a far greater existing investment and base to build from. Some have savings as a resource (like Ithala) and others have institutional investors, which provides them with cheaper access to capital. Some of the largest lenders include Land Bank (which now has a microlending portfolio of 41,000 clients, but an outstanding book of only about R10 million), Ithala, and the Eastern Cape Banks.

Township lenders/Mashonisas

The mashonisas are the informal sector lenders who operate completely outside of the formal sector. When there was no other alternative for borrowers, the mashonisas were their solution. The mashonisas specialise in short term loans, generally for 30 days. Interest rates run in the range of 50 percent per month, though no additional interest is charged if the borrower is late, effectively reducing the cost of lending. Mashonisas are often women with no other means of support who try to earn a living wage out of this job. They will often have 15-20 clients, borrowing an average of R150 -250 at a time, so

individually, they are extremely small players. However, there are many of them, estimated at between 25,000 and 30,000 around the country. Monthly earnings by a mashonisa are often quite small, in absolute terms, in the range of R2-3,000 per month. Interestingly enough, it appears that most mashonisas are very close to their clients and the clients are loyal to them. The borrowers' survey, referenced below, demonstrates that most clients of mashonisas look to make sure that they can afford the repayment stream before starting their payments.

Pawnbrokers

Pawnbrokers comprise one of the oldest industries in South Africa. Pawnbrokers use durable and semi durable goods as collateral against money that they advance to individuals in need of short term (generally less than 30 days) funds. These are often used to finance emergencies, or short term cashflow deficiencies in their daily lives and businesses. The advances are made against the pledged item(s) at a rate of 25-30 percent per month, and the borrower has up to three months to reclaim his items by paying off the advance, or else he forfeits the items that he has pledged. Between the time the pawnbroker has made the advance until the time the client comes to reclaim the item, the pawnbroker must store and maintain the item in original condition. If the client forfeits the item, the item then belongs to the pawnbroker and he is free to sell it as a second hand good. Roughly 35 percent of all pawned items are not paid off and collected.

While there is much debate about the value that is applied to the items that are pawned compared to their real value, the pawnbroker must incur many costs. The pawnbroker must appraise the item, transport it to his shop, store it for up to three months (with the opportunity cost of capital), and, if the item is not collected proceed with the sale, which could take several months depending on the demand for the item.

There are roughly 5000 pawnbrokers in South Africa, according to the Association of Pawnbrokers, which officially represents 1500 of them. Pawnbrokers are registered under the Second Hand Goods Act, so are already regulated and pay VAT on all transactions. The cost structure for pawnbrokers differs radically from the cost structure for microlenders, due to their primary operation of storing and selling the second hand goods.

Stokvels

In this instance, we use Stokvels to refer to the various informal financial institutions that capture member savings and then either save them or on-lend them to some of the members of the groups on a rotating basis. These include the Stokvels, properly stated, burial societies, and rotating savings and credit associations (ROSCA's). According to NASASA, the association of Stokvels, there are an estimated 800,000 such institutions comprising about 8.25 million adults accounting for about R200 million a month in savings. They are governed under the Banks Act under the Stokvel exemption. This allows for stokvels, as member based organisations providing services just to their members, that are members of the NASASA to be regulated by NASASA. Only 15,000 groups are officially registered with NASASA, but in actuality, all Stokvels are only providing services to their own members, this is considered to be safe.

In terms of calculating costs associated with lending, there are very few. Management of the associations is voluntary, and most of the funds are normally distributed to members at the time of the group meeting and deposit of funds. Since all repayments, with whatever interest, if any, go back into the group fund for redistribution to the members, the interest rates serve more as mechanisms for forced savings for the members.

Supply by Officially Registered firms

Among the officially registered firms, one can differentiate several different types of suppliers which have different attributes and which use different means to collect repayments. One important category are those who specialise in payroll deduction, which allow for deduction of payments at the source, before the employee actually sees the money. The largest payroll is from the government, through the SITA system, which provides access codes to a limited number of financial institutions, currently fixed at 143. These privileged institutions have access to more than one million clients. This section will first look at the overall market, with statistics derived from data collected by the MFRC and will then focus in on the suppliers of service by the Persal registered firms.

The statistics presented below were captured by the MFRC in raw form and were extrapolated by the consultants based on the information reported to the MFRC by their registered firms. It is important to note that the data was collected over a period from July to January, representing the statistics in the firm at the time that the firm registered with the MFRC. As the MFRC passes its first full year of operations and firms register for the second time, it will be able to capture much more accurate data that can be more appropriately extrapolated and analysed.

While there are certainly many errors in the data collected by the MFRC, these statistics are the best ones that are formally available. The bulk of the analysis is carried out on the statistics from those firms that have been registered by the MFRC, excluding those that have not been registered, because this data is considered to be the cleanest data. It also represents the greatest level of volume in the industry (current loans outstanding). These figures must be recognised for what they are, extrapolations based on firm level data, but they should depict a fairly accurate overall picture of the structure of the microlending industry from statistics provided at the time of registration by the microlenders. If we consider all the firms that have been registered by the MFRC (see Annexe 3 for a detailed overview) it is clear that the greatest number of these firms are closed corporations (CC), but they represent the smallest book by individual operation and the smallest number of average branches per firm. At the other end of the spectrum are the banks, with only seven of them registered, they account for the greatest outstanding book and the largest average number of branches per bank.

The real dark horse in these figures is the private companies. Some of them are simply individual money lenders, but others are large corporations involved in other retail operations that have entered the microlending industry since the creation of the MFRC. Two of the private companies account for 1057 branches, over one half of the registered branches in their category (and 25% overall). However, these lenders have only made a total of R1.8 million in loans. When they start lending full bore, it is anticipated that the number of loans and the value will increase tremendously.

Comparison between registered firms and those that have not yet been registered

The data collected by the MFRC indicates that there are a large number of firms (about 400) that have applied, but have not been registered for a variety of reasons. These usually included incomplete applications, not having a legal registration, or missing important pieces of information, either financial statements or incomplete information on clients. The main differences will certainly be among the smallest lenders, where the least accurate data is presented.

The statistics from the MFRC show that most of the firms that have applied but have not yet been registered are in the 30 day money lenders and the 1-6 month lenders. It appears from the stats that the total client base, according to the registration statistics, is

more than 1.1 million for the 30-day lenders, an increase of nearly 700,000 clients (150%) over those that have been officially registered. The next biggest gap is in the 1-6 month category of lenders, where there are an additional 250,000 clients (an additional 100%) listed with an extra R200 million in outstanding book.

Distribution of the outstanding book, by term

Total outstanding book for registered lenders was estimated at R5.3 billion. When one looks at the distribution of loans that are currently outstanding, the longer term lenders dominate the market for microfinance with 64 percent of the total outstanding book, or about 3.4 billion Rand. Those term lenders with a shorter time horizon of six to twelve months account for about 16 percent of the total book, while the short term cash lenders only account for about 8 percent of the book.

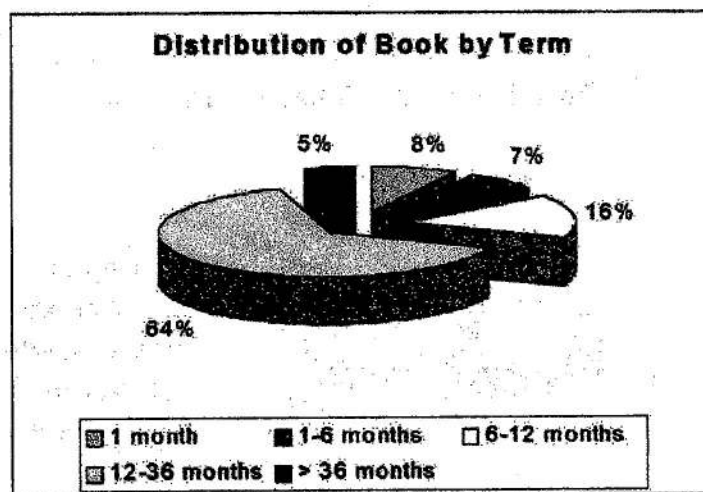


Figure 1: Distribution of Book by Term

Annual turnover

However, when one contrasts this with the overall annual turnover in the industry, the picture changes somewhat. Making assumptions that loans with a term of one month actually turn over 12 times in a year, and that a 36 month loan only turns over once every

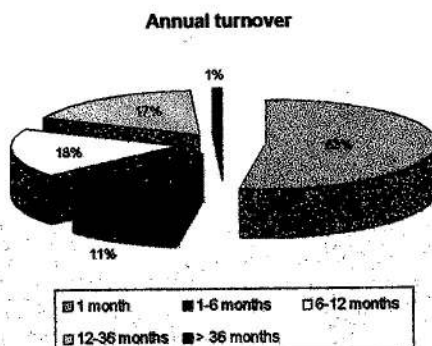


Figure 2: Annual Turnover

three years, we are able to make the following estimates on the level of formally regulated lending. Total turnover among the registered firms increases to 9.7 billion Rand, of which

53 percent comes from the 30 day cash lenders and only 11 percent come from the main term lenders (12-36 months).

When one adjusts these figures to include the number of MFI that are not included in the registered firms, the importance of the short term money increases even more, as noted above. This can have an important effect on all of the other averages and figures that are presented below.

Clients by loan term

We have the same issues with distribution of clients by term over the course of the year that one finds with the volume of loans outstanding. Looking at the total number of loans outstanding by size, it is clear that only a small fraction of the clients of the registered lenders are in the 30 day category (17%), while a much larger percentage is in the 12-36 month category (52%).

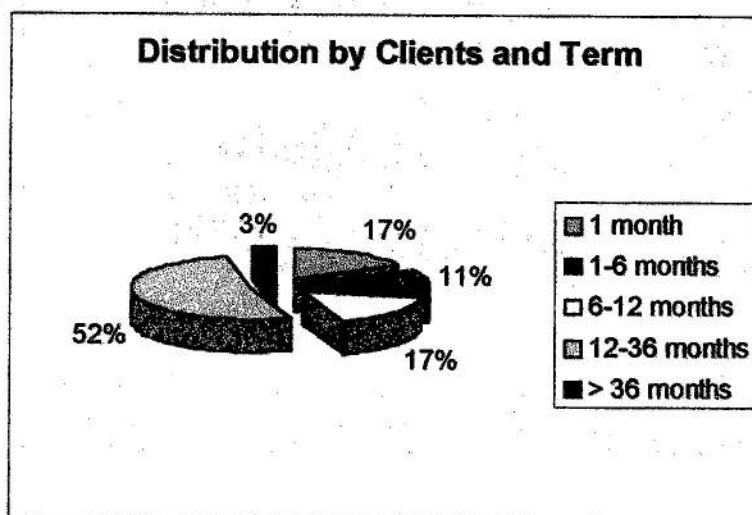


Figure 3: Distribution by Clients and Term

However when one annualises the numbers of clients receiving loans over the course of the year, it is clear that there are far more transactions at the 30 day lender level (68% of all transactions) than there are at the 12-36 month level (9% of all transactions).

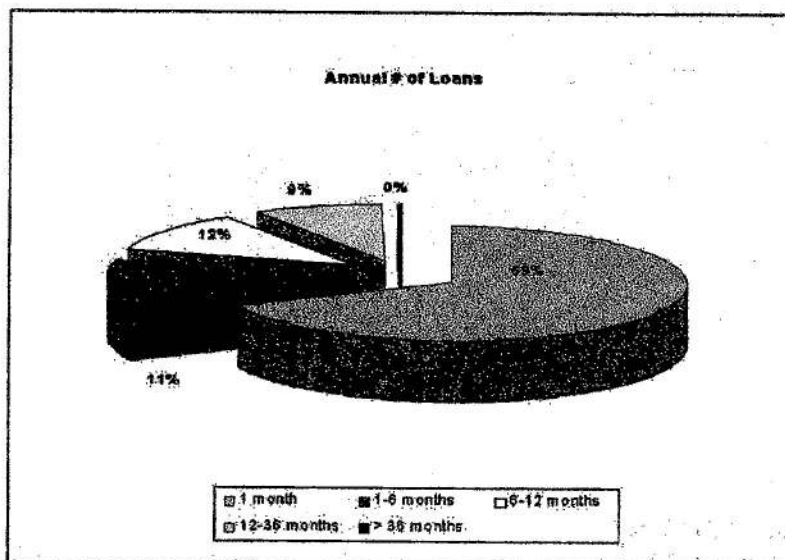


Figure 4: Annual number of Loans

Clients by loan size

As with the earlier analyses, the term of the loan plays a very important role in the analysis of the number of clients by loan size. Since the short term lenders only make loans below R1,000, their clients are concentrated there (21% of the outstanding client base), with the vast majority falling into the 1,000 – 6,000 loan size. This latter group is handled by the term lenders, who rarely lend below R2,000. Relatively few clients thus far had been registered in the above R6,000 loan size, since that had been the former ceiling on exemption. It is anticipated that this amount will increase greatly through new loans.

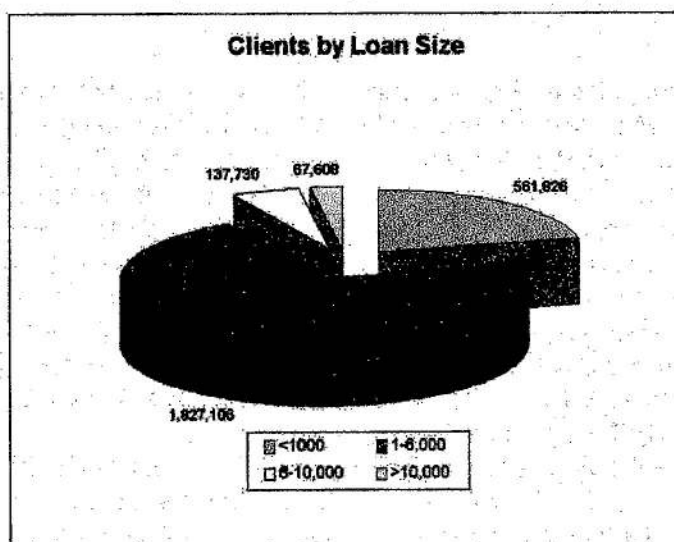


Figure 5: Clients by Loan Size

Periods of Repayment

The vast majority of the registered firms collect loans on a monthly basis (96.4 percent of all clients). While there are a few fortnightly collections, 2.7 percent of the clients serviced by lenders said that they collect on a weekly basis. The roughly 3.5 percent of clients who repay on a weekly or fortnightly basis pay substantially higher rates of interest (effective rate above 624 percent).

Another key group of lenders includes the furniture traders and other retail outlet companies that are getting into microlending. As of their registration, they included just a limited number of clients, but this is certain to grow. As noted above, with more than a thousand outlets, the two largest should be handling close to a million clients alone within a few years.

2.4.3 Supply from Other Key Microloan providers

In addition to the formally registered lenders that have been captured above, there are a great number of other institutions and individuals that are participating in microlending. In order to get a perspective on the size of their industry, we will develop the size of their market.

Township lenders/mashonisas

The best estimates on the number of Township moneylenders is approximately 30,000. This is the figure that has been developed by Du Plessis and is most commonly referred to by researchers. The research by Jimmy Roth on Township moneylenders in the Grahamstown area can be taken as a proxy for the average lender. This was confirmed by a recent survey in the North, which found similar statistics. The typical lender has about 15-20 clients with a total outstanding book of about R5,000. Therefore, using this as a proxy, the township lenders account for about 600,000 clients on a monthly basis, equal to the number from the formal moneylenders, but their outstanding book is significantly smaller, about R150 million. On an annual basis this comes out to R1.8 billion.

Pawnbrokers and Second Hand Dealers

The estimates for pawnbrokers vary. Different reports on pawnbrokers in South Africa from the association of pawnbrokers put the number at about 3000 full time pawnbrokers and an additional 2,000 part time pawnbrokers. Legally they are governed under the Act on Second Hand Goods. Most loans are for one month or less. Estimating that the average portfolio outstanding is about R 60,000 per pawnbroker, there is an outstanding monthly balance of about R300 million. Taking an average term of one month (which may be too long), there is an annual turnover of R3.6 billion

Stokvels/Burial Societies/ROSCAs

The association of Stokvels (NASASA) estimates that there are 8 million individuals who are members of about 800,000 of these informal groups that provide loans to their members from own resources⁸. Interest rates may or may not be charged depending on the group and its operating procedures. Legally, they are governed under the Banks Act as a self regulating organisation. Taking an estimate of R25 per member per month, there is a monthly contribution of about R200 million into the systems of which an important part is loaned back out to the members. This comes to a total annual turnover of R2.4 bn.

2.4.4 Summary table of the entire industry

Table 8: Summary table of the entire industry

	No. of branches	Current Portfolio	Value of Loans Written/yr
Cash Lenders	4,000	1,300,000,000	12,000,000,000
Term Lenders, payroll	500	4,500,000,000	2,250,000,000
Term lenders, no payroll	1,200	1,200,000,000	1,200,000,000
Total Registered Lenders	5,700	7,000,000,000	15,450,000,000
Pawn Brokers	5,000	300,000,000	3,600,000,000
Mashonisas	25,000	150,000,000	1,800,000,000
Stokvels, B.S., K.C.	800,000	250,000,000	2,500,000,000
Total Informal Sector	830,000	700,000,000	7,900,000,000
Total Current Lenders	6,530,000	7,700,000,000	23,350,000,000

⁸ Interview with Andrew Lukhele and Andrew Japp,

Furniture and Retail lenders		5,000,000,000	2,500,000,000
Total Adjusted Microlending Sector to include retail		12,700,000,000	25,850,000,000

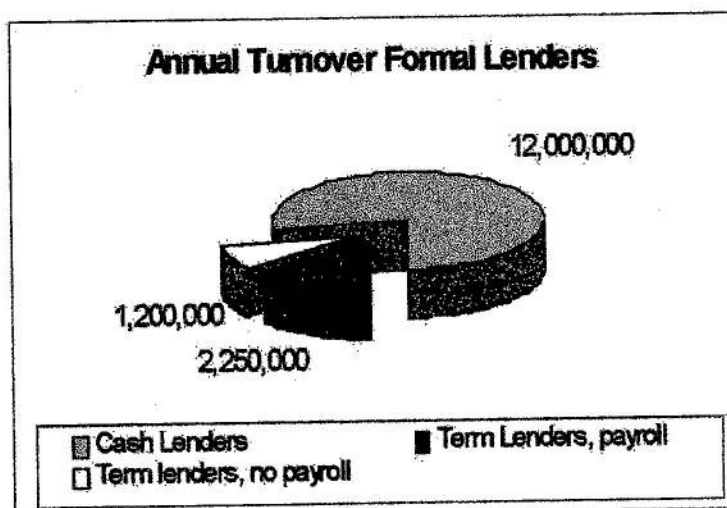


Figure 6: Annual Turnover Formal Lenders

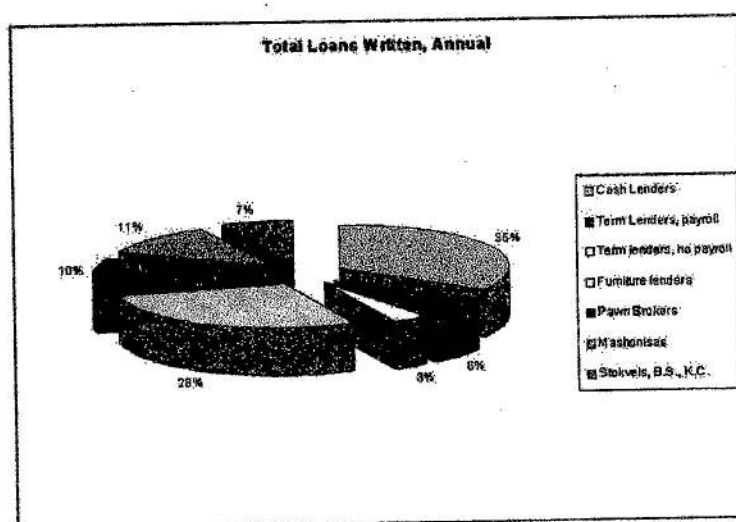


Figure 7: Total Loans Written: Annual

2.4.6 Loan Product Overview Table

The table below presents a rapid summary of the different kinds of lenders and their products. This table clearly indicates that there are a great number of different products being offered by many different kinds of institutions. The approximate figures for interest rates presented below indicate the wide spread that exists in the market and how much the effective rates can vary from their nominal rates. Risk can vary by loan and by product because of the nature of the security that is provided, the term of the loan, and the method

of repayment, among others. But institutional efficiency has the greatest impact on the cost of lending for the type of institution. At the same time, it is impossible to put a single cost of lending next to each of the different products, as the cost of lending is really institution specific, not product specific.

Table 9 Overview of loan products in the South African Market, by institution

Type of Lender	Size of loan	Term of Loan	Repayment Period	Expressed cost	APR	Method of collection	Type of security	Default rate
Cash Lender	R 50-100	< 7 days	End of mo.	free	0%	Bank card + pin	Bank card	Na
Cash Lender	R100-500	7-25 days	End of mo.	30% flat	540% - 1040 %	Bank card + pin	Bank card	5% per month
Cash Lender	R500	30 days	End of mo.	30%	360 %	Bank card + pin	Bank card	5% per month
Cash Lender	R500	25-30 days	End of Mo.	30%	360-450%	Bank card + pin	Bank card	5% per month
Cash Lender	R 500	25-30 days	Weekly	30%	640-780%	Bank deduction	None	3 % per month
Cash Lender	R 500	25-30 days	monthly	30%	540%-1040%	Cash payment (after bank card disallow.)	None	7% per month
Cash lender	1,500 - 3,000	<6 months	Monthly	12.5%	287%	Bank deduction	Known client	2% per month
Cash lender	<10,000	<24 mo.	Monthly	10.5	242%	Cash payment	Known client	???
Cash lender	<6000	3 months	Monthly	8.5%	153%	Cash payment	Credit screening	
Term Lender	2,000-6,000	6-12 mo.	Monthly	3.5%	78%	Bank deduction	Payroll	??
Term lender	<9000	24 mo.	Monthly	2.46%	57%	Bank deduction	payroll	
Term lender	>2000	12 months	Monthly	29.5%	45%-88%	Off Payslip	Payroll	??
Organised Furniture lender	R1,000	>6 months	Monthly	Highly variable		Bank deduction, cash payment	Credit screening	Na
Clothing Lender	R1,000	>6 months	Monthly	Highly variable		Cash payment	Credit screening	Na
Housing Term lender		12-36 mo.	Monthly	15%	24%	Bank deduction	payroll	
Housing Term Lender	R6,000	12-36 months	Monthly	26%	48%	Cash payment	none	
ST Enterprise Lender	R1,000	3 months	Monthly	4% per month.	72%	Cash payment	None	Varies drastically
ST	R360	6 months	Monthly	100%	420%	Bank	None	Up to

Enterprise Lender						deposit		65%
ST Enterprise lender	100-2000	14-30 weeks	Weekly	40/100 14 wk; 45/100 20 wk; 49.7/100 30 wk	109.99% - 277.33%	Cash payment	none	25% of turnover in 1999
Term Enterprise lender	R3,000	12 months	Monthly	Highly Variable		Cash payment		Varies drastically
Spaza Shop loans	R 500	5 days	Weekly	5% per week	365%	Cash payment	None	NA
Pawn Broker	Any	30 days	At expiry of term	30%	360%	Cash payment	Deposited item	33 %
Mashonis a	200-300	30-60	Monthly	30-50%	360 - 600%	Cash payment	None	5% per month
Stokvel				Varies				

It is important to note for the cash microlenders that there is a definite cyclical in their lending, so that they have large amounts of cash on hand for part of each month. Therefore, while the cost to the consumer, in terms of interest rate for a 7 – 25 day loan, is quite high, the revenue to the lender comes back to 30% per month, as he cannot relend the excess funds that he is holding.

3. Considerations on interest rates and microlending

3.1 Literature and theoretical review

The majority of economic literature and schools of thought in economics use the allocative role of the market as point of departure. They argue that any intervention in the market would distort signals in the market and in this way optimal allocation of resources to their best use would not be possible.⁹ Thus government refrains from legislating price in most markets because economic theory and experience has shown that a competitive market makes a larger amount of a good available, at a lower price, than any alternative structure.

Four arguments are frequently made to justify the intervention of government in financial markets: (i) monopoly; (ii) externalities; (iii) imperfect information; and (iv) contract enforcement problems. Monopolies are frequently associated with markets segmented by geography. Introducing more competition into these markets increases the supply of loans beyond the profit maximising level determined by the monopolist. Hence government intervention to correct for the under-supply of finance does not necessarily have to imply direct supply by a government lender. The same effect could be achieved indirectly by breaking down barriers to entry and encouraging additional competitors through temporary tax credits or subsidy schemes or increasing access to the segmented area through the expansion of public goods like roads that in turn generate other positive externalities. When the monopolist enjoys increasing returns to scale, governments typically intervene with marginal cost pricing formulas to regulate the monopolists output behaviour and returns.

Externalities are the classic form of market failure. In the realm of financial markets externalities can emerge on the side of borrowers or lenders. On the borrowers' side,

⁹ See Stiglitz and Weiss, 1981; Levine, 1993, Mayer, 1992.

defaulted borrowers increase interest costs to good borrowers as lenders pass on the higher costs of their bad lending experience to the rest of their clientele. Externalities exist on the lender's side when borrowers have access to more than one source of credit (i.e. obtaining partial funding for a project from more than one lender). This multiple lender scenario creates a potential free rider problem in monitoring since the lenders benefit each other via their monitoring. Another scenario is where a borrower borrows for several projects from different sources of credit. The effort on each project is not separable. The terms and conditions of one lender's contract can affect the effort and payoff for the other lender (Besley, 1992).

Multiple indebtedness, a feature common to microfinance markets where both formal and informal finance intermingles can generate more loans than is socially optimal (i.e. excessive indebtedness). While government interventions to deal with this feature of multiple indebtedness would be desirable, it is not clear what form this intervention could take. Private lenders could undertake denying or reducing the size of loans to those who are already in debt to another source. However, one would need to generate an all embracing credit bureau that shared (or charged for) this universal information base for this to become effective. It is not clear what form government intervention could take to directly address this issue of excessive indebtedness caused by multiple lending unless it undertook to carry out or subsidise this credit bureau clearinghouse role.

Asymmetric or imperfect information is the third and most discussed perspective on market failure. This refers to the uneven, one-sided distribution of information favouring borrowers at the expense of lenders. Adverse selection highlights how interest rates do not clear the market between supply and demand since rising risk premiums only induce risk averse borrowers to leave the loan market while encouraging relatively more risk-prone borrowers with riskier projects to stay in the market. The end result is a rise in loan losses for the lender, hence lenders choose not to raise interest rates (beyond some reasonable risk adjusted level) but rather ration the quantity of credit in the market. This is considered socially inefficient since even a constrained Pareto optimum has not been reached with under-investment governing the supply of credit (i.e. some credit-worthy borrowers are denied credit since the lender cannot tell the difference between some good and bad borrowers). This is the classic market failure example used to argue for government intervention in credit markets.

Moral hazard underscores the possibility that individuals with loans will exert less effort to restrain risky behaviour the higher the interest rate. This adverse incentive effect on borrowers' behaviour also increases the likelihood of a worsening portfolio for the lender who in turn faces this challenge by rationing credit at lower interest rates. The quantity of loans lent to an individual is restricted for incentive reasons.

Adverse selection and moral hazard jointly generate a socially inefficient supply of finance, i.e. a smaller supply than that which would obtain in a world without asymmetric information problems where truly creditworthy clients would not be rationed out of lender portfolios. This creates an argument for government intervention to deal with the problem of imperfect information. Creating the argument is one thing. Carrying it out is another thing altogether. This brings us to the fourth and most important dimension behind market failure, namely, the lack of an effective contract enforcement framework. Practically all the writers in the asymmetric information school assume away this problem. Perhaps this is due to the fact that they all live largely in the United States where contract enforcement is reasonably robust. However once one moves to the developing world, especially the world of the disenfranchised within the developing world, one has to face this issue and cannot assume it away. The lack of clearly specified property rights and cost effective and equitable contract enforcement machinery are severe problems for financial markets in these societies. The role of the government here is obvious. Strengthening property rights and

streamlining more rigorous contract enforcement procedures and mechanisms are likely the most significant action governments can undertake in developing societies to improve the alleged market failure of financial market.

It is instructive to note that the major breakthrough, substantially reversing financial market failure in the past decade, owes nothing to the traditional recommendations outlined above. This is the breakthrough in lending technologies for the "best practice" microenterprise organisations. These organisations directly addressed the core problem of substantially reducing the imperfect information problem, enhancing monitoring, and devising innovative ways around the contract enforcement problem. Direct government intervention in financial market variables played no role in this unique effort except to fund a select number of donors who in turn supported, in an ad hoc manner, consultant and non-profit organisations carrying out these innovations in financial technology.

These breakthroughs emphasise the emulation of a market and incentive based system and appropriate links between property rights and governance in institutions. It further emphasises that the market with no interference from government would find its own way in efficient allocation of resources. However, this is based on the assumption that information can flow unhindered in this market and all the aspects that result in efficient markets are in place. This is not always true in all markets. Markets may be at different levels of maturity and institutions operating in markets may be at less-optimal levels of decision making and allocating resources. In these situations one may find less optimal allocations and opportunities for the formation of cartels, monopolies and exploitation of uninformed clients. Then, what should be done to improve these situations. Mostly theory and experience will tell us that intervention in these markets should be to increase information flows. This is due to the fact that the inefficiency of a market is mostly ascribed to a lack of information and resultant frictions in the market that contributes to inefficient allocation of resources. Thus the problem is basically information and not price. Intervening on price (by setting price ceilings) do not address the original problem, information. Thus the message is that the identified problems should be addressed directly.

It has been argued that, while most consumers can shop effectively for credit, some live and work in areas (and due to historic discrimination) where there is not adequate competition amongst credit providers. That may certainly be true in some instances, especially with respect to cash credit. However, the experience is that the imposition of an interest rate ceiling under these circumstances discourages competition that would bring the benefits of multiple alternatives to consumers. Further, most of the credit we are discussing would be classified as consumer credit, thus for the purchase of consumer items. Thus, while a merchant may be prohibited from charging more than an imposed ceiling nothing prohibits the merchant from charging more for a specific consumer item (for example charging R500 for an item selling somewhere else for R250).

Many argue also that interest rate ceilings protect the unsophisticated consumers when they seek credit. Once again it can be argued that there is rational for attempting to protect unsophisticated consumers with rate ceilings when they shop for credit, when there is no rational way to protect them when they protect the goods and services that constitute a much larger portion of their total expenditure. It is also argued that it is difficult to believe that the legislator can understand the circumstances of a specific consumer in a specific market better than the consumer herself.

Price determination

Price determination is a standard market function. Demand for more credit puts pressure on prices to move upwards. Competition amongst credit providers puts a downward

pressure on prices. A highly competitive market exists where the number of credit providers is sufficiently large or entry by new competitors is so easy that no single credit provider could change the market price through its own decisions on how much to lend.

Another important component of a competitive market is the presence of informed borrowers who are knowledgeable about the availability, pricing and features of alternative credit projects. Creditors respond to increased competition with price cuts only if they fear their customers will defect to a lower price alternative.

In summary, the international theory and practise show that, given the cost structure of microfinance, interest rate restrictions usually undermine and institutions ability to operate efficiently and competitively. Typically, restrictions do not achieve their public policy objectives of protecting the most vulnerable sectors of the population. Instead they drive informal lenders underground, so that poorer borrowers fail to benefit from the intended low-cost financial services. While there is reason to question the appropriateness of interest rate limits in any form, financial institutions that can demonstrate services to the poor at a reasonable cost should receive exemptions in countries where usury laws are in effect.

3.2 Practical experience from elsewhere around the world

The US experience of the past 25 years (Staten & Johnson, 1995) has shown that competition in the credit market has dramatically expanded the range of loan products and features available to consumers, facilitated by the relaxation or removal of rate ceilings in most states. They found that the removal of rate ceilings brought more and new competitors to the market with resultant positive impact on the price and availability of consumer credit.

All financial institutions operating in the eight countries that make up the West African Economic and Monetary Union (UEMOA) are subject to a Usury Law provided that the maximum interest rate charged to a borrower should not exceed double the discount rate of the Union's central bank. In 1996 the Usury Rate fluctuated around 13%. Microfinance institutions, NGOs and donors were active in working with the Central Bank to persuade it to grant an exemption that would enable microfinance institutions to charge high enough rates to reach financial sustainability. Their advocacy efforts were successful and the central bank is in the process of revising the usury law. Two usury rates that would no longer be linked to the discount rates have been enacted: one for commercial banks (18 percent) and one for NBFIs and microfinance institutions (27 percent). The flexibility of the central bank demonstrates an understanding of the important role that microfinance institutions are playing in West Africa (Cecile Fruman – Sustainable Banking with the Poor Project). Despite this easing of the interest rate ceilings under the usury act, the Central Bank of the UEMOA still maintains rates that are considered to be too low by microfinance practitioners to provide incentives to invest in microfinance. The Central Bank of the UEMOA does not perceive microfinance as a part of the private sector, but as a part of the co-operative and non-governmental sectors, financed with support from donors.

When we study the legislation examples on credit agreements in many countries some examples are interesting in terms of this study.¹⁰

- In Europe the emphasis is on the standardisation of the presentation of the cost of credit through the use of the APR. All creditors and intermediaries must be registered and bodies are established to handle complaints. The EU approach assumes that clear

¹⁰ Deloitte and Touche study on Credit Legislation

information alone is the most important element for protecting consumers against bad practices from creditors.

- Different EU members states have expanded these rules into national legislation. A case in point is Belgium. One example of the extra arrangement is that the creditor must advise the client on the suitability of the specific credit product for the need of the client. They have a ceiling on interest rates, which are revised every six months. A central database with information on defaulters is maintained by the Central Bank. A lender should only provide a loan after ascertaining that the borrower is in a good position to repay the loan. "Reckless" lending may result in the courts punishing creditors by allowing the interest to be reduced or forfeited to compensate the customer.
- In France the Usury Act places the ceiling at 33% above the average lending rate of the banks over the last three months. A free debt rescheduling service (over a four-year period) is now supported by the Central Bank.
- In Spain the consumer credit act was passed in 1995. It follows closely the EU dispensation, focussing on the availability of information to the consumer. The Bank of Spain also runs a complaint service where customer can lodge complaints on unfair practices. They have a Usury Act but the ceiling is to the discretion of a judge on a case by case basis.
- In the USA the Law of consumer credit is embodied in state and federal law. Several states have interest rate ceilings. A state like South Dakota with no ceilings drew all the credit card companies to settle there. Consumer Credit Counselling Services provide debt counselling in all major cities. They are self-financed through a levy system on loans. Bankruptcy procedures are available for all customers on the fresh start principle. You can either file for full bankruptcy or for administration procedures.
- In Australia legislation emphasises full disclosure, provision of regular statements and notices, power for courts to address unjust contracts and scrutinise unfair interest rate changes or levying of fees, protection against unfair contract enforcement and repossession practises, penalties to provides who break these rules, use of a comparison rate. A national strategy is in place to educate the consumers about responsible credit use and to reduce financial over commitment. Counselling is provided through 31 agencies financed by the Federal Government emphasis is placed on isolated customers, low-income families and social security recipients.
- Brazil has a consumer protection code. The code provides rules for access to information and public consumer protection agencies are entitled to receive and handle complaints by consumers.
- In Chile creditors are obliged to provide information on the cost of credit. The National Consumers Service has the function of studying, evaluating and educating consumers. The service also has authority to bring consumer complaints to the courts. The Consumer Protection Act has created the right to equal and non-discriminatory treatment.
- In India small claims and arbitration procedures have been established which are cheap and informal and consumer courts handle all claims. People have responded positively to this mechanism and many complaints are lodged with most of the judgements in favour of consumers.
- Although there are many specific acts in Malaysia very few are enforced and consumers are not adequately protected. Confusion also exists as to what law would apply in a specific circumstance.

The conclusion drawn by a recent study on credit legislation¹¹ is:

- that all loans should be regulated,
- that rules on consumer credit practices should be contained in a single act,

¹¹ Only salient aspects drawn from the Deloitte and Touche study on Credit Legislation

- ❑ that clear inclusive definitions of consumers and credit should be provided,
- ❑ that specific rules on information to consumers should be enacted,
- ❑ that the presentation of the cost of credit should be standardised,
- ❑ that a cooling or cancellation period should be part of the agreement,
- ❑ that ceilings should be carefully considered as they limit access to loans and that different ceiling should apply to different loan categories,
- ❑ a minimum down payment should be considered,
- ❑ early repayment should be allowed and penalties should be within reasonable limits,
- ❑ there should be a limitation on lending periods, in situations where defaults are due to trauma extensions should be considered,
- ❑ credit bureaux should be regulated by legislation with specific client rights emphasised in terms of access to personal information,
- ❑ national co-ordination of consumer education, provincial consumer desks should be involved in educational campaigns, debt counselling services to help in over-indebted situations should be created, appropriate mechanisms should be in place where consumers can lodge complaints.
- ❑ applicants should be informed of the basis for decisions not to extend credit

The study found that the international comparison does not provide clear answers to the debate for or against ceilings. It was found in the UK that absence of regulation led to high cost credit. In Italy it was found that within the realm of regulated rates illegal lenders flourish while the limitations are respected in other countries where no parallel markets exist. In most countries with interest rate limitations the ceiling is not uniform. Different limitations are applied to different types of credit. The study concluded that there is no uniform approach to the imposition of limitations on interest rates and a real possibility that the imposition of ceilings would limit access to credit.

The study was quite comprehensive but did not go into enough detail and sound arguments for the motivation of each proposal. The proposals seem to be merely taking the measures of a range of other countries and applying them for South Africa. However, the study shows clearly that information flows to consumers, consumer education and a system for the lodging and handling of complaints should be the backbone of the government support system to borrowers. The study is not conclusive on interest rate ceilings and lacks a good discussion of the dangers of intervening and distorting market signals.

3.3 Practical experience from South Africa - response to exemption

The microlending industry has shown explosive growth over the last few years. The market development has largely been done by independent organisations and the expected consolidation of activities is now taking place. First independent firms consolidated their activities and now the banking sector is slowly starting to buy up (ABSA buying controlling stake in Unibank) the successful bigger entities or forming strategic alliances with bigger outfits (e.g. Standard Bank and African Bank). The South African situation is a perfect example of the power of legislative changes and the ability of the private sector to react to identified incentives. It is further a good case study of the development of a market and the changes that occur in this process. It started with a few players reaping tremendous profits and now it expanded to numerous players and serious competition in the market. Unfortunately the competition has not necessarily led to much downward pressure on prices, as the market has still not been penetrated to its full potential. It is expected that the prices will stay constant for the foreseeable future but our analysis shows clearly that the cost profile of the sector is under pressure.

The abuse of customers by many formal and informal lenders resulted in serious attention by consumer protection authorities and also in the formation of many alliances that are

striving to bring more integrity to the market. Members of these alliances or associations should abide to codes of conduct that are designed to protect the customer. However, the alliances/associations cover not more than the estimated 3500 formal microfinance institutions and the 40 to 70 financiers of enterprise lending. It implies that the majority of the informal and semi-formal organisations are outside the reach of the alliances.

4. Findings from the information gathering exercise

4.1 Introduction

A wide range of methods has been applied to gather useful information over a short period of time at a reasonable cost. Although the results from these efforts will be touched on in many sections of this report we provide a summary of the analysis of information obtained in this section. We focus our discussion on the requirements of the terms of reference. In the proposals section we will provide ancillary discussions to contextualise our proposals.

In this section we will address the results of the several data gathering exercises. We will first deliberate on the data provided by the MFRC. This will be applied to look at the cost components of lending of different categories of lenders. These will range from microlenders providing cash and term loans to parastatal institutions. We will also look at the cost estimates provided to us by industry organisations and individual institutions (these will not be identified, as this was the agreement when the data was obtained from individual institutions).

4.2 Cost of lending by category based on MFRC information

The detailed information supplied by the MFRC and the financial statements of institutions also supplied by the MFRC were merged in one database reflecting a sample of 90 institutions drawn from the more than 800 registered institutions as at the end of February 2000. Information fields covered are reflected in Table 10.

Table 10: Information fields in the MFRC database

Legal Status	Address	Name and contact	Revenue (time periods)
Loan Book	Clients	Branches	Purpose of loans
Monitoring method	Turnover	Income profile	Loan terms
Loan status	Repayment frequency	Income detail	Expenditure detail
Profits and tax	Assets detail	Liabilities detail	Some ratios

The characteristics of the institutional groups active in the microfinance sector have been detailed in section 2. This will not be repeated here. In section 2 the institutions have also been divided into groups. We follow that taxonomy also presenting information on cost of lending. Also, in section 2 detailed discussion was provided on the issues around profitability of microfinance institutions. That also is not repeated.

Based on the information supplied a cost profile was calculated for different institutional groups. One clear differentiation in the sector (although it is slowly starting to blur at the edges) is purpose of loan. There is a distinct difference on the basis of several variables between enterprise financiers and consumer finance financiers. Traditionally the enterprise financiers came in the format of parastatals and NGOs. Recently there have been examples of microenterprise financiers in the form of for profit businesses. We also estimate that a fair percentage of loans obtained for consumer finance purposes land as

investments in small businesses. Money is fungible and where limited opportunities exist for a generation of income from wages or salaries people will add other activities to ensure a higher income.

Our first option for grouping therefore is on the basis of enterprise finance vs. consumer finance. In the group focusing on consumer finance a wide range of institutions operate. It must be noted that the first hurdle to cross was to decide on which basis the grouping within the consumer finance group of institutions should be done. Turnover would have provided us with groups in terms of size. However, this ignores the life cycle phase a specific institution is experiencing. The same is true for number of clients and loan volume. During the research period and based on our analysis of the volatility and change continuously experienced in quite a new sector as well as the obvious differences between institutions interviewed in terms of term of loan emphasis, it was decided to group institutions on the basis of loan term. Thus we used this as the overall criteria. We see the industry moving to institutions that supply a diverse range of products (whether in the same or a range of institutions) and thus it will become more difficult over time clearly differentiate. Further, most of the microenterprise finance institutions struggle to reach operational self-sufficiency. This is due to numerous problems that will not be detailed here, however, it means that we cannot base interest rate or cost of operations discussions on their information.

Three groups were identified viz., one month lenders (referred to as the cash lenders), one to six month lenders and those that concentrate on loan terms longer than 12 months (referred to as term lenders). Note that nearly 50 percent of these institutions provide a range of products in terms of loan term. Our grouping is based on the term emphasised by the institution indicated by at least 70 per cent of the business originating from a specific term product.

The financial information supplied to the MFRC during application for membership served as the basis for our calculations of cost components of these institutions. We concentrated on grouping the information into four categories, namely, administration costs, cost of capital, risk costs and surplus before tax (see discussion on these components in section 1.2.4). Thus it also serves as a summary of the income statement of these institutions.

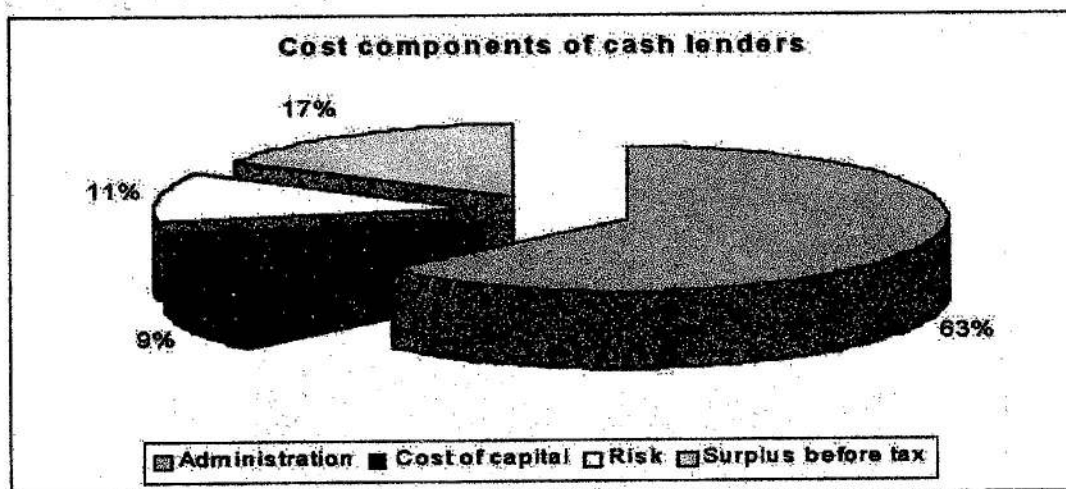
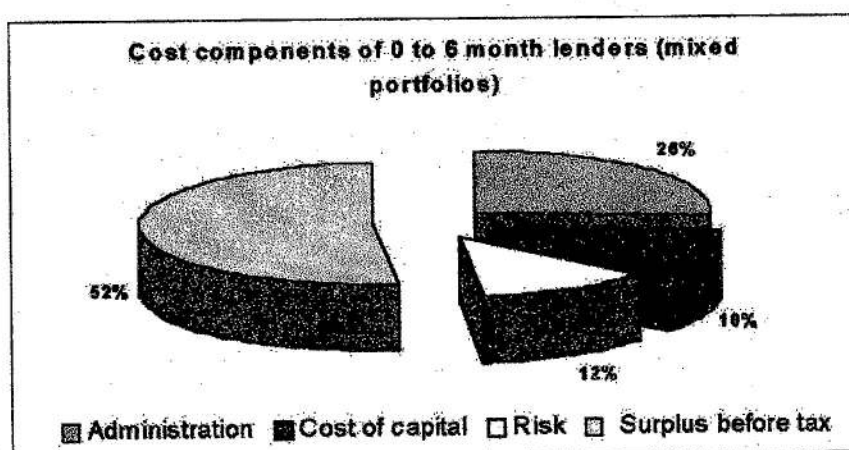
Figure 8: Cost Components of Cash Lenders

Figure 8 indicates that the bulk of the costs of cash lenders are administration costs. Cost of capital and risk costs contributes the minor proportions to the overall cost structure.

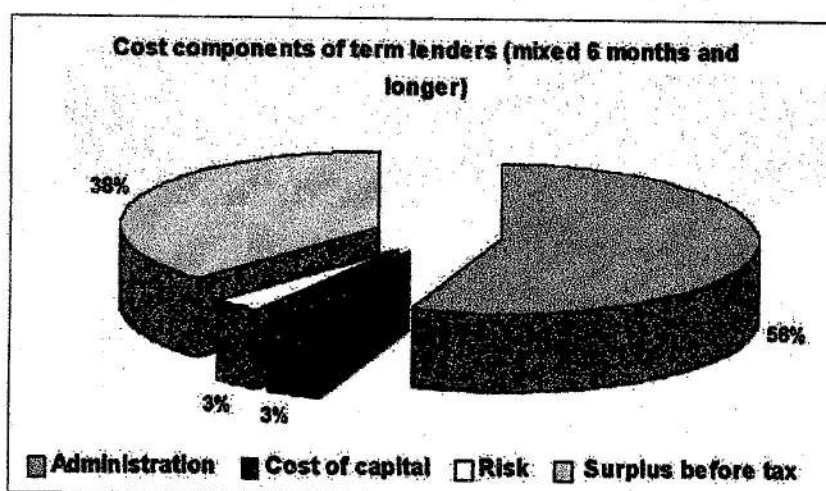
It also shows that the cost-to-income ratio¹² of cash lenders is on average 83 per cent for those registered with the MFRC. This is a relatively high ratio compared to the average for the whole microfinance sector, which is 61 percent.

Figure 9 indicates the cost components of the 1 to 6 month lenders.

**Figure 9: Cost Components of 0 – 6 month lenders**

In this group risk increased and administration costs decreased tremendously. The ratio of cost-to-income is 48 per cent, which is a quite low level in general commercial banking terms.

Figure 10 indicates the cost components of the group that provide term loans (those with loan terms longer than 6



months).

Figure 10: Cost components of term lenders

It is clear that there is a marked difference between the cost elements of the 1 to 6 month and the term lender groups. The cost-to-income ratio is 62 per cent, which compares favourably with those of commercial banks in South Africa. Administration costs are surprisingly high since most of these institutions make use of payroll deductions and thus direct debits to their accounts. This is why the risk costs attached to term lenders are normally lower than for shorter term and specifically cash lenders which is echoed by the level of the risk component (at 3 %) for term lenders.

Table 11: Cost components for different groups based on MFRC data

	Cash lenders	1 to 6 month	Term lenders
Administration costs	63 (75)	26 (54)	56 (90)
Cost of capital	9 (11)	10 (21)	3 (5)
Risk costs	11 (13)	12 (25)	3 (5)
Surplus before tax	17	52	38
Cost-to-income ratio	83	48	62
(x) indicates the percentage of total expenses			

When studying the three groups it is clear that cost of capital and risk costs are not as significant as the level of administration costs for these institutions. Thus changes in prime rates or other standard measures of the cost of capital will have a negligible effect on the cost structure of microlenders. Anything that increases administration costs¹³ would most

¹² Ratio explained in detail at end of this section.

¹³ Adding the cost of first registration for the MFRC to the administration costs of the cash lenders increase their administration costs by one percentage point and decreases their surplus before tax by one percentage point.

definitely have an effect on the bottom line of these institutions and especially the smaller institutions, thus mostly the cash lenders. The term lenders are normally operating at a bigger scale and are far more sophisticated in terms of premises and technology.

The assessment of the efficiency and level of return on investment by microlenders gave a wide range of results. The use of a ratio like return on equity that indicates the profitability of applying own funds in a microlending organisation resulted in a range of mostly meaningless answers. This is due to the fact that many of these firms start with very low levels of equity and it results in very high ROE ratios. The differences are once more vivid between the cash lenders and the term lenders. We tried several ratios to depict efficiency and return (see discussion in section 1.2.2). We settled on a basic ratio indicating the relationship between expenditure and income referred to as the cost-to-income ratio.

This ratio is used widely in the banking industry and South African banks reaching cost-to-income ratios of 55 per cent are considered to be quite efficient. Figure 5 provides the cost to income ratios for South African banks over the last 5 years. However, as is the case with the difference between the cash lenders and the term lenders one also has to contextualise the banks that you are comparing on the basis of this ratio. A bank may have only high value clients (in terms of net worth of clients) and that may imply that loans are normally bigger and cost per loan lower. This will in turn force the cost-to-income ratio lower. Another bank may have a large presence in the lower value client market (those clients with lower net worth's) and this will imply smaller Rand volume transactions per client, that increases administrative cost per transaction and forces the cost-to-income ratio upwards.

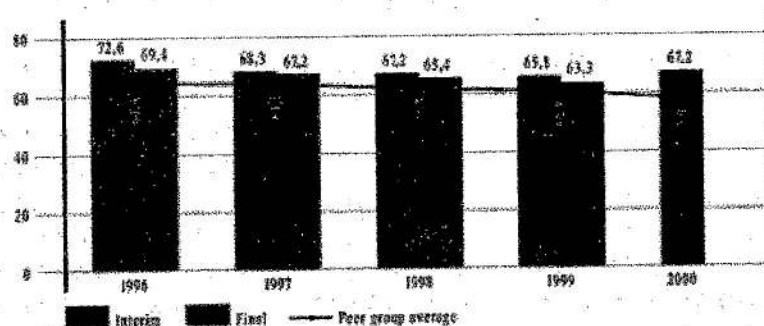


Figure 11: Cost-to-Income ratio for ABSA and peer group average 1996 to 2000

Thus the cost-to-income ratio is widely used in the banking sector as an indication of operational efficiency. It is not yet clear what the standards are for the microlending sector in South Africa. As the sector's growth has been phenomenal and most of the institutions operating in the sector are recent creations one would expect higher cost-to-income ratios that will decrease over time.

Commercial banks also report on operating expenditure as a percentage of average assets to indicate efficiency of asset utilisation.

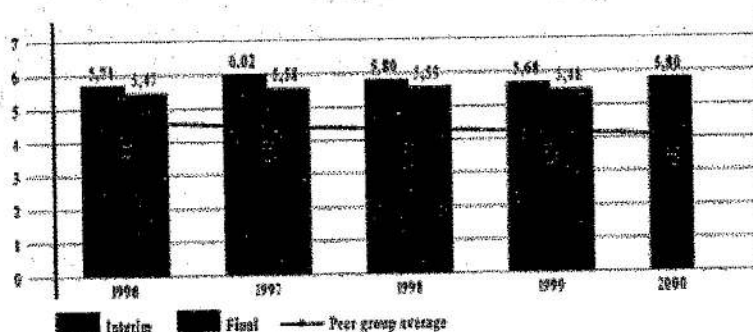


Figure 12: Operating expenditure as a % of average assets of ABSA and peer group banks

We have compared expenditure with the assets¹⁴ of the microfinance institutions. The average for the sector is 22 percent. This is far in excess of the 4.11 percent average for the commercial banking sector in South Africa, which is a clear illustration of the higher cost structure of the microfinance sector and the lower entry-level requirements of the microfinance sector.

In this section we have provided an argument for grouping the microfinance institutions and indicated efficiency ratios and cost components for the different groups. It is clear from the arguments and evidence presented that there are distinct differences between the groups identified which necessitate different approaches with each group. Further, the arguments presented earlier about volume of loans and number of clients in each grouping should now be compared with the findings of this section. We return to this argument in section 6 where we will summarise the findings of the study before we present the recommendations in section 7.

4.3 Information from the survey of microlenders

This section reports on the fieldwork done during April 2000. It presents the views of the micro lenders and outlines the results obtained from the field survey of 24 microlenders. During the course of the fieldwork two groups within the industry were interviewed, the cash lenders and the term lenders. They also differ on interest charges.

While getting the views about the industry one could detect that those offering short-term loans do not support the Government's activities around the changing of the Usury Act. A number of reasons were highlighted. Firstly the cash lenders argue that the Government has taken away their only form of security, namely the bankcard. In addition they didn't (government) come up with a better recovery method, which resulted in the cash lenders losing larger sums of money. Secondly they argue that since the term lenders are granted access to PERSAL codes they take all the money, and by time the borrower receives her salary she is unable to repay back his loan to them. They argue that since they do not have the privileges enjoyed by the term lenders by having access to PERSAL stop orders they are highly exposed to risk. The cash lenders also do not have huge amounts of capital as they use their own capital as compared to long-term lenders who get loans from commercial banks (their perception).

As mentioned there are two distinct markets in the sector, the first being the so called 30 days 30% short-term loans (cash lenders) and the other is the long-term with loans of 12 to 36 months (term lenders). From the information gathered most cash lenders if not all charge interest rates of 30% per month and this is the interest charge agreed upon by their association (MLA). Only few charge interest rate of below 30% and these are the ones, who intend offering longer-term loans. The term lenders interest rate range from 2.57 to 9.1 percent per month. But one has to realise that some lenders add charges in addition to the interest charge, this includes administration fee and range from R200 to R450 depending on the size of the loan. In addition to admin fee others charge insurance against death and retrenchment and funeral cover, but the charges differs according to the size of the loan. The cash lenders also have the perception that the term lenders have decreased their rates over the last two years. Their own rates stayed constant.

¹⁴ Note we work with assets of one year while the ratio for the commercial banks is based on average assets.

Most cash lenders argue that if the Department tampers with the interest rate it will force them out of business, resulting in hundreds losing jobs. But some stated clearly that if that happens they would have no alternative but to operate underground. They argue that their costs are too high and the business is risky, and the cost of going informal are minimal. Risks which organisations face are almost the same, most emphasising borrowers not being able to repay because of various reasons. As a result of non-payment they are forced to take the matter to court, which create more costs. This usually happens to cash lenders, as they do not have convenient mechanisms of collecting money, as is the case with term lenders. They usually rely on borrowers to repay their loans in cash, now that the bank card and PIN have been eliminated. Another risk faced by both cash and term lenders is retrenchment of mostly civil servants. One important aspect raised by nearly all the organisations is that people tend to overload themselves with debt. You find that one person has acquired loans from five different organisations and by the end of month all organisations have to deduct their money, which results in the individual taking home nothing. Sometimes not all organisations get their money back and normally those who suffer are the cash lenders because they rely on the borrower to come forward and pay in cash. Other issues raised are death of client, clients disappearing, and also not stable in their jobs, they change jobs every month, which is difficult and costly to trace.

One important observation during the fieldwork is competition. One would never walk more than 200 meters without seeing a cash lender outlet. In Durban it was even worse as in the building in which two interviews were conducted the cash lenders occupy 80 percent of the offices. This shows that this industry is very big and lenders are in tough competition.

4.4 Information from the PERSAL database and the survey of informal lender clients

4.4.1 Introduction

Although most of section 4 covers the supply side of the microfinance sector it is also important to look at the situation and perceptions of clients. Many publications and newspaper and magazine articles have highlighted the plight of clients in detail when trapped in a debt spiral. Few have highlighted the success stories of clients that had access to services that help to smooth consumption in times of financial shock. One could also question the distribution of client distress, is it really a major problem? What percentage of the market is in distress? We turn to answers to two sets of data, the survey of informal lender clients in the Pietersburg area by the University of Pretoria and the analysis of information on microlending captured on the PERSAL database of the Department of State Expenditure.

4.4.2 Survey of informal lender clients

This survey was executed earlier this year in the peri-urban and rural areas to the east and south-east of Pietersburg. In total 193 clients were interviewed. In the next table we are summarising the client profile. Note that we are using this data based on a preliminary analysis. The first section of the table provides demographic overview of the clients

Table 12: Demographic overview of clients interviewed in the informal finance survey

Female clients	52%	Similar to PERSAL (see next section)
<u>Age classes</u>	Percent	This supports the life cycle approach to savings, except for the 50 and more class, where use of accumulated savings should be seen, however, similar in other surveys
Below 25	1.6	
26 - 30	14.5	
31 - 49	51.3	
50 and more	32.7	
<u>Highest Education</u>	Per cent	In this sector very few people will have low education as educational level is important in obtaining a job, thus indirect eligibility criteria for a loan as well
None	4.1	
Primary	10.4	
Secondary	51.8	
Diploma	22.8	
Degree	9.8	
Other	1.0	
<u>Occupation</u>	Per cent	The professional refers mostly to state employees. Teachers, nurses, policeman, soldiers, officials. Interesting the self-employed and none, probably also self-employed.
None	8.3	
Pensioner	15.0	
Driver	7.3	
Labourer	19.2	
Self employed	3.1	
Professional	47.2	
<u>Marital status</u>	Percent	This is very similar to the PERSAL data, see next section
Married	55.4	
Single	34.2	
Widowed	10.4	
<u>Monthly salary income class</u>	Percent	Note that the 2000 to 8000 category is represented by approx. 2m people in SA and this is the category with the highest incidence of loans overall, estimated potential of R18b market.
1000 - 2000	26.9	
2000 - 3000	14.0	
3000 - 4000	23.3	
4000 - 5000	23.8	
>5000	4.7	
<u>Other monthly income</u>	Percent	This could indicate a second job or small business activities. What it does indicate is that we often judge loans as a percentage of income only based on salary income as we will do in the next section on PERSAL
0	53.4	
1 - 200	12.4	
201 - 500	14.0	
501 - 800	8.8	
801 - 1000	7.3	
>1000	4.1	
Information available on expenditure	Covering	School, groceries, transport, clothing, loans

Table 13 Overview of clients financial transactions

<u>Monthly loan repayments</u>	Percent	
0	14.0	
1-200	32.1	
201-400	16.1	
401-600	18.1	
601-800	15.5	
801-1000	2.1	
1001-1300	1.6	
>1300	0.5	
What interest do you pay?		Only 8.8 % could state an interest rate

<u>Purpose of loan</u>	Percent	Instalments refer to loans to pay other loans, 11.6% go to enterprise finance
Instalments	27.8	
School fees	38.9	
Household needs	22.2	
Agriculture	5.6	
Small business	5.6	
<u>Source of loan</u>	Percent	
Businessman (trader)	12.4	
Money lender	43.0	
Stokvel	8.8	
Burial Society	9.8	
Family & Friends	25.9	
<u>Why the specific source</u>	Percent	25% could be emergency or people who have exhausted other sources
Only option	25.0	
Convenience	44.7	
Low interest rate	0.5	
Know each other	8.9	
No interest rate	16.1	
Other or no reason	4.2	
<u>Loan amounts</u>	Percent	Majority below 1000
<u>Repayment period</u>		Majority below 3 months
<u>Last loan</u>		72.5 within the last year

4.4.3 Analysis of information from PERSAL

The PERSAL system started capturing microloan details three years ago. As the system was designed merely to track salary changes and deductions it is not designed as a loan repayment tracking programme. Thus, no data exist on the system for interest rates and original capital sums and other detail loan information. However, the information from the PERSAL system does paint a picture on the profile of lenders and raise questions that could be addressed by affecting changes to the PERSAL system that would put us in a position to monitor the borrowing of state employees and to ensure that exploitation (and bad decisions) are minimised.

We carried out analysis that is based on two sets of PERSAL data, namely data for July 1999 and data for February 2000. The July 1999 date provides a fair snapshot of the situation before the effect of the June exemption change could take place (the MFRC only started officially to operate in July). Thus the PERSAL data will tell us what happened in the market since July 1999 and what was the effect of the legislative announcements and regulatory body. Table 14 provide us with a summary of changes since July 1999.

Table 14 Evolution of microloans on the Persal system

Variable	July 1999	Feb 2000	Change in %
Number of people on the system	976 098	1 011 213	4%
Percentage of people with microloans	44.7	49.2	10%
Female percentage with microloans	52.02	51.89	-0.2%
Total monthly deductions	540.09	1295.14	140%
Gross salary	4435.85	4418.91	-0.4%
Net salary (after all deduct)	1697.30	1411.96	-17%
Avg. remaining balance of micro loans/borrower	7516.59	11797.68	57%
Avg. no of loans per employee with microloans	2.0	2.17	8.5%

In table 14 it is evident that the level of indebtedness of individuals with loans on the system increased by 57 percent. Net salary decreased and gross salary stayed constant. The pressure on repayment ability is evident. Table 15 indicates the slow creep in terms of the increase in number of loans per employee who borrows. This is cause for concern. The very brief analysis reflected in these two tables is but a glimpse of what is possible based on a thorough analysis of the PERSAL data. It can therefore serve as a good barometer of client profile in the market since Persal based loans are the easiest to make for term lenders, trends in the database can also serve as a forecaster of trends to come among private sector employees.

Table 15: Number of loans per person that borrowed in persons and in %

Number of loans	Jul 1999		Feb 2000	
N	436421	%	497328	%
01	199972	45.82	201562	40.53
02	118285	27.10	135458	27.24
03	65659	15.04	84250	16.94
04	31966	7.32	44679	8.98
05	13458	3.08	20042	4.03
06	4885	1.12	7773	1.56
07	1611	0.37	2598	0.52
08	453	0.10	721	0.14
09	108	0.02	185	0.04
10+	24	0.00	60	0.01

4.5 Cost of lending based on submitted information by lender groups

During the court case in November a study of 47 microlenders (members of the MLA) was used to illustrate the impact of credit ceilings on the viability of these institutions. During our study both the MLA and the SAML submitted studies indicating profitability calculations. These are reflected here and discussed relative to the results of our analysis of MFRC supplied information.

4.5.1 Cost components of the MLA 47 study

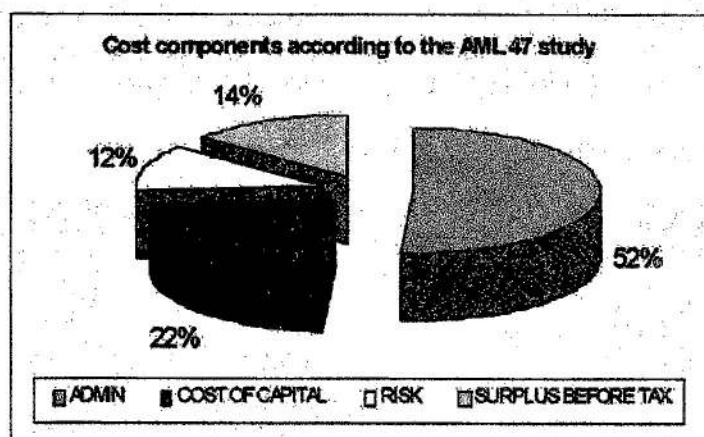


Figure 13: Cost components of the MLA 47 study

4.5.2 MLA – recent information submitted

The MLA also provided detailed information based on their analysis of 143 outlets studied and submitted for the first time through this study. A summary table provides the information. They do not provide information as to the representativeness of this sample. Offices are spread through out the country with the emphasis on Gauteng, Free State and Mpumalanga. Offices are also evenly spread between rural and urban (depending on their definition of rural). All of the clients are consistent wage earners which implies that the rural referred to here would be larger rural towns where there will be a high incidence of wage earners. It is also clear that most offices are small since 95 percent of the offices have outstanding balances of less than R300 000.

Table 16: Distribution of microlenders office by region, location and size

Region		Location of office		Size	
Number		Number		Number	R'000
6	KwaZulu-Natal	42	Central Business District	73	-100
8	Northern Cape	4	Urban	52	-200
8	Northern Province	10	Industrial area	13	-300
11	Eastern Cape	16	Economic Development Area	3	-400
25	Mpumalanga	14	Rural Large	2	-400+
25	Free State	33	Rural Medium		
22	Gauteng North	20	Rural Small		
13	Gauteng South	4	Mining Industry		
7	Western Cape				
18	North West				
143		143		143	

The majority of clients of the MLA is male (71%). Approximately 60 percent of their clients fall in the age group between 30 and 50 years. Clients receive their salary mostly on a monthly basis (87%) and thus repaid mostly on a monthly basis.

Table 17 Average monthly salary of borrowers in MLA sample

Monthly salary in R	<500	501 - 1000	1001 - 2000	2001 - 3000	3001 - 4000	4001 - 5000	>5000
% of clients	11.8	27.7	41.2	12.3	3.7	1.4	1.9

The highest incidence of salaries received is in the below R2000 per month range.

Table 18: Number of offices, loan volume per office, average loan size, average number of clients per office and net client gain per month for all 143 offices

Number	Loan Volume (R)	Average Loan Size (R)	Average number of clients	Net gain
73	0 – 100 000	550	513	-438
52	100 001 – 200 000	635	818	36.4
13	200 001 – 300 000	717	1361	195
3	300 001 – 400 000	690	1364	18.6
2	400 001 +	649	2503	169.6
143		601	747	-18.4

The figures quoted here represent the results of an analysis of 143 offices of one microlender, the AMSA, a founder member of the MLA. The MLA has 1200 microlender members. The typical profile of a MLA client is a 30-day lender (what we refer to as the cash lenders). The MLA argues that the industry is subject to fierce competition and that clients have wide ranges of choices. They see their target market as those individuals with lower incomes and urgent short-term cash needs with a high-risk profile. More specifically, members of this target market do not have any collateral available as security.

They found that clients mostly borrow for education, housing costs, small business costs and emergency situations. They note a tremendous lack of insight in their target market about money matters and knowledge of financial management. Overall the number of clients in the cash lender market is declining (as depicted by the analysis of this sample of 143 offices). These offices lose in total 18 clients per month, indicating that their market stabilised and started a slight decline in numbers. However, loan sizes increased slightly as well. It is also clear that the smaller offices (in terms of number of clients) are experiencing extreme pressures on their margins. These offices are in the medium and smaller rural towns, in the mining areas and urban areas¹⁵, thus in the areas serving on the average poorer people.

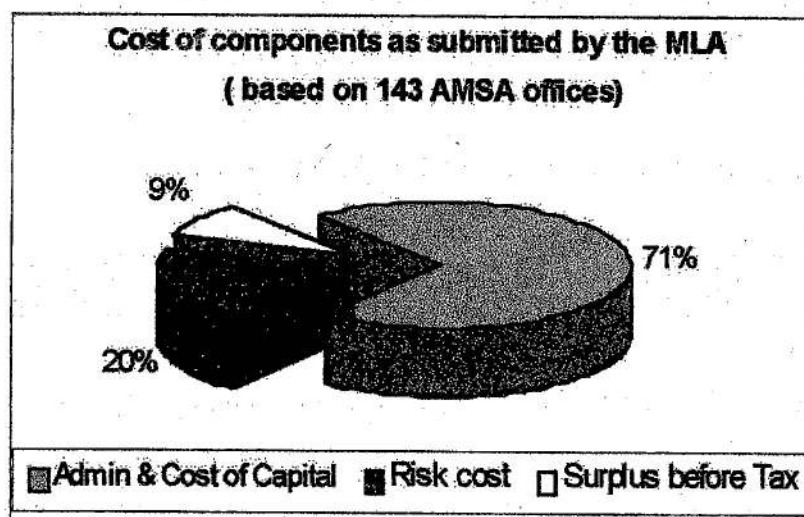


Figure 14: Cost of components as submitted by the MLA

¹⁵ Urban is not well defined, however, if central business district refers to the core urban, then urban probably refers to the outlying areas, or peri-urban areas.

The MLA did not provide detailed enough information to split the cost of capital from the administration cost. There is however no reason to believe that this will fall outside the proportions calculated earlier.

4.5.3 Analysis of information submitted by SAM

The South African Microlenders Association also submitted a detailed report to the study. They emphasise the fact that they are cash lenders (less than 35 day term) and that they have a profile uniquely different from the rest of the market (the longer-term lenders). They argue that the Card and Pin arguments have been taken out of context and that their competition in the market uses it to take their clients and put them in a bad light. They further argue that all these negative sentiments increased the cost of capital and made it increasingly difficult to finance their operations. They illustrated the difference between themselves and banks on the basis of a number of issues, including the size of loans and the profile of clients and especially between the practise of the banks to split fee and interest charges while theirs is an all inclusive charge.

They provided information on the breakdown of costs and income figures for four different branch sizes. We calculated the cost of components as for the other organisations. This is depicted in the next graph. It is clear that their cost of capital is higher than for the rest of the cash lender market. It may be that this information is derived from the Keynes group which may imply higher cost of capital since they source their capital through the stock exchange. We also calculated the impact of MFRC registration costs on the different branch sizes and the smaller branches are loosing 3 percentage points of profit while the bigger branches only looses one percentage point. This may put further pressure on the increase in size of branches and the closure of amalgamation of smaller branches.

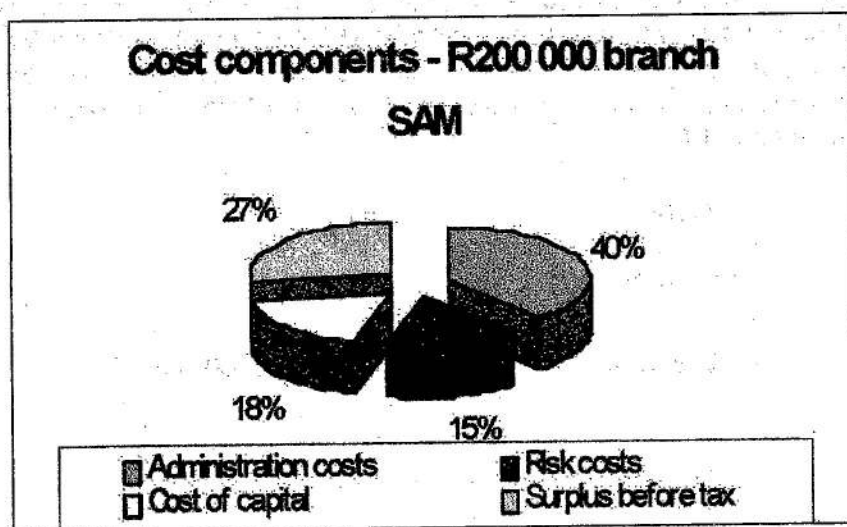


Figure 15: Cost of components – R200 000 branch

The cost components differ slightly between the analysis based on the MFRC information and the in-house analysis by the MLA and the SAM as shown in the next table.

Table 19 Comparison of short term cash lender cost components across samples.

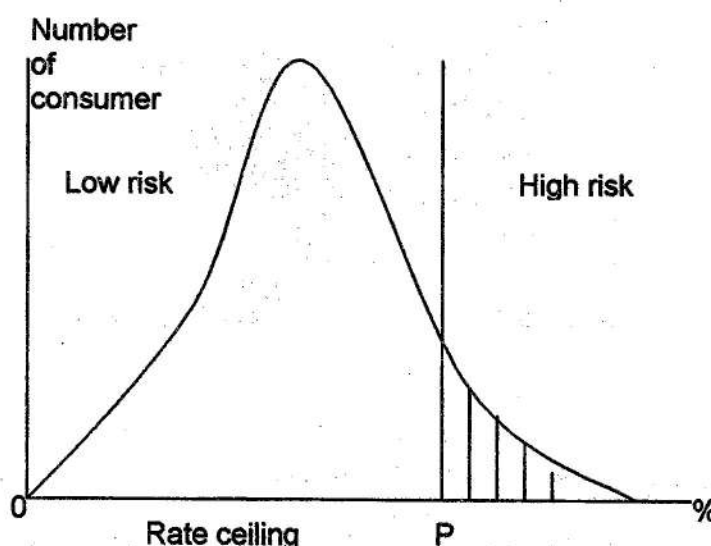
Variable	MFRC	MLA 47	MLA	SAM
Administration	63	52	71	40
Cost of capital	9	22	-	18
Risk component	11	12	20	15
Surplus before tax	17	14	9	27

The biggest differences are between the estimates of cost of capital and the risk cost estimate. These differences can be ascribed to the choice of institution and the timing of the data presented. However, overall it does not change the fact that cost of capital is indeed far smaller than the administrative costs associated with the lending activity. In all the analysis done in this study, based on a range of sources it has been clearly shown that administrative costs are indeed the biggest cost component (76, 62, 78, 55 % of total expenses for the above institutions respectively).

4.6 Interest rate ceilings and the consumer

The one outstanding issue in this report pertains to the request to propose a specific interest rate at which the interest rate ceiling under the Usury Act should be set. We have argued that we found no evidence of the positive effects of interest rate ceilings in our study of the available literature. We have further argued that liberalised markets improve competition that drives down costs and improve services to the consumer. In this side of the argument we have emphasised the role of the financiers.

But, what is the impact of credit rate ceilings on the borrowers, and especially the borrowers of small loans. Contrary to the best intentions of legislators; rate ceilings on loans – primarily instalment loans and mortgage loans - heap "distress" on consumers in two general ways. First, some consumers are simply denied credit. Second, having been denied credit these consumers resort to "second-best" sources (else they would have used them in the first place). The following diagram illustrates the impact of rate ceilings on the availability of cash credit to high-risk consumers (the majority of individuals in the South African micro-finance market).

**Figure 16: Impact of rate ceilings**

Consumers are arranged along the horizontal axis according to the minimum percentage finance charge at which creditors would be willing to extend them a loan. A small number of low-risk consumers comprise the left-most tail of the distribution of all consumers. Repayment risk associated with customers increases outward along the horizontal axis, driving up the minimum loan rate at which those customers could be served. The right hand tail of the distribution represents the highest risk customers in the distribution of all potential borrowers, those whom creditors would be willing to serve only at very high interest rates. Should the government impose an artificial cap on loan rates at P, all consumers to the right would be denied access to the legal market. Why is this so? The higher the risk posed by credit applicants, the higher the costs to creditors of granting them credit. A rate ceiling normally rations out the high-risk customers from the market and in addition it rations out customers seeking small loans. Why, since certain cost components (like administration costs) do not really change as the size of the loan decrease financial institutions have to charge higher rates on smaller loans to cover these components. Who are these customers in the South African context? They are those individuals who have limited assets that can serve as collateral, that have inadequate credit records on which to base decisions and that borrow typically small amounts.

The application of an effective interest rate ceiling below the current market rate of 30% in South Africa would most likely exclude at least 40 percent of the current clients from a sample of cash lenders investigated (based on information supplied by SAM). This calculation is based on the clients of branches that already are working on a tight margin under the current 30% interest rate due to a low volume of clients per branch. These branches are typically in the rural areas and the lower income peri-urban and outlying areas. Reduction of the interest rate below thirty percent would most likely lead to those outlets closing.

4.7 Assessment of risk and costing for risk

Although it is quite straightforward to divide the risk of microlenders into categories it is quite difficult to attach a cost to each risk category. In this section we will state the different risk categories as discussed in section one and attach costs to these categories as far as possible. We differentiated between systemic risk and organisation specific risk.

Systemic risk refers to risk originating in the sector as a whole. Here we define the sector as the microfinance sector. However, due to trends of integration in the sector embodied in consolidation and purchasing of shares in microfinance institutions by the commercial banking sector and other actors in the financial sector the microfinance sector is integrated in the financial market and specifically also in the stock market. This implies that negative stock market movements may translate in downward pressure of those microfinance institutions listed on the stock exchange directly or indirectly on the share prices of controlling commercial banks. These in turn impacts on the capitalisation of the microfinance institutions and may increase demand for loan finance, exerting pressure on interest rates. A further point of importance is that if the stock market as a whole is negatively impacted on (as during the recent Asian financial crisis) it will also impact negatively on the levels of microfinance organisation share prices. It is possible to cost these risks by estimating the percentage decrease in share prices due to a range of influences and indicating the decrease in value of these shares. The following section illustrates the situation with respect to microfinance institutions listed on the stock exchange. It also illustrates the impact of perceptions and outside influences on the share prices of these institutions.

Five institutions listed on the JSE over the last four years with mixed results as indicated in table 20.

Table 20: Summary information on microlenders listed on the Johannesburg Stock Exchange

Company	Date of listing	Section of the Exchange	List price (cents)	Share price (cents) 22/10/99
Theta Group	03/07/95	Banks & Financial Services	25	1180
Zeltis Holdings	17/08/98	Development Capital	100	23
Money Wise Holdings	02/12/98	Development Capital	100	16
ABC Cash Plus	18/02/99	Venture Capital	100	25
Thuthukani Group	04/03/99	Banks & Financial Services	100	37

It is clear from table 20 that most of the recent listings have experienced a considerable decline in share prices. The Theta group however has shown consistent growth and is also the biggest group listed. Experience also shows that investors prefer investing in these institutions once they have built a track record, thus once they have more information on which to base investment decisions. Small lending institutions are new phenomena and many consider the market as being saturated by these institutions. This also contributes to reticence in investing in these shares. An interesting occurrence is the interest of commercial banks as investors in these firms. As commercial banks have a limited direct involvement in the microfinance sector they consider the JSE listings as an alternative to getting involved in the industry by acquiring significant shares in these newly listed companies. This approach to participation has various advantages for commercial banks, additional to sharing in a very lucrative market. They are able to withdraw quickly from this investment should they wish to, which greatly reduces their risk in a high-risk business. A further advantage is that the commercial banks can be represented on the board of directors, without the need to develop the expertise of directly managing this type of business, something in which those that have tried have largely failed (Baydas et al, 1997).

When analysing the degree of success of the newly listed companies it is important to take into account the fact that with the exception of Theta, none of the five listed micro lending industry companies were listed on the main board of the JSE. The significance of these sub board listings became very evident over the last 12 months with the turmoil in financial markets in developing countries, and specifically in South Africa. Since these sub-boards are high-risk investments, they were all sold off rapidly during the international financial crisis of 1998/99.

The South African stock market has an emerging market classification, which further contributed to a downward trend for share prices. Although the South African market has started recovery (see figure 1), the JSE like most other emerging markets lags the developed economy countries of which most has already surpassed their highs of 1998 and are constantly improving. During the recovery of the last few months microfinance shares did not retrace lost ground. This was mainly due to the fact that those foreign and local investors that did return to the market demanded high quality low risk investments, which excluded the micro lending companies with the exception of Theta. Investors are interested in those shares with above average earnings growth over a period of a couple of years, for it is inevitably a sign of good management, and arguably might lack for some of the more recent listings.

The small loans industry also suffer from the negative perceptions created (partly by members of the industry) in terms of exploitation which resulted in uncertainty that is definitely not conducive to building investor confidence about the industry. It is this factor which is mostly responsible for the continuous downward slump in the relevant share prices since December 1998.

Figure 17: Overall index of the Johannesburg Stock Exchange 1997 to 1999



The negative perception that tainted this industry is nothing new and one of the main reasons why the current study is in process. The implementation dates for the announced interventions (in 1999) were quite short and as could be expected the high degree of criticisms and uncertainty quickly converted into a negative perception of this industry amongst the participants of the various financial markets, and the investing public at large. In line with investor behaviour this quickly resulted in these companies' share prices being negatively influenced on the Johannesburg Stock Exchange.

Another high systemic risk area is the probability of the collapse of a large portion of the market through over-indebtedness. As we indicated in the earlier discussions there are marked trends in terms of an increase in outstanding loan size per client, an increase in length of loan term per client, an increase in number of loans per client and not a commensurate increase in repayment ability per client. This is evident of a loan spiral and the first signs are showing as illustrated by an analysis of some of the PERSAL data as depicted in figure 19.

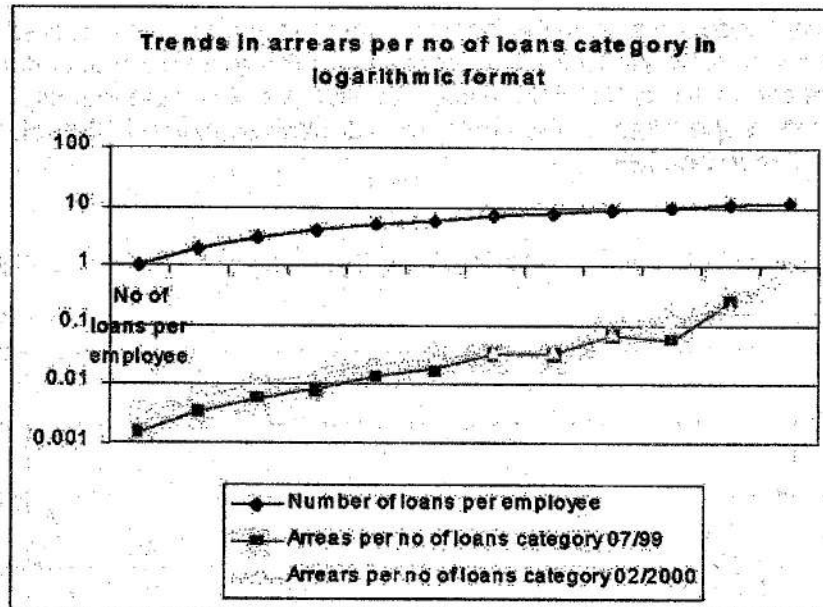


Figure 18: Trends in arrears

It is clear from the diagram that the number of loans per employee increased in the eight-month period up to February 2000. The average number of loans per employee increased from 2 to 2.17 over the same period. In addition the outstanding loan per employee who borrows increased by almost 57%, a sure danger sign in terms of a sharp increase in the level of indebtedness.

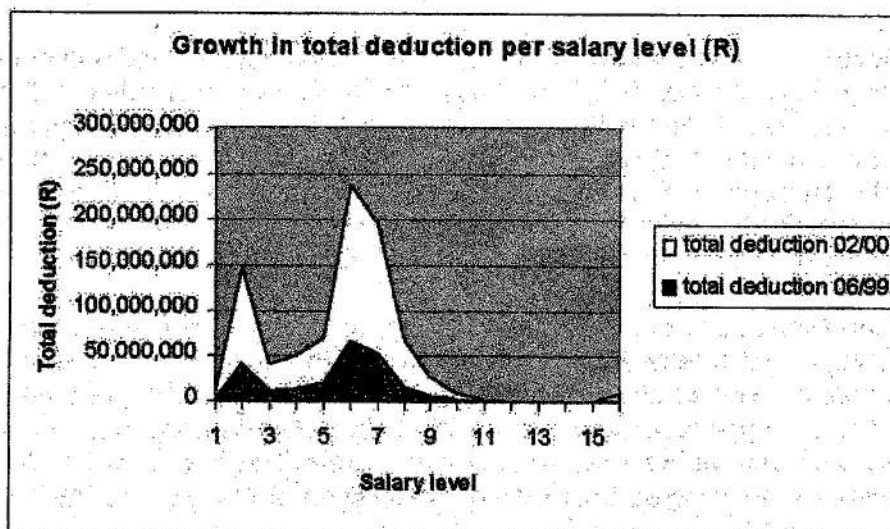


Figure 19: Growth in total deduction per salary level

A collapse of clients' repayment rate will impact severely on the microfinance industry. It will not only cause the collapse of the smaller term lenders (as this problem is mostly evident in the term lender market), it will also have a knock-on effect in terms of retrenchments of workers, impact on the share prices of the listed institutions and lastly on

the larger financial institutions (the commercial banks). This will not bring the big commercial banks down, however, it will have major political backlashes and it will create very negative perceptions and sentiments regarding financial institutions. Thus it will increase unwillingness to invest in microfinance and that brings a concomitant increase in prices. How do we assess the price of this type of systemic risk? One way would be to assume that a certain percentage of clients (for example all of those with more than four loans on PERSAL – 62000 clients representing an outstanding loan amount of R1.2 billion) collapses. This can then be costed in terms of the impact on the term lender institutions. For example, it can imply that a third of the book of African Bank vanishes overnight, thus decreasing the value of African Bank's asset side of the balance sheet by a third, or a total collapse of Unibank, or half of Saambou vanishing!

It is clear that the microfinance sector has reached the proportions where systemic risk is high and real. The loan situation cannot be evaded by legislation or capping rates, as that will not necessarily decrease existing lending. This calls for a different strategy and also a comprehensive strategy taking into account all facets of the market. There will be more discussion about strategy in later sections.

Organisational risk stems from the clients or the internal operation of the organisation. In terms of the internal operation of the organisation risk is a function of the quality of management of the organisation. Quality of management (and governance) is embodied in the efficiency that is indicated by the growth and quality of the loan book of the microfinance organisation. An indication of the quality is the portfolio at risk (Balance of outstanding loans in arrears divided by the total outstanding loans). Quality of the book is also impacted on by the profitability or repayment ability of clients. Anything impacting on the repayment ability of clients is a risk factor and can be costed in terms of the lost growth in the size of the book and defaults in terms of repayments.

We also costed organisation specific risk in terms of the costs incurred to manage risk (before it takes place) or to cover risk (after it took place).

Risk management costs	Risk coverage costs
Insurance	Bad debts write-off
Bad debts provision	Collection fees / Repossession fees
Legal costs	Fines
Security costs	Legal costs
	First Aid

All of these costs were estimated for the different microlenders (term groups) and included in our estimates for the risk cost component.

Figure 20 depicts the situation with respect to trends in organizational specific risk in the South African commercial banks in terms of charges for bad or doubtful advances as a percentage of total advances (on an annual basis).

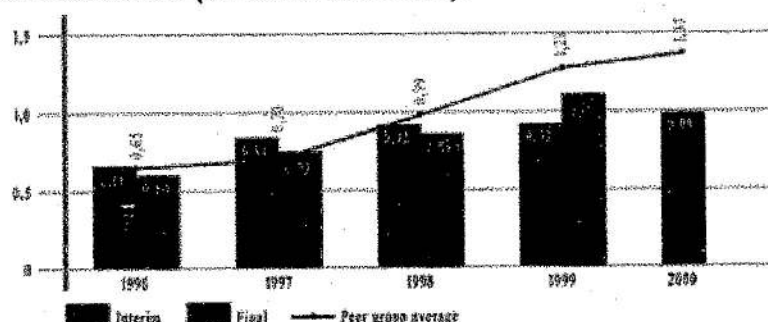


Figure 20: Charge for bad and doubtful advances as a % of advances for South African banks 1996 to 2000

The same trends apply for the microfinance sector. In the cash loan sector a study of 111 cash lenders indicated an increase in arrears from 0.04% of outstanding loans to 5% over the last year (March 1999 to April 2000).

5. Risk weighting assessment

We have argued earlier that the risk of microfinance institutions can be divided into two sources, viz., systemic risk (the risk that the system transfers to the institution) and organisation specific risk (the risk originating from the clients or from inside the organisation). These risks are presented and assessed in the next tables. At this moment we are not quantifying the risks in detail. We have argued in section 4.7 how these risks can be quantified. In this table we will attach a value to each risk (in generic form).

Table 21: Risk estimate based on systemic risk

Risk and Functioning	Assessment	Estimated cost expressed as impact on income	Weighting / importance ○ ▲ ▲ ▲ ▲
Impact on Microfinance institutions due to impacts on the broad financial market	Medium but small impact due to cost structure of microfinance institutions	1 – 2 %	▲
General increase in wages, transport costs, etc	Medium to high	5 – 10 %	▲
Market collapse because of over indebtedness	High	10 – 50 %	▲
More unemployment, especially of government employees	High	10 – 20%	▲
Segmentation of market cause risks – sharing of information	Medium	5 – 15 %	▲

The estimated cost is provided as a range covering the different types of microfinance institutions, ranging from cash lenders, micro enterprise lenders to term lenders. We have estimated that nearly 7 per cent of government employees on the PERSAL system are vulnerable in terms of over-indebtedness. We have provided several salary slips (see Annex 7) which indicate the severity of this debt trap of certain employees. This translates into nearly a one billion Rand potential loss (if we assume that provident funds or other collateral does not cover these clients) that will impact on the term-lenders specifically.

Table 22: Risk estimate based on organisational risk originating from outside the firm

Risk and Functioning	Assessment	Estimated cost expressed as impact on income	Weighting / importance ○ ● ▲ ◆ ◆ ◆
Client cannot provide security	Medium – reality of this market, have collateral substitutes	3 – 7 %	▲
Income risk – client cannot pay	Low, medium, high	5 - 7 %	◆
Income risk – client will not pay	Medium	2 – 3 %	▲
Policy & legislation risk	Low to medium	1 – 5 %	○

Most clients in the microfinance market have scarce collateral. Until recently this was a severe problem as most financiers based their collateral estimates on conventional concepts of collateral, for example, fixed property. Innovative thinking in the microfinance sector led to the use of repayment ability, with assets like provident and pension funds serving as collateral. There are however still risks pertaining to collateral. Losing your job implies a severe impact on your repayment ability. Also, you put future consumption at risk when you use your provident fund to guarantee consumption loans (as example as this should not happen in the sector).

Policy and legislation risk refers to the changes to the sector that changes in legislation can initiate. A very good example is the growth of this industry based on the lifting of the Usury Act floor from zero to R6,000.

Table 23: Risk estimate based on organisational risk originating from inside the firm

Risk and Functioning	Assessment	Estimated cost expressed as impact on income	Weighting / importance ○ ● ▲ ◆ ◆ ◆
Technical risk – information technology	Medium to high	10 – 25 %	▲
Technical risk – financial technology	Medium to high	10 – 25 %	◆
Marketing risk – appropriateness of products	Medium	5 – 15 %	▲
Operational risk	Low to medium	5 – 15 %	▲
Price risk	Medium	5 – 15 %	◆
Human resource risk	Medium	10 – 15 %	◆
Information risk	High	10 – 30 %	◆

What about the risks the clients engage in when signing a loan contract?

Table 24: Risk estimate of clients entering into loans

Risk and Functioning	Assessment	Estimated cost expressed as impact on income	Weighting / importance ○ ● ● ● ● ●
Lack of information – taking to high levels of loans and not understanding the implications of repayment	Serious problem	High	●

It will be incomplete if we do not provide an indication of the risk of the microfinance sector for the broader financial sector. In the next table this is presented.

Table 25: Risk estimate of the possible risks of the microfinance sector impacting on the broad financial sector

Risk and Functioning	Assessment	Estimated cost expressed as impact on income	Weighting / importance ○ ● ● ● ● ●
Risk of collapse in microfinance market – consumer finance	Low to medium risk	Medium to high (not due to cost but to political backlash)	●
Risk of collapse in microfinance market – enterprise finance	Medium	Setback for employment and job creation	●

6. Trends in the sector and summary of findings

6.1 Major Trends in Microfinance in South Africa

As noted earlier in this report, we have identified a number of major trends in the sector. Many of these trends are owed specifically to the creation of the MFRC and the resulting formalisation of the sector. It is worth discussing these trends to identify the implications for the microlending as a whole. Then we will look at some of the trends by segment of lenders.

♦ Increasing formalisation of the industry.

Since the creation of the MFRC, there has been the registration of many new firms. A large number of the firms registered with the MFRC have become closed corporations (CC's) or Pty's in just the last year. This is a positive trend as it implies that the principal lenders want to operate within the regulatory framework.

♦ Increased interest of the formal financial sector and commercial banking sector in microlending

Most of the major commercial banks have registered a microlending institution since the creation of the MFRC. In addition, there has been substantial activity in mergers and joint ventures. ABSA has acquired a controlling interest in Unibank, Theta acquired African Bank to house its different microlending branches (Altfin, King Finance, and Unity), and then African Bank has established a joint venture with Standard Bank. Saambou has

increased its exposure in the market significantly (up to R2 billion from R80 million two years ago), using its network of agents. This investment by the formal financial sector demonstrates that the industry has attained a certain status. This trend is occurring primarily among the term lenders.

♦ **Increasing direct formal investment in microlending.**

Funds are being raised on the stock market or through private placement for investment in microlending. For groups such as Theta and Keynes Rational, this implies that they must have an appropriately high return on equity to attract the investors. These investors can also move their funds to other investments if the returns are not being achieved. These funds are being raised for both short term and long term lenders.

♦ **Introduction of new actors into microlending**

In addition to the formal financial sector, the leading retail stores and furniture dealers are becoming active in microlending. For the general retail outlets, such as Woolworths and Edgars, their existing client base, their knowledge of their clients, their existing credit systems and their credit scoring abilities make this a reasonable investment.

For the furniture lenders, another set of issues arises. Considering that the annual furniture sales on credit are around R10 billion per annum, this offers them an alternative way for them to finance the sale of the furniture aside from the Credit Agreements Act. It also allows them to lend some additional credit for other purposes. As with the normal retail outlets, they have a solid credit history on most of their clients and know who is a better risk than not. There is some debate whether this is being used as just a way to get around the Credit Agreements Act, which is governed by the usury laws, but the furniture traders disagree.

♦ **Increasing levels of client indebtedness.**

The figures from the Persal system are the best time series data available. They demonstrate that since the increased formalisation of the sector with the creation of the MFRC, there has been an unprecedented push towards increasing the amounts of credit in the sector.

6.1.1 Segment Specific Trends – the 30 day cash lenders

□ **There is a decrease in the number of storefronts serving the public.**

The credit bureaux are very specific on the trend of reduced numbers of operating businesses. This is occurring through a number of operations:

- either small businesses are closing (in particular those with less than R75,000 in book, according to short term cash lenders),
- the owners are selling the business to larger consortia that are on acquisition binges, such as Keymatrix and others, that will then often close the less viable branches and consolidate the clients into one branch;
- several small businesses are merging and consolidating on their own; or
- businesses are simply going underground. This latter phenomenon is happening with the smaller branches that cannot support the combination of increased charges coming from the formalisation of the sector¹⁶ and the fact that there is little to stop them from operating informally.

¹⁶ Increased costs come from the fee to the MFRC, the fees associated with registering as a company, the costs of having a certified audit, and the increase in bad debt due to forfeiting the bank card and pin number,

- **Increasing rate of default due to the changing rules governing the sector. This will force the microlenders to change their methods of operating.**
 - Loss of the ability to hold the bankcard and use the pin number has led to an increase in the risk of default to the lender. While average defaults were running between 3 and 5 percent with the bank cards (which one may have considered virtually a guarantee for repayment), these have already started to climb by several percentage points for those firms that have already stopped using them.
- **Companies are getting larger and have better operating systems and risk management tools.**
 - With the increasing size and formalisation, there is increasing investment in the computerisation and sophisticated software. This facilitates tracking loans and while some software allows lenders to collect repayments (Applitech, Loan King, Micromax, Saswitch, etc.) directly from the bank accounts. While these systems reduce some risk, they also add cost to the operations (2-3 percent of the revenue per loan), and may cause additional problems for the borrower (risk of fraud).
 - Some of the cash lenders are quitting the pure short-term 30-day lending, and are changing over towards more term lending for good clients with a proven track record. While this is more capital intensive, it has proven less risky in terms of default and cheaper in terms of administration. However, since the interest rates are lower, the overall return is not as high.
 - There is increased use of credit bureaux (3 specialised ones for 30 day lenders and one (ITC) for general credit issues) to check on new clients that are coming into a lender's system. As the credit bureaux expand, they will encompass the majority of the short term borrowers in South Africa.

The combination of these factors is leading to a more formalised and modern microlending sector in the 30 day cash lending industry. However the costs of the new regulations are important, without even addressing the interest rate issue. The firms that are on the margin of profitability will either go out of business or will go underground where they will continue to operate completely in the informal sector.

6.1.2 Segment Specific trends: the term lenders

As noted above, there is consolidation of the lending institutions with the mergers and acquisitions that are taking place. These are leading to greater economies of scale/cost reduction.

□ **lower cost money from deposits.**

Own funds are always the most expensive funds to use for a corporation. Through the consolidation and inclusion into the formal financial sector, the largest institutions are accessing increasing amounts of relatively cheaper capital coming from deposits in the commercial banking sector.

□ **Risk reducing innovations.**

As with the 30 day microlenders, there is the introduction of new products and risk measurement tools. Examples of these include the new software system being introduced by Teba Cash, the trend towards consolidating debt accounts into a single account at a lower interest rate, and the diversification of lending activities and loan products, including adding micro-enterprise lending to the mix of commercial products.

6.1.3 Segment Specific Trends: the housing lending sector

The majority of the term lending originated from lending for housing and home improvements and provisions governing use of provident funds and government payroll (Persal) to guarantee and repay such loans, respectively. While these two limitations are officially still in place, the microlending industry has evolved with time to unofficially cover a wide variety of other uses. However, still focusing on the housing loan sector, we can note a few trends, mostly on the positive side.

- ❑ There is increasing integration and consolidation in the housing lending sector, with an added focus on specialisation of lending.
- ❑ More commercial banks lending for small housing.
- ❑ Better access in rural areas. Through the RHLF program, there has been an increase in the provision of lending for housing improvements and for
- ❑ There has been a slight increase in unsecured lending by lenders seeking access to this market.
- ❑ NHFC notes that there has been an a rising average loan size, which had reached just under R6,000 at the time of the increase in the exemption. Experts expect this average loan size to continue gradually increasing up to the new ceiling of R10,000.
- ❑ There has been a fair amount of investment in new product development by the housing lenders and dropping interest rates. Rates that are secured by mortgages are now running at prime minus, while unsecured microloans are being made at 40-50 percent effective interest rates.

6.1.4 Sector Specific Trends: Enterprise and Developmental Lending

Enterprise lending is perhaps the least dynamic section of the microfinance industry in South Africa. At the larger loan sizes, between R10,000 and R50,000, the commercial banking sector is virtually absent, reluctant to make business loans below R50,000. Recognising this, the commercial banks, through the Banking Council, have started a special project (the Sizawani Scheme) to address this range of credit. However, the fact that only 13 loans have been approved out of the 127 applicants, demonstrates that the commercial banks will continue to avoid this sector. Khula's commercial bank portfolio guarantee programme for micro loans has also had few subscribers, to date, but their loan guarantee fund has been seeing increasing use. It is unclear whether the loan guarantee fund is actually stimulating new loans or whether the clients fall into commercially accepted risk parameters for the banks.

On the micro-enterprise side, after nearly a decade of investment in micro-enterprise finance programmes and four years of intensive support from Khula, the results are still underwhelming. Statistics from Khula, which monitors the sector very closely demonstrate that very few of the operations have achieved operational sustainability. Some of the key trends that have been:

- ❑ **Structural problems in terms of ownership and governance affecting cost structure.**

Few of the micro-enterprise lending institutions have sorted out proper governance and ownership structures. With many of them starting as projects with outside funding there has been little emphasis on achieving profitability quickly. This retards their developing commercially viable systems and controls. Also removes investor incentives. At the same time there is not the same professionalism that exists in the much of the rest of the

microlending sector, which has hired bankers to manage their operations and do respond to investor incentives.

□ **Khula's withdrawal of support is closing down many non-performing microenterprise lending institutions**

While many argue that Khula has been overly demanding on the sustainability side and trying to push the RFI too quickly, it has been very strict with its clients (retail finance institutions) recently. Khula has recently withdrawn its support for a number of RFI, which has effectively put them out of business, reducing the overall outreach to microenterprise clients in the country. When the recent round of closings is complete, roughly 25 percent of the microenterprise lending clients will have lost their lenders.

□ **At given cost structures, RFI cannot make it.**

The low level of operational sustainability found among the microenterprise lenders demonstrates that they do not have their cost management structures and their interest rates in synch. While many of the RFI have tried charging interest rates much lower than the rest of the microlending sector, they are not able to control their costs and generate sufficient revenue to reach sustainability. Only three out of 26 RFI have reached sustainability, including Ithala and SCF (these latter two are not true microenterprise RFI as they have average loans outstanding of 45,000 and 300,000 respectively). Start-up fund, the largest RFI, had seemingly reached operational self-sufficiency. They had been charging an effective interest rate of 415 percent on its smallest loans, decreasing as the loan size got larger.

The one interesting finding from the analysis of the Khula statistics is that for Khula's clients (the RFI) there is a higher correlation between loan size and operational self-sustainability (64 percent) than there is between repayment and sustainability (34 percent) and number of clients and sustainability (23 percent). Considering the trend in the commercial banking industry in terms of ignoring loans below R50,000, this demonstrates that there is potential at that level if done properly.

□ **Rural finance seemingly not moving despite Strauss Commission**

Since the Strauss Commission finished its work in 1997, there has been little effective increase rural finance in the country.

□ **Demise of most parastatal retail lenders**

In 1994, there were more than a dozen parastatal retail lenders involved in developmental finance. Today there are only a few that are operating profitably (Ithala, Land Bank, Eastern Cape Development Agency, and the Eastern Cape Agricultural Bank).

6.1.5 Other Informal Lenders

In stark contrast with the other sectors that are either booming or in regression, the informal sector has been relatively unchanged by the recent regulatory financial changes. Most of the clients of the informal lenders are those who cannot qualify for microloans through the semi-formal and formal lenders which rely on salaried employment and bank accounts.

□ **Mashonisas continuing as normal**

The 25-30,000 informal township lenders continue to operate as they always have, charging effective interest rates in the 360-600 percent range for relatively small loans. Despite this, they are earning relatively little in absolute terms, as their average loan book

is quite small because they have few clients (15-20) and small average loans (less than R500). They continue to meet the emergency demands for credit from the bottom end of the spectrum, those who cannot access semi-formal or formal finance from the 30-day and term lenders.

❑ **Pawnbrokers continuing as normal**

The pawnbrokers continue to operate as second hand goods dealers, under the supervision and regulation of the South African Police Department which monitors the second hand goods businesses. The pawnbrokers continue to meet the need for short-term emergency finance, though much of their business revenue is actually derived from the sale of the goods.

❑ **Stokvels continuing as normal**

Despite the efforts of NASASA to organise the Stokvels, they remain virtually completely informal and technically outside of the law. But they meet the needs of their members and will continue until there are better systems for their members to access these services elsewhere. An increasing number of Stokvels appear to interact with the formal financial sector by depositing their savings there, increasing their security and adding a little bit of revenue.

6.2 Summary of main findings

It is impossible to conclude and provide recommendations for this study without first making a range of observations. These observations are important, as we would like to create the context within which we would like to make the recommendations.

First, this study was carried out in the midst of a process of rapid evolution. South Africa started to change at a rapid pace 10 years ago. This is true for all facets of society and economic life. In the microfinance sector (as broad as we have defined it) this rapid change and evolution is vividly evident. The sector is adjusting and changing and growing like any other sector following the removal of extreme controls. In the process, some organisations reaped tremendous profits, which often happens for those first going into profitable new markets. All along things are slowly improving. More institutions entered the market and competition forced the improvement of services and more people started to get better services. Clients are also experiencing painful lessons and gaining experience. A large proportion is already locked into debt, yes, but more people are handling debt with caution, some people even stand away from the sector for a few months because they do not need continuous debt. The essence is change, evolution, competition and experience.

Secondly, this is a sector full of variety. Institutions range from age old informal money lending businesses that have been serving the same clients for years, in a variety of rural and urban settings, to highly developed technologically innovative institutions financed by issuing shares on the Johannesburg Stock Exchange. It ranges further from reformed government parastatals providing savings and loans (and applying for banking licences) to powerful commercial banking groups buying up microfinance institutions. It ranges from small loans of R10 for a day, to large R10 000 loans over 36 months. Anything is being financed, from a R10 inventory of a rural spaza owner to a R10 000 extension to an urban home, from educational fees for the new grade one student to university fees for the oldest sister.

Thirdly, like elsewhere in the world, South Africans also need to be far more informed about the advantages and disadvantages of the use of credit. All countries studied have some type of Consumer Credit Protection Legislation in place or are planning to implement. This is true for industrialised and developing countries. In the USA, they are discussing the phenomena of pay-day lenders at the moment. This is similar to our cash

lenders. In Australia they are emphasising the need for and applying resources to educate and inform people. This is the same in Europe, Brazil, Argentina and India and many more. They emphasise education and information, not only to the clients, but also to employers and providers of services. They also emphasise access points where consumers can bring their complaints. Then, complaints can be acted on.

Fourthly, most of the regulatory discussion about this sector is about interest rates. However, the key issues from the borrower's perspective are about access, convenience and monthly payments. This is an important difference. When people are looking in from outside the sector they make observations, all they see are high interest rates. This drives most of the discussions on the sector and is seen as the one variable with which the sector can be influenced. If the sector is studied closely, it is clear that transaction costs are the most important aspect. Clients look at interest rates yes, but they look harder at how near is the service, how quickly can the service react, is it friendly and does it understand their needs. This is then weighed against the monthly payment to obtain a specific amount of capital.

In the survey in the Northern Province, only 8.9 percent of people could tell what interest rate they are paying on their loans. Meanwhile all of them could clearly provide the monthly payment. On the side of the financiers, interest rates play a minor role as a component of costs. We have shown that administrative costs are the biggest contributor to expenses and that aspects that influence administrative costs are important. We have also shown that the majority of loan volume and clients are not interacting with the cash lenders (those asking the "highest" rates), but with the term lenders (those asking the "lowest" rates). When we study the clients of the term lenders we see most of the problems of over indebtedness. We have studied pay slips of numerous people from the PERSAL system. There are many cases where one term lender will have two or more loan contracts with one client, where take home pay is less than 10 per cent of gross (and sometimes negative), and where some people have up to 10 loans. We have also seen responsible term lenders who do not provide a loan if the client has any other outstanding loan.

We therefore conclude that merely fixing an interest rate at a specific level is a naïve approach to regulating this sector. This sector is much more complex. Fixing an interest rate ceiling will not address the indebtedness of the people already trapped. It will not increase competition, leading to lower prices. Interest rate ceilings have never worked in other countries and will not work in South Africa. People already in debt will suffer more, since ceilings will drive many of their providers underground, out of public scrutiny. Even if a ceiling is fixed, no amount of resources will ensure a complete monitoring of the sector. No, we argue a far more pragmatic approach, based on the reality of the sector, the assumption that we do not want to stifle the sector with legislation. We also do not propagate unlimited freedom to microlenders and we believe in transparency and the strong vested interest that the larger lenders have in developing this into a sound market.

7. Recommendations

As we review the status of the microlending industry in South Africa and weigh the recommendations on interest rates that will have a tremendous impact on the future of microlending, it is worth taking a step back and asking the following questions:

- ☐ What would we like the microlending industry to look like in ten years?
- ☐ What regulatory system is needed to achieve this vision?

The answers to these questions will help to guide characteristics of the interest rate policy to be developed. The statements below provide a starting point for our recommendations.

VISION FOR THE FUTURE – WHAT WOULD WE LIKE THE MICROLENDING INDUSTRY TO LOOK LIKE?

- Microlending industry that meets credit needs of the poorer segments of the South African economy;
- An industry with many suppliers, promoting competition and prices based on industry efficiency;
- An industry that offers a choice of appropriate products to the customers at competitive prices, ranging from small consumer lending to small and medium enterprise finance;
- A competitive environment that does not promote the over indebtedness of the clients, which is eventually a great risk to the industry as a whole;
- An industry whose internal codes of conduct are more stringent than government's; and
- An industry that is integrated into the formal financial sector so that funds can flow easily into the bottom end of the economy in sufficient quantities to meet demand.

WHAT ARE THE CHARACTERISTICS OF THE REGULATORY SYSTEM THAT IS NEEDED TO ACHIEVE THIS VISION?

- One that is enforceable and which incites participants to act according to the rules;
- One that is transparent and allows the participants to understand the regulatory environment and to make sound investment decisions in order to promote sound investment in the industry;
- One that does not create artificial distortions and stifle the industry;
- One that promotes innovation and the development of new products;
- One that promotes and rewards participation in a formalised financial sector;
- One that will serve as a reference point for many years into the future and not require frequent or major changes;
- One that promotes consumer awareness and education; and
- One that responsabilizes the different participants in the industry: the lenders, the borrowers, and the employers.

7.1 The Problems and Broad Solutions

At the root of this study are three main concerns for the DTI:

- Apparent increasing indebtedness of the client;
- Perceived exploitation of the clients by microlenders; and
- Insufficient finance for small enterprises.

Each of these is caused by a variety of factors, some of them overlapping, some of them not. Associated with each of these causes are a number of categories of solutions, with different options within each one. We will systematically explore each of these different areas, with a recommended set of options for addressing the constraints that will hopefully allow the DTI to establish the right policies to achieve the vision laid out above.

□ Apparent over-indebtedness of the client, causing a debt spiral.

The base cause for this condition is due to two major factors: aggressive lenders and uninformed or naïve clients. The high interest rates being charged to the clients are not the cause of the over indebtedness, but do exacerbate the problem.

Three major types of solutions are possible to address the main cause of the problem:

- Restrict or control the lenders;

- Educate and inform the borrowers and their employers of the dangers of borrowing; and/or
- Restrict borrower access to credit.

□ **Exploitation of the clients by microlenders, leading to apparent over-indebtedness.**

Exploitation can be seen either as lending a borrower more than s/he needs or wants to borrow or charging them a higher rate than they thought that they would be paying by adding on extra charges. The base cause for this condition is due to aggressive lenders, uninformed clients, and poor information flow between clients about alternative options. Exploitation can take the form of overselling the borrower on credit (i.e. lending him/her more than s/he needs), not providing accurate information to the borrower about the implications of the cost of lending and the borrower not being aware of other options.

As with the problem of over-indebtedness, there are three major categories of solutions that are appropriate to address the cause:

- Restrict or control the lenders;
- Educate and inform the borrowers and their employers of the dangers of borrowing;
- Improve information flow among borrowers and lenders; and/or
- Restrict or monitor/control borrowers access to credit.

□ **Insufficient small and micro-enterprise finance.**

While consumption credit is spreading like wildfire, based on payroll deductions, small and microenterprise finance, where repayment is based on cashflow not on guaranteed salary deductions, is not growing very rapidly. The commercial banking sector provides very little enterprise finance under R50,000 and the microlenders provide very little above R10,000. The fact that it is cashflow based, means that the perceived risk is higher than payroll based lending.

Unlike the problems noted above, which focus on over indebtedness and consumer exploitation, there are two main causes for the insufficient supply of small enterprise finance: inappropriate lending technologies to cover the risk and costs associated with lending and a lack of incentives to the lenders to enter the market.

7.2 The Recommendations

Based on the above analysis and the considerations for the vision of the microlending sector in the future we propose the following recommendations to address the issues confronting the microlending sector.

7.2.1 Who to try to regulate?

Between the purely informal lenders (the mashonisas and stokvels), short term cash lenders, commercial retail lenders, and the term lenders, we recommend that DTI should concentrate its regulatory efforts on those groups where it gets the biggest return on investment. The formal short term cash lenders, the commercial retail lenders, and the term lenders account for the largest portion of the lending and are easiest to monitor and regulate. In contrast, the informal lenders are very difficult to monitor and, on a lender by lender basis, handle very few clients. Trying to regulate the informal sector hence becomes relatively cost ineffective.

Otherwise, regulations should apply to all participants in the sector. This will promote a smooth transition for participants within the sector to find that segment in the industry where they wish to operate.

7.2.2 Interest Rate Ceilings

The analysis demonstrated that the size of the branch has a big impact on the surplus that the branch earns, as does the age and maturity of the lending institution. Given the wide range of margins that were witnessed, the instinctive reaction is to not recommend setting any interest rate ceiling at all. After all, setting interest rate ceilings will restrict the flow of credit into the system by forcing marginal lenders (primarily in the rural and peri-urban areas) to close or go underground. This will impact those who have the greatest need for short term emergency credit, the poor, forcing them to go to the informal lenders who are even more expensive.

However, if the DTI insists on setting interest rates, they should not be set based on the cost of money, but based on administrative costs of making the loans. In order to promote the greatest amount of transparency in the industry to promote and stimulate investment in new products, while still maintaining the level of service provision, the DTI should set the interest rate ceiling as high as possible and should set it as a fixed rate. Interest rate ceilings may lead to some disinvestment from the sector, restricting the cash available for short term loans, as well as many of the smaller lenders going underground into the informal sector. But having a fixed rate of interest will allow investors to do their calculations and determine where they wish to invest their money.

The effective interest rate ceiling should be based on the price that has been set by the current short term market forces. This will cause the least distortion in the market, today, and will not penalise the rural poor. Therefore our recommendations would be to place the ceiling at 30 percent per month, if one has to place a ceiling at all. This ceiling can be targeted for a gradual reduction over a period of time providing the industry with time to develop new tools and technology to reduce their administrative costs and to reduce their risk. A period of one to two years should be allowed for the interest rate reductions.

If interest rate ceilings are being set based on the administrative costs, the DTI should address the short-term cash lenders separately from the term lenders, as they have extremely different cost structures due to their methods of operation and risk profile of their clients. While the ceiling for the short term cash lenders should be set at 30 percent (effective interest rate), initially, the ceiling for the term lenders should be set at 10 percent (effective interest rate), with targets for gradual reduction over a period of one to two years.

7.2.3 Other Restrictions on Lenders

As noted in the discussion above, there are other kinds of restrictions that should be placed on lenders that will have a more important impact on addressing the concerns confronting the DTI.

DTI should institute a system to make the term lenders responsible for limiting the level of debt exposure that they place on borrowers through the PERSAL system. This should be based on a repayment ceiling of 25 percent of gross salary (for interest and principal repayments). This is considered to be the safe lending limit in most developed countries for term loans, where salaries are higher, so should be considered as the maximum allowable in South Africa. This will protect the long-term integrity of the market. Short term loans, which respond to emergencies and which can be paid off after a month should not be subject to this ceiling. In any event, it could never be enforced.

DTI should institute measures that will increase the risk to lenders who practice irresponsible lending practices, such as depriving them of recourse to

compensation in case of default. As with the recommendation above, this will force the lenders to take responsibility for their actions.

DTI should motivate the large term lenders, as well as the short term cash lenders, to institute their own more stringent industry standards on lenders for acceptable levels of debt exposure. These should be based on levels that the lenders determine, in conjunction with the MFRC and DTI, to be safe levels that will protect the integrity of the market and promote responsible lending.

Improve the system for handling complaints by the MFRC. While most systems should be incentive based to motivate lenders to do the right thing, monitoring of complaints must be immediate precise if the MFRC is to have an impact on controlling the lenders who deviate from the established rules.

7.2.4 Improved borrower education

Simultaneously to addressing concerns to problems caused at the lending level, attention must be paid to the borrowers, to inform them of the dangers of taking on too much debt and to make them responsible for their own actions. One very effective way to help address these issues is to include the employers in the solution, as with PERSAL. These recommendations include:

DTI should promote the development and delivery of improved education materials for prospective borrowers and their employers by the microlenders. Since the employer is the best point of control for lenders desiring to provide the service through the company, they must be included in this campaign and must insist that the microlenders provide the educational material as a condition for entry into the company.

DTI and the MFRC, in conjunction with consumer groups, should launch a national education/sensitisation programme on the risks of becoming over-indebted.

7.2.5 Improving the flow of information for borrowers as well as lenders

Clearly, there is limited flow of information about borrowers at present, even though there are three credit bureaux that are concentrating on the clients of the short term cash lenders.

Therefore, the DTI should promote the creation of a national loans register that will allow lenders to identify the level of debt exposure already facing an individual, either through creating a national loans register managed by the MFRC (government financed) or by the private credit bureaux (privately financed).

DTI should continue to require the full disclosure by lenders of all charges to the consumer and the monthly flow of payments over the course of the month in easily understandable language, including the annual percentage rate as calculated by the MFRC.

7.2.6 Restrict borrower access to lenders for certain categories of borrowers.

This is the flip side to restricting lender access to clients, and can only be done under certain circumstances. It would require a centralised system, and at the extreme would only make it more difficult for the borrower to access credit. But if s/he really needs it, s/he will find it.

- **Limit the level of debt coverage that the user can afford**
- **Limit the number of loans a borrower may access at a time.**

Both of these can be easily bypassed by the borrower, but at least making them aware of it and promoting industry standards as safe limits may make it more difficult for them to access them.

7.2.7 Stimulating investment in SMME finance

Stimulating investment in SMME finance remains a serious challenge. It was clear from the fieldwork that the formal banking sector has little incentive or initiative to invest in making loans into this sector. There has been some investment specifically in microenterprise finance by Quatro Trading, which has achieved a very sizeable book for Spaza shop lending, but this is VERY short-term working capital finance. Traditional microenterprise term finance is in short supply, as well as loan funds below the commercial bank's "glass floor" of R50,000.

The constraints revolve around incentives to lend and appropriate technologies to reduce the cost and risk of lending. Since the commercial banks have demonstrated limited interest in the sector, the recommendations must therefore focus on stimulating new lending technologies and investment in the sector from the microlending side. The recommendations are:

- **Increase the ceiling on the exemption from SMME loans beyond R10,000 to R25,000.** Increasing the ceiling will make it more interesting for commercial microlenders to invest in this market. Loans at this size should be comparatively easier to track and monitor than the microloans, to avoid abuse, and could be restricted to firms that have specifically registered with the MFRC for this range of products. Keeping the ceiling well below the "glass floor" will limit abuse of the Exemption by commercial banks wishing to divert funds into this much more lucrative market, but only on the margin. This will also lead to the promotion of technological innovation in this segment of the market by those lenders who have demonstrated the best aptitude for innovation: the microlenders.
- **Continue to facilitate capacity building through government sponsored programmes such as Khula and promote standardised reporting to the MFRC for enterprise lenders.** These latter two items will work in tandem with the increased interest rate ceiling to stimulate innovation in the sector.

7.2.8 Increased Monitoring and Analysis of the Sector

The work carried out under this study has been the most in-depth analysis of the MFRC data on microlending institutions and of the data from the PERSAL system to date. Both systems could capture data more efficiently for improved monitoring by the responsible parties (MFRC and DTI). An unprecedented opportunity now exists to carry out proper analysis of the evolution of the sector. Therefore the recommendations are:

The MFRC should continue its strong efforts to capture data on the industry, to carry out regular analysis on the trends in the industry, and publish those reports for the industry as a whole. This will promote the flow of information, as well as allow for better tracking of the industry. The better flow of information should stimulate competition.

The DTI should carry out regular monitoring of the trends on the PERSAL system to monitor the impact of its policy initiatives on addressing the key problems of over-indebtedness. This is not a complicated process, the information just needs to be identified in advance, and the key searches must be effected on a regular basis.

Implementing these two monitoring activities will provide sound information on the transformation of and trends in the microlending industry following the implementation of regulatory policy. This will inform the DTI on kinds of interventions that have been most successful in addressing the key problems, assisting it with future decisions.

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ANNEX II

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4. Interest Rate Calculations

Annex 4: Interest rate calculations¹

There are several ways to calculate interest on a loan, of which two methods are most common: the declining balance method and the flat (face-value) method. Interest is generally paid over the term of the loan, although it is sometimes paid up front. These methods are discussed in detail in Annexe

The declining balance method

This method calculates interest as a percentage of the amount outstanding over the loan term. Interest calculated on the declining balance means that interest is charged only on the amount that the borrower still owes. The principal amount of a one-year loan, repaid weekly through payments of principal and interest, reduces or declines every week by the amount of principal that has been repaid (table 1). This means that borrowers have use of less and less of the original loan each week, until at the end of one year when they have no principal remaining and have repaid the whole loan (assuming 1 00 percent repayment).

For example, by month 6 of a 12-month loan for 1,000, the borrower will only owe approximately 500 if she or he has paid in regular weekly installments. At that point, she or he is paying interest on only 500 rather than 1,000. (Note that with interest paid on the declining balance, a greater portion of the monthly payment is paid in interest during the early months of the loan and a greater portion of principal is paid toward the end of the loan. This results in a slightly larger amount than half of the principal remaining outstanding at the mid-point of the loan. In the example in table 1, in month six 524.79 is still outstanding, not 500.)

To calculate interest on the declining balance, a financial calculator is required. On most financial calculators, present value and payment must be entered with opposite signs, that is if present value is positive, payment must be negative, or vice versa. This is because one is a cash inflow and one is a cash outflow. Financial calculators allow the user to enter different loan variables as follows:

PV = Present value, or the net amount of cash disbursed to \$c borrower at the beginning of the loan.

i = Interest rate, which must be expressed in some time units as n below.

n = loan term, which must equal the number of payments to be made.

PMT = Payment made each period.

In the example above, a one-year loan of 1,000 with monthly payments and 20 percent interest calculated on the declining balance is computed by entering the following:

PV	=	-1,000 (enter as negative amount, as it is 0 cash outflow)
I	=	20 percent per year; 1.67 percent a month
n	=	12 months
Solve for PMT :		
PMT	=	92.63

Total payments equal 1,111.56 (12 months at 92.63). Total interest is 111.56. The declining balance method is used by most, if not all, formal financial institutions. It is considered the most appropriate method of interest calculation for MFI's as well.

¹ Several texts exist that covers interest rate calculations. In this report we use a standard text as base and to ensure that we do not compare different methods. The text used is Ledgerwood, Joanna. (1999). *Microfinance Handbook: An institutional and a financial perspective*. Published by Sustainable Banking with the Poor Project, The World Bank, Washington DC.

Table 1 Declining Balance Method - Loan amount: 1,000; 12-month loan term; monthly loan payments: 92.63; interest rate: 20 percent

<i>Month</i>	<i>Payments</i>	<i>Principal</i>	<i>Interest</i>	<i>Outstanding balance</i>
0	-	-	-	1,00.00
1	92.63	75.96	16.67	924.04
2	92.63	77.23	15.40	846.79
3	92.63	78.52	14.21	768.29
4	92.63	79.83	12.81	688.46
5	92.63	81.16	11.48	607.30
6	92.63	82.51	10.12	524.79
7	92.63	83.88	8.75	440.91
8	92.63	85.28	7.35	355.63
9	92.63	86.70	5.93	268.93
10	92.63	88.15	4.49	180.78
11	92.63	89.62	3.02	91.16
12	92.63	91.16	1.53	0.00
Total	1,111.56 ^a	1,000.00	111.76 ^a	-

Difference of 0.2 is due to rounding

Source: Ledgerwood 1996

The flat rate method

This method calculates interest as a percentage of the initial loan amount rather than the amount outstanding (declining) during the loan term. Using the flat method means that interest is always calculated on the total amount of the loan initially disbursed, even though periodic payments cause the outstanding principal to decline. Often, but not always, a flat rate will be stated for the term of the loan rather than as a periodic (monthly or annual) rate. If the loan term is less than 12 months, it is possible to annualise the rate by multiplying it by the number of months or weeks in the loan term, divided by 12 or 52 respectively.

To calculate interest using the flat rate method the interest rate is simply multiplied by the initial amount of the loan. For example, if an MFI charges 20 percent interest using the flat rate method on a 1,000 loan, the interest payable is 200 (table 2).

It is clear that the actual amount of interest charged varies significantly depending on whether the interest is calculated on the declining balance or the flat amount. The flat method results in a much higher interest cost than the declining balance method based on the same *nominal* rate. In the example in table 2, interest of 200 (20 percent flat basis) is 88.44 or 80 percent greater than interest of 111.56 (20 percent declining balance).

To increase revenue some MFI's will change the interest rate calculation method from declining balance to flat rather than increase the nominal rate. This may be in reaction to usury laws imposing a maximum rate of interest that is not high enough to cover the MFI's costs. However, MFI's should realise that regardless of the nominal rate quoted, clients are well aware of how much interest they are actually paying, based on the amount due each payment period. It is important that all interest calculations be transparent.

Table 2 Flat method: Loan amount: 1,000; 12-month loan term; monthly loan payments: 100; interest rate: 20 percent

Month	Payments	Principal	Interest	Outstanding balance
0				1000.00
1	100	83.33	16.67	916.67
2	100	83.33	16.67	833.34
3	100	83.33	16.67	750.01
4	100	83.33	16.67	666.68
5	100	83.33	16.67	583.35
6	100	83.33	16.67	500.02
7	100	83.33	16.67	416.69
8	100	83.33	16.67	333.36
9	100	83.33	16.67	250.03
10	100	83.33	16.67	166.70
11	100	83.33	16.67	83.37
12	100	83.33	16.67	0.00
Total	1200	1000.00	200.00	-

These examples show that with all other variables the same, the amount of interest paid on a declining balance loan is much lower than that on a loan with interest calculated on a flat basis. To compare rates of interest calculated by different methods it is necessary to determine what interest rate would be required when interest is calculated on the declining balance to earn the same nominal amount of interest earned on a loan with a flat basis calculation.

In example 1, a 1,000 loan with 20 percent interest calculated on a declining balance for one year with monthly payments results in interest of 112 (rounded from 111.56). The same loan with interest calculated on flat basis results in interest of 200. To earn interest of 200 on a loan of 1,000 with interest calculated on the declining balance, the interest rate would have to increase by 15 percentage points to 35 percent (additional interest revenue of 88). Interest on a 1,000 loan at 35 percent declining balance results in monthly payments of 99.96 for one year or a total interest cost of 200 (rounded from 199.52).

This example shows that an MFI calculating interest on the declining balance would have to increase its *nominal* interest rate substantially to earn the same revenue as an MFI calculating interest on a flat basis.

Example 1					
Interest	20%	20%		20%	35%
	Declining	Flat	Difference	Flat	Declining
Actual costs	112	200	88	200	200

How Do Fees or Service Charges Affect the Borrower and the MFI?

In addition to charging interest, many MFI's also charge a fee or service charge when disbursing loans. Fees or service charges increase the financial costs of the loan for the borrower and revenue to the MFI. Fees are often charged as a means of increasing the yield to the lender instead of charging nominal higher interest rates.

Fees are generally charged as a percentage of the *initial* loan amount and are collected up front rather than over the term of the loan. Because fees are not calculated on the declining balance, the effect of an increase in fees is greater than a similar increase in the nominal interest rate (if interest is calculated on the declining balance).

In example 2, the MFI wants to determine its future pricing policy. In doing so, it wants to calculate the effect on the borrower of an increase in the interest rate and, alternatively, an increase in the loan fee.

In example 1 a 20 percent interest rate (declining balance) on a 1,000 loan resulted in 112 in interest revenue. A loan fee of 3 percent on this loan would result in a fee of 30, making total revenue 142. The MFI wants to increase its rate by 5 percentage points either through the loan fee it charges (from 3 percent to 8 percent) or the interest rate it charges (from 20 percent to 25 percent declining balance). Each increase results in the following:

- ❑ A loan fee of 8 percent on a 1,000 loan results in fee revenue of 80. This represents an increase of 50 from the 3 percent fee (30).
- ❑ An interest rate of 25 percent (declining balance) on a 1,000 loan results in interest revenue of 140 (monthly payments of 95). This represents an increase of 28 from a 20 percent interest rate (112).

Total revenue collected on a 1,000 loan with 20 percent interest (declining balance) and an 8 percent fee equals 192 (112 + 80). Total revenue collected on a 1,000 loan with 25 percent interest (declining balance) and a 3 percent fee equals 170 (140 + 30). The effect of a 5 percentage point increase in the loan fees from 3 percent to 8 percent is greater than a 5 percentage point increase in the interest rate, provided interest is calculated on the declining balance. This is because the fee is charged on the initial loan amount whereas the interest is calculated on the declining balance of the loan.

Although the interest rate may be the same *nominal* figure, the costs to the borrower and hence the yield to the lender vary greatly if interest is calculated on a flat basis or if fees are charged. This will be discussed further in the section below on calculating effective rates of interest.

Example 2						
	Service fee	Service fee	Increase	Interest 20% decl. balance	Interest 25% decl. balance	Increase
Actual costs	30	80	50 (167%)	112	140	28 (25%)

Calculating Effective Rates

MFIs often speak about the 'effective interest rate' on their loans. However, there are many ways in which effective rates are calculated, making it very difficult to compare institutions' rates. The effective rate of interest is a concept useful for determining whether the conditions of a loan make it more or less expensive for the borrower than another loan and whether changes in pricing policies have any effect. Because of the different loan variables and different interpretations of effective rates, a standard method of calculating the effective rate on a loan (considering all variables) is necessary to determine the true cost of borrowing for clients and the potential revenue (yield) earned by the MFI.

The effective rate of interest refers to the inclusion of all direct financial costs of a loan in one interest rate. Effective interest rates differ from nominal rates of interest by incorporating interest, fees, the interest calculation method, and other loan requirements into the financial cost of the loan. The effective rate should also include the cost of forced savings or group fund contributions by the borrower, because these are financial costs. We do not consider transaction costs (the financial and non-financial costs incurred by the borrower to access the loan, such as opening a bank account, transportation, child-care costs, or opportunity costs) in the calculation of the effective rate, because these can vary significantly depending on the specific market. However, it is important to design the delivery of credit and savings products in a way that minimises transaction costs for both the client and the MFI.

When interest is calculated on the declining balance and there are no additional financial costs to a loan, the effective interest rate is the same as the nominal interest rate. Many MFIS, however, calculate the interest on a flat basis, charge fees as well as interest, or require borrowers to maintain savings or contribute to group funds (trust or insurance funds). The cost to the borrower is, therefore, not simply the nominal interest charged on the loan but includes other costs. Consideration must also be given to the opportunity cost of not being able to invest the money that the borrower must pay back in regular instalments (the time value of money).

Variables of microloans that influence the effective rate include:

- ☐ Nominal interest rate
- ☐ Method of interest calculation: declining balance or flat rate
- ☐ Payment of interest at the beginning of the loan (as a deduction of the amount of principal disbursed to the borrower) or over the term of the loan
- ☐ Service fees either up front or over the term of the loan
- ☐ Contribution to guarantee, insurance, or group fund
- ☐ Compulsory savings or compensating balances and the corresponding interest paid to the borrower either by the MFI or another institution (bank, credit union)
- ☐ Payment frequency
- ☐ Loan term
- ☐ Loan amount.

When all variables are expressed as a percentage of the loan amount, a change in the amount of the loan will not change the effective rate. A fee that is based in currency (such as R25 per loan application) will change the effective rate if the loan amount is changed; that is, smaller loan amounts with the same fee (in currency) result in a higher effective rate.

Calculation of the effective rate demonstrates how different loan product variables affect the overall costs and revenues of the loan. Two methods of calculating the effective rate of interest are an *estimation* method, which uses a formula that does not require a financial calculator, and the *internal rate of return* method.

Note that the estimation method does not directly take into account the time value of money and the frequency of payments, which are considered in the internal rate of return method. Although the difference may be minimal, the greater the length of the loan term and the less frequent the loan payments, the more substantial the difference will be. This is because the longer the loan is outstanding and the less frequent the payments, the greater the effect on the cost will be and hence the difference between the estimated effective cost and the internal rate of return calculation. In addition, the estimation method does not take into account compulsory savings or contributions to other funds, such as trust or insurance funds. It is presented here simply as a method for calculating the effective rate if no financial calculator or spreadsheets are available.

Estimating the Effective Rate

If you do not have access to a financial calculator or a computer spreadsheet, you can compute an estimation of the effective rate. The estimation method considers the amount the borrower pays in interest and fees over the loan term. The estimation method can be used to determine the effect of the interest rate calculation method, the loan term, and the loan fee. An estimation of the effective rate is calculated as follows.

Effective cost = Amount paid in interest and fees divided by Average principal amount outstanding

Note: Average principal amount outstanding = (Sum of principal amounts outstanding) divided by number of payments

To calculate the effective cost per period, simply divide the resulting figure by the number of periods.

As previously illustrated, the amount of interest revenue is largely affected by whether interest is calculated on a flat or declining balance basis. With all other variables the same, the effective rate for a loan with interest calculated on a declining balance basis will be lower than the effective rate for a loan with interest calculated on a flat basis.

Using an example similar to that in tables 1 and 2, the effective rate is estimated for a 1,000 loan with interest of 20 percent and a 3 percent fee, first with interest calculated on the declining balance and then with interest calculated on the flat basis. Calculating the interest on the declining balance results in an estimated annual effective rate of 25 percent or 2.1 percent per month. Calculating the interest on a flat basis results in an estimated annual effective rate of 42 percent or 3.5 percent per month.

With all other factors the same, the effective rate increases from 25 percent (2.1 percent per month) to 42 percent (3.5 percent per month) when the method of calculation is changed from declining balance to flat. The effective rate also increases when the loan term is shortened if a fee is charged. This is because fees are calculated on the initial loan amount regardless of the length of the loan term. If the loan term is shortened, the same amount of money needs to be paid in a shorter amount of time, thus increasing the effective rate. This difference is greatest when a fee is charged on a loan with interest calculated on the declining balance. This is because the shorter loan term increases the *relative* percentage, of the fee to total costs. The effective rate can be estimated for a number of loan variables, including an increase in the loan fee and a decrease in the loan term. Note that the effect of an increase in the fee by 5 percent (to 8 percent) has the same effect (an increase of 0.8 percent per month in effective rate) whether the loan is calculated on a declining basis or flat method. This is because the fee is calculated on the initial loan amount.

5. The Options – Pros and Cons

ANNEX V

OVERVIEW OF PROBLEMS, CAUSES, TYPES OF SOLUTIONS AND VARIOUS OPTIONS

PROBLEM FROM DTI PERSPECTIVE	CAUSE	TYPE OF SOLUTIONS	OPTIONS
Over Indebted Client (Debt Spiral)	Aggressive Lender	Restrict/control Lenders:	<ul style="list-style-type: none"> ♦ Interest Rate ceilings ♦ Total cost of credit ceiling ♦ Restrict access to Persal and clients ♦ If > 3 loans already, then no recourse ♦ Closer MFRC monitoring
	Uninformed Client	Educate Borrowers & Employers	<ul style="list-style-type: none"> ♦ Improved MFI education materials ♦ Intervention of employers on behalf of employees ♦ National Education Programmes (DTI & MFRC) ♦ Consumer Groups
Exploitation of Clients (Loan Sharking)	Poor information to Client	Improve Information Flow	<ul style="list-style-type: none"> ♦ Loan register ♦ Link Credit bureaux ♦ Full disclosure by lender
	Aggressive Lender	Same as above	Same as above
	Irresponsible Client behavior	Restrict Borrowers access (for employees with < 8K/ mo.	<ul style="list-style-type: none"> ♦ Limit no. of loans ♦ Limit % of net salary to be used for payment
Insufficient microenterprise finance	Inappropriate Technologies for SMME lending	Promote investment in the development of new lending technologies	<ul style="list-style-type: none"> ♦ Increase the ceiling for loan size for SMME under the exemption to R25,000
	Perceived high risk and cost to lending to SMME	Provide incentives to banks and microlenders to enter the market	<ul style="list-style-type: none"> ♦ Increase interest rate ceiling for SMME lenders below R50,000

SUMMARY OF VARIOUS OPTIONS AND THE ADVANTAGES AND DISADVANTAGES

Restrict/Control Lenders	
Options 1: Institute interest rate ceilings or Total Cost of Credit ceiling	
Pros: <ul style="list-style-type: none"> • Sets a limit on the cost that the lender can place on a borrower; • If set properly, above the point where supply and demand intersect, should not affect the supply of credit. 	Cons: <ul style="list-style-type: none"> • Provides a disincentive to invest in the sector; • If set too low, will ration credit, excluding those at the bottom • Can be very difficult to monitor and enforce; • Does not prevent the borrower from going elsewhere; • Can force marginal lenders to go outside the regulated sector or "underground".
Option 2: Restrict access to Persal for lenders found to abuse the system by making dangerous loans, defined as surpassing 25 percent of gross salary, or more than 3 loans.	
Pros: <ul style="list-style-type: none"> • Access to Persal is a privilege, Serves as a reward to incite responsible lending. • Easy to monitor; • Easy to enforce; • Serious penalty for irresponsible lending 	Cons: <ul style="list-style-type: none"> • Must define "abuse of the system"
Option 3: Institute measures to increase risk to the lender for unsafe lending: if a borrower already has more than three loans or has passed 25 percent of gross take home pay, then the lender loses recourse to any compensation in case of default	
Pros: <ul style="list-style-type: none"> • Incentivizes responsible lending. 	Cons: <ul style="list-style-type: none"> • Implies that the borrower has no responsibility for his actions. • May force borrower to use informal sources of credit.
Option 4: Closer monitoring by MFRC and Decentralization of Inspection and Education Offices to the provinces, (must do cost benefit analysis first)	
Pros: <ul style="list-style-type: none"> • Specialized regulatory body knows what to monitor and has comprehensive records; • Brings the MFRC closer to the clients 	Cons: <ul style="list-style-type: none"> • Becomes expensive • Requires larger infrastructure and staff for the MFRC; • "Big brother is watching" syndrome • impossible to monitor everything
Option 5: Improve system for handling complaints	
Pros: <ul style="list-style-type: none"> • MFRC will be able to react more effectively to penalize irresponsible lenders 	Cons: <ul style="list-style-type: none"> • Increase in costs, may increase regulatory fee, adding to lender's premium on margins.

Option 6: Microlenders institute more stringent industry standards on lenders for numbers of loans and level of debt exposure that is acceptable for borrowers to provide for a strong microlending industry that have been determined in conjunction with DTL.	
Pros: <ul style="list-style-type: none"> • Increase awareness among lenders of dangers that are facing the industry. • Lenders take positive steps to address the debt spiral problem and maintain strong market for microlending • Puts onus on individual microlenders to protect the market from abuse which could lead to collapse and greater government intervention. 	Cons: <ul style="list-style-type: none"> • Impossible to police • May be difficult to reach consensus
Option 7: Promote the continued formalization of the microlending industry through strict controls on larger informal lenders, but should not waste time on the small informal microlenders	
Pros: <ul style="list-style-type: none"> • Cost effective way to capture 99% of the credit flow in the sector 	Cons: <ul style="list-style-type: none"> • May be some irresponsible borrowers left out in the informal sector who are not captured.

Educate Borrowers and Employers to create more informed clients	
MFI Develop and deliver improved education materials to prospective borrowers and to their employers. Provide awards for best sensitization materials.	
Pros: <ul style="list-style-type: none"> • Forces MFI to think about problems associated with extending credit to small borrowers. • Puts onus on MFI to educate borrowers as to risks and promote sound borrowing practices. • Strengthen the future market for microlending. 	Cons: <ul style="list-style-type: none"> • Difficult to monitor to ensure compliance.
Intervention of employers on behalf of employees for requiring credit education by microlenders and controlling the debt spiral due to over-indebtedness	
Pros: <ul style="list-style-type: none"> • Employers are concerned about their employees financial condition as it will impact on their performance. • Employers can play an important role in screening responsiveness of lenders to needs of their employees • Employer set own standards and conditions for lenders to work with their companies. 	Cons: <ul style="list-style-type: none"> • Preventing borrower from accessing credit may force it into the informal sector with higher interest rates.
National Education Programmes (DTI and MFRC) in conjunction with Consumer Groups. To be carried out for both the MFI on risks of creating over indebted clients, and for the clients on the debt trap and how easy it is to fall in.	
Pros: <ul style="list-style-type: none"> • Government has the financial capacity to fund awareness campaign for the public good • Gets NGOs involved in the most difficult side of the equation: responsabilising the borrower. 	Cons: <p>Government and consumer groups not directly implicated in the contract between borrower and lender, so may have limited impact.</p>

Improve information flow for lenders as well as borrowers**Establish a Loan register that will capture all loans that are currently outstanding managed by the MFRC****Pros:**

- Allows MFI to see the full extent of client exposure.
- Lessens the risk of creating bad debt problem for the lender.

Cons:

- Provides irresponsible lenders with accurate data on the limit of credit ceiling still available to borrower.
- Very difficult and expensive to implement
- Credit checks and references are normally the domain of the private sector.

Link Credit Bureaux to provide comprehensive client analysis**Pros:**

- Credit bureaux are already collecting information on borrowers, have the systems in place and the loyalty of their clients (the mfi).
- Will be funded through fees for service, removing the funding onus from government.

Cons:

- Requires the credit bureaux to collect more information on clients.
- May require some funding from the government, initially, to get off the ground

Full disclosure by lender of all charges to the consumer and the monthly flow of payments over the course of the loan in easily understandable language, including the APR as calculated by the MFRC.**Pros:**

- Provides maximum information to the client, so that the client does not have the excuse of blaming the lender.

Cons:**Restrict Borrowers access to lenders for certain categories of borrowers****Limit the number of loans****Pros:**

- Prevents easy access to loans that would push the borrowers over the edge of heavy indebtedness and into debt spiral.

Cons:

- Force Borrower to go to informal lender for emergency loans.
- Impossible to monitor completely
- What is government's right to intervene in the actions of individuals

Set limits on the percentage of gross or net salary based on ability of the client to repay, in conjunction with the banks.**Pros:**

- Prevents easy access to debt load that would push the borrowers over the edge of heavy indebtedness and into debt spiral.

Cons:

- May force the borrower to go to the informal lenders for absolute needs.
- Difficult to monitor

Encourage investment in SMME Lending	
Increase the ceiling on the exemption from SMME beyond R10,000 to R25,000	
Pros: <ul style="list-style-type: none"> • Will provide greater profit incentive for microlenders to enter the market for enterprise lending. • Stimulate innovation among existing lenders to provide more diversified products in the R10,000 range. • May improve the choice of lenders and products for borrowers/SME. • Keeping the ceiling substantially below the current commercial bank floor for SMME lending will limit the diversion effects of the increase. 	Cons: <ul style="list-style-type: none"> • Difficult to monitor • May lead to substitution/diversion of credit to under the credit ceiling where banks can charge higher rates. • May promote businesses with riskier profiles to get loans with banks.
Increase the interest rate for SMME lending for loans in the R25,000 to R50,000 range, and continue supporting Khula's loan guarantee programme.	
Pros: <ul style="list-style-type: none"> • Will provide greater financial incentive to commercial banks to provide SMME with loans. 	Cons: <ul style="list-style-type: none"> • May lead to substitution/diversion of credit • May promote businesses with riskier profiles • Will require greater monitoring costs.
Promote technological innovation	
Facilitate access to capacity building through Government sponsored programmes, like Khula	
Pros: <ul style="list-style-type: none"> • Strengthen the capacity of microenterprise lenders 	Cons: <ul style="list-style-type: none"> • Cost may be too high for the smaller microenterprise lenders already under pressure.
Promote Standardized Reporting to the MFRC	
Pros: <ul style="list-style-type: none"> • Focus the MFI on key issues relating to sustainability • Ease of information flow into the MFRC 	Cons: <ul style="list-style-type: none"> • Readjustment for some of the MFI with cost of changing their systems.

6. Scenarios for interest rate reduction

ANNEX VI

SCENARIOS FOR INTEREST RATE REDUCTION

The three scenarios below were developed to help in the decision making process for the Department of Trade and Industry in their regulation of the microlending sector. These scenarios are not all encompassing, but help to provide a little more structure to the debate around interest rate ceilings. In this analysis, the following characteristics will be kept in consideration:

- microlending is a service for which there is demand and will continue to be demand in the future. When people really need money, they will look for it, and will find it, at any cost.
- the microlending industry in South Africa is a commercially driven sector, that responds to profit incentives;
- the microlending industry in South Africa has many vested interests that will seek to modify their behavior if the incentives are correct;
- if the industry becomes "overregulated" then it will either disappear (lenders will stop lending) or will go underground (lenders will not be registered and will lend illegally);
- it is in the best interest of the DTI and South African population to keep the microlenders formally registered and recognised by the government;
- It is in the best interest of the government and the South African population to keep the microlending industry alive to provide financial services to the poorer segments of the economy; and
- incentives should be provided to lenders to change their behavior in the direction desired by the DTI, while keeping them in the formal sector.

The predominant current effective market rate of interest is 30 percent. This reflects a price that corresponds to what borrowers are willing to pay for funds and the rate where lenders are willing to supply funds. Most of the short-term money lending industry in South Africa has been developed around this price.

Current Trends in the Short Term Cash Lending Industry.

Structure of the industry. Current trends in the industry have been towards consolidation of smaller lending shops into larger lending shops, or the acquisition of independent lenders by larger, corporately structured, lenders. This has already led to a reduction in the number of shops, which is predicted to continue through this year.

These larger cash lenders view this as an industry in which they earn corporate profits and will continue to invest in the industry as long as they see a reasonable return on investment. They will also determine where to open branches based on the profitability of those branches. As with the formal banking sector, which is closing many of its branches in less profitable areas, hence depriving the population there of financial services, the large, formal cash lenders will close their formally registered branches in less populated areas.

The industry is becoming more competitive, as the larger money lending institutions increase their outreach and seek market share. They are trying different techniques to gain market share, hence increase their overall profitability. This trend is very positive for leading to reductions in the cost of lending and introducing new technologies, over time.

Price sensitivity. In urban areas with a more concentrated market, it is likely that there will be more competition. Some of the larger lenders have tested different pricing strategies and found that customers are price sensitive and will switch to a lender that has a cheaper product over time. But price sensitivity is also related to the borrower's ability to repay. Calculations are not made based on interest rates, but on the amount of the repayment, the availability of the funds, and the service provided by the lender.

The more structured lenders have also done detailed analysis to determine their minimum cost structure, below which they will lose money. This is discussed more fully below under the profitability section.

Repayment techniques/technology. The elimination of the use of the bank card and pin has led the sector to seek other ways of reducing the risk of lending. Where default rates ran between 2.5% and 5%, per month, with the use of the bank card, the best indications are that these are increasing by several percentage points per month. Few of the cash lenders have succeeded in actually switching away from using the bank card and pin. Therefore at the very time when pressure is being applied to reduce interest rates, the lenders costs are rising due to increased risk.

There are new technologies being used by the lenders, including greater use of credit references and tests of new software products to allow for the direct deduction of loan repayments from the individual's bank account. However, these have not been refined yet and are still being tested.

Profitability. Profitability of lenders varies by the size of the business, the location of the business (rural vs. urban), and the use of systems to minimize risk and manage their business. It was estimated in the study that the average 30 day cash lender earns a surplus of about 17 percent, over the course of the year.

Based on analysis carried out on the sample of 143 microlenders and taking into consideration administrative expenses and risk for bad debt, a lender with an outstanding book of R120,000 and charging 30 percent will just break even over the course of the year (after including salary to the owner). This figure will vary based on the size of the microlender, his outstanding portfolio, his bad debt and his administrative expenses. Assuming that there is no change in the cost structures, as one drops the interest rate to 25%, a book of more than R200,000 is required to just break even. At an interest rate of 20%, it will take an outstanding book of R400,000 to break even. If one is to add some profit incentive to the activities, these amounts will increase.

New product development. There has been little new product development surrounding the 30 day cash loan. One trend, in some lending companies, has been for the lenders to seek to shift their better and more reliable clients over to longer-term loans.

Scenario 1.

- Set the maximum monthly effective interest rate at 30%
- To be reduced within 6 or 12 months to 25%
- To be farther reduced within another 6 or 12 months to 20%

The logic behind a progressive reduction in the allowable rate of interest is sound. In theory, setting gradually lower interest rate ceilings in the future will give current lenders the time to develop new techniques to lower their costs, primarily through reducing their risk or refining their administrative structures. Alternatively, smaller lenders, who cannot achieve economies of scale, need to have sufficient time to sell their businesses to larger lenders. If the time is sufficient, it will allow for a smooth transfer of assets from small operations to larger operations.

The eventual interest rate ceiling of 20 percent is still higher than the effective rate of interest for most of the large, payroll deduction based term lenders, so there will be no impact on them or their practices. Therefore, the impact will be on the cash lenders who are making thirty-day loans.

The current trends. Following this progression will provide for a relatively smooth transition in the industry, allowing it to continue its current process of rationalisation. With a clear deadline for the drop in interest rate ceilings, microlenders will have the time to make a decision on whether to try to compete and stay in business by reducing their costs and improving their repayment methodologies or whether to sell out to other, larger microlenders.

Six months is most likely too rapid a period to allow for the rationalisation of businesses by reducing their costs or to effect the sale and transfer of a business to a new larger company. Twelve months should provide sufficient time to reduce their costs by five percent and to stay in business. This timeframe will also allow for the MFRC to monitor the effect of this consolidation on changes in the structure and supply of financial services, in particular in the smaller towns where there is less competition. Providing another 12 months to reduce the interest rate to 20 percent will allow for a smooth transition to complete the rationalisation of the industry.

The size of the industry. The overall size of this segment of the industry in the formal, registered sector will probably gradually decline a little bit. This may be brought on by greater selectiveness on the part of the lenders to counteract the increased risk associated with the loss of the use of the bank card, as well as the closing of some of the smaller registered lenders.

The players. The players in the industry will change from a multitude of small, independent lenders to a more concentrated group of lenders controlling larger numbers of branches. These lenders will be better financed, will use better systems to manage risk and to control costs. They will also be more competitive and will focus on traditional corporate approaches to earning higher returns, including gaining market share.

The product. The fundamental product would not change. It would remain a thirty day loan for which there are easy controls to estimate the ability of the borrower to repay. The repayment mechanisms will gradually change as banking technology changes. There may be more investment in working with the commercial banks which hold the majority of the deposit accounts from which loans are repaid.

The client. The effect on the client, in terms of access to finance, will be minimal. Over time, the clients will get access to lower cost money.

Scenario 2

- **Set the initial rate at 22.5%**
- **Reduce the effective interest rate ceiling to 20% after 12 months**

This interest rate ceiling is higher than the effective rate of interest for most of the large, payroll deduction based term lenders, so there will be no impact on them or their practices. The impact will be on the cash lenders who are making thirty day loans.

Trends in the industry. Setting the maximum monthly effective interest rate at 22.5 percent will effectively exclude most of the smaller lenders from earning a profit and will force them to either close, go underground, or find some way to get around the legislation. The larger corporate lenders will stay in business, at least for the short term, but they will very likely reduce their investment in the industry because they will see a reduced return on investment that will not make it financially viable for them to continue investing in the sector. The sudden reduction in interest rates might also lead the larger cash lenders to close out their shops in the more disadvantaged areas.

The size of the industry. Initially the size of the industry will drop quite a bit in the formal registered sector. However, as registered supply drops, many of the borrowers will simply shift over to the informal sector to get needed loans, where they have less protection from the regulatory agencies.

The players. There will be a gradual, but significant change in the different players in the industry. Dropping the effective interest rate by 7.5 percent, will cause many of the smaller lenders to decide to close their businesses immediately or to go underground, leaving only the larger lenders in operation.

The product. As above, there will be very limited change in the product.

The clients. The impact on the clients under this scenario will be to immediately reduce the access to formally registered financial services by those people resident in less "profitable", more isolated areas. Since they will need to borrow the money somewhere, they will most likely be forced to borrow it from unregistered lenders who will be charging higher rates of interest.

Scenario 3: Keeping the interest rate ceiling at the current amount of 10 x prime (average of the four major banks).

This interest rate ceiling is higher than the effective rate of interest for most of the large, payroll deduction based term lenders, so there will be no impact on them or their practices. The impact will be on the cash lenders who are making thirty day loans.

Based on the analysis carried out in this study, it is clear that the most significant costs facing the cash lenders come from administrative costs and risk, not from the cost of capital. In addition, very few of the short term cash lenders have access to funds from the formal financial sector based on the prime rate of interest. Hence, changes in the prime rate of interest therefore have very limited impact on the short term lenders' cost structures. In addition, since a one point variance in the prime rate would lead to a 10 point variance of the

effective interest rate, there is disproportionate weight placed on this single variable, which accounts for such a small portion of their cost of lending.

Setting the effective interest rate at ten times prime entails setting the interest rate at below the break even point for almost all of the cash lenders who were analysed. Therefore, choosing this rate will effectively force the closing of a large number of the existing cash lenders in the formally registered sector to either cease their activities, to take them underground, or to develop new ways to get around the legislation.

The players. There will be very visible drop in the number of formally registered microlenders. The immediate impact would most likely be to eliminate lenders who are operating in the rural areas and the lower income peri-urban areas.

The product. The 30 day cash loan will probably all but disappear from the formal registered market. Only cash lenders with proven clients will still remain in business, offering longer term loans.

The clients. The impact on the clients under this scenario will be to immediately reduce the access to formally registered financial services by those people resident in less "profitable", more isolated areas. Since they will need to borrow the money somewhere, they will most likely be forced to borrow it from the informal lenders.

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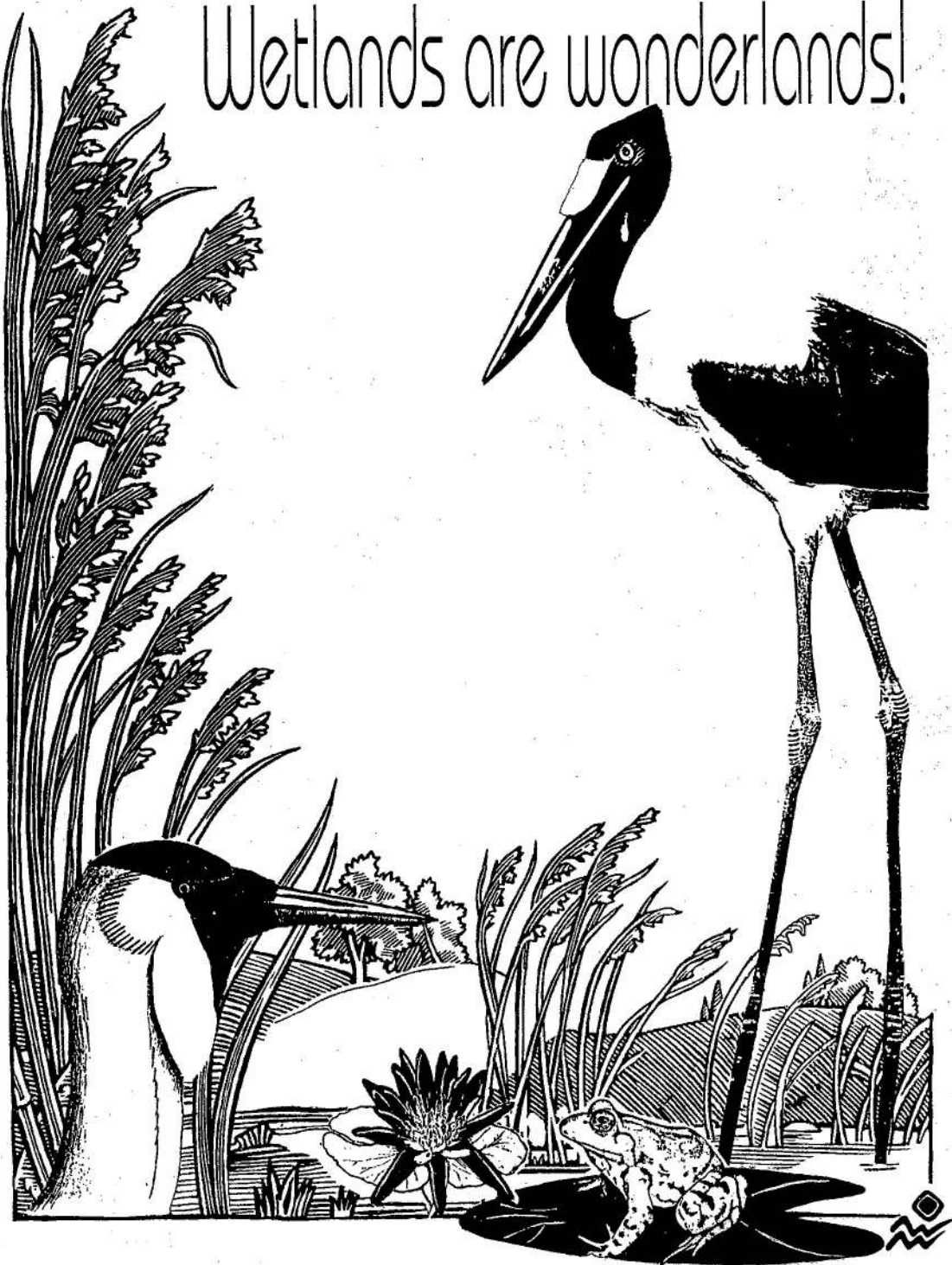
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