Micro lending at the crossroads

Johan Hough profiles the training and skills development needs of the micro lending industry in South Africa

The micro lending industry has been identified as one of the growth areas in the financial services industry in South Africa, because of political pressure, increased demand from micro borrowers and the formal banking sector's lack of support for lenders and borrowers.

However, the micro lending industry in South Africa is now at a crossroads. Various strategic issues such as the availability of funds to lenders, risk and outstanding debt considerations, increased government intervention, high-level legal action, the formation of the Micro Finance Regulatory Council (MFRC), possible maximum prescribed interest rates, technological requirements, and changing client preferences, demand that micro lenders reposition themselves to adapt to these changes and become more competitive and relevant in the 21st century.

The economic landscape of South Africa is not the same as it was five or ten years ago, nor is the pace of economic change expected to slacken in the next five or ten years. Rather, change is likely to accelerate.

Therefore, micro entrepreneurs and business managers must understand the impact of different economic systems, the role of the financial sector in these economic systems, which trends will influence these systems, what drives them, and, ultimately, how to develop a mind-set to 'manage' these changes.

Micro lenders are a reaction to the failure of the formal financial sector to serve a specific section of their potential market ... the lower income, mainly salaried black people, who borrow to pay accounts already in arrears

Micro Lenders in South Africa

It is important to clear up any uncertainties that may arise with regard to who is included in the term "micro lenders". The criterion generally applied to distinguish between formal and informal financial intermediaries is whether an intermediary is regulated by government or not. In terms of this generally accepted yardstick, there is no question that micro lenders used to form part of the informal or non-regulated financial sector. However, the distinction is made between "formal" (visible) and "informal" (unidentifiable) micro lenders in South Africa. Any references to micro lenders here will imply "formal" or MFRC registered micro lenders, though it should not be forgotten that they also formed part of the non-regulated financial sector until September 1999.

The services micro lenders provide are in reaction to the failure of formal financial intermediaries to serve a specific section of their potential market. This is the lower income section, mainly salaried black people, who chiefly borrow for paying accounts already in arrears. The market failure is due to the information asymmetries that exist between intermediaries and borrowers, the high operating costs of small loan accounts and the high transaction costs for borrowers to gain access to formal lenders. Micro lenders, nevertheless, solve these problems
TAKING THEIR CUT With an estimated 50-60% of the South African population still unbanked, the informal sector has nowhere else to turn but to the informal financial sector - or micro lenders - for funding.
and they consequently succeed in meeting the demand of this segment of the market with regard to amount and term of the loan at a mutually acceptable rate of interest.

The failure of the formal financial sector to serve a certain segment of the potential market has resulted in the emergence of informal financial intermediaries. It is caused by a combination of high risk, high cost and low returns associated with such business. Furthermore, it is estimated that 50-60% of the South African population is still unbanked and with the lack of formal credit, the informal sector has nowhere else to turn but to the informal financial sector or micro lending sector for funding.

However, this is busy changing as bigger financial institutions are busy entering the market from 2000 and have transformed the market into a more professional and multi-product industry. A major factor in this transformation has been the entry into the micro lending market of major financial institutions and corporations.

Gabriel Davel, CEO of the Micro Finance Regulatory Council, says that major banks, financial institutions and corporations now regard micro lending as part of their core business. They include industry leaders such as FirstRand, Standard Bank, African Bank and Unibank, among others, as well as retail groups such as Joshua Doore and Ellerines.

There are 10 247 micro lenders registered with the council, with a total of 50 793 branches. Lenders span the entire spectrum of financial intermediaries, from small to very large companies. They currently include ten banks, six public corporations, almost 20 private companies and a number of close corporations.

### The Justification for Informal Financial Services

A market failure - in this instance the failure of the formal financial sector to serve a certain segment of its potential market - has resulted in the emergence of informal financial intermediaries. This failure of the formal sector banks is caused by a combination of the high risk, high cost and low returns associated with such business.

Banks are normally very careful in granting credit. The reason is that the delay involved in discharging the debt obligation exposes the credit transaction to considerable risk. To offset this risk, banks perform three tasks:

- They screen potential borrowers to establish the risk of default;
- They create incentives for borrowers to fulfil their promises;
- They develop various enforcement actions to make sure that those who are able to repay will do so.

However, these actions are often very difficult and costly to undertake in the case of the informal sector. The scarcity of data results in important information asymmetries between informal sector borrowers and formal sector lenders. To circumvent these asymmetries banks normally attach collateral requirements to loans. Unfortunately, these generally cannot be applied to the informal sector because they seldom have sufficient forms of conventional title.

Yet, even with the promise of higher rates, banks are still generally reluctant to provide credit to the informal sector. In this regard, Stiglitz and Weiss argue that the interest rate assumes a dual function, i.e. it represents both the price of money and regulates the risk composition of loan portfolios.

As the interest rate increases, borrowers with riskier projects will apply for funds. These borrowers are less concerned about high interest rates because they realise there is a greater likelihood that their projects will fail. In the event of this happening they will not have to repay their loans. In contrast, borrowers with lower risk projects are more likely to repay and will be the first to be discouraged by high interest rates.

The failure of formal sector banks to serve the informal sector has, however, not left the latter totally in the lurch. Their demand for financial services has led to the widespread emergence of informal financial intermediaries. These intermediaries have succeeded in overcoming formal credit market failure by utilising innovative techniques to minimise information and transaction costs.

Informal lenders have developed innovative forms of collateral, e.g. the requirement that clients must hand over their bank cards and secret PIN numbers to the micro lenders in South Africa, which in principle ensures that lenders have access to their borrowers’ salary for repayment purposes.

Under the new regulation in terms of Government Notice 713 of 1999 of the Usury Act, however, these practices have been outlawed. There is clearly a huge need for credit among South Africans who have either limited or no access to conventional banking services. Bad debt and profit warnings from players like Saambou may influence the credibility of this market. But financial intermediaries exist because they succeed in meeting the demand for financial services that is not fulfilled by the formal financial sector.

### Table 1: Size of the micro lending industry in South Africa

<table>
<thead>
<tr>
<th>Group</th>
<th>Type and number of offices</th>
<th>Turnover (R billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>95</td>
<td>97</td>
</tr>
<tr>
<td>Formal</td>
<td>750</td>
<td>1500</td>
</tr>
<tr>
<td>Informal</td>
<td>4000</td>
<td>25000</td>
</tr>
<tr>
<td>Total</td>
<td>750</td>
<td>1500</td>
</tr>
</tbody>
</table>

* estimate

### The Size and Structure of the Micro Lending Industry in South Africa

To conduct research into the informal financial sector, the mailing lists of the two biggest associations in the micro lending industry, the Micro Lending Association (MLA) and the Association of Micro Lenders and Associated Consumers (AMLAC), were used to send questionnaires to 1 892 registered members. Of these, 18% or 342 micro lenders responded.
No distinction was made between members of the MLA and AMLAC.

The main objective of this research was to determine the current training needs and skills requirements of the micro lending industry in South Africa, but in addition certain background information regarding the size and structure of the micro lending industry was obtained as part of the empirical results.

There is a wide variety of individual micro lenders, big companies, groupings and franchises active in the micro lending industry, with differences in lending policies, interest rates, values, geographical distribution, biographical particulars, and services and products. They use different legal entities such as sole proprietorships, close corporations, companies, business trusts and partnerships to serve the public and it is therefore virtually impossible to describe the industry in terms of a general grouping or representation or distribution. However, the MLA commissioned a survey in 1997 of their members and useful findings regarding the role and structure of the industry were published in a 1998 research report.

Size of the micro lending industry

The micro lending industry is geographically distributed throughout South Africa. Micro lenders are located in some of the best, most up-market, First World areas of the main centres. They function next to, or in close proximity to, most of the largest formal banks in the country. They are also found in just about every industrial and business area in every town and city in South Africa.

It is difficult to accurately estimate the number of participants and the total value of turnover of the micro lending industry in South Africa. The information in Table 1 stems from the data gleaned by means of the empirical survey and from discussions with the major role players in the industry. A turnover for 2002 is also estimated.

The micro lending industry’s loan book (Figure 1) indicates that commercial banks have the biggest share of the market, namely 50%, followed by private companies with 25% and public companies with 17%.

Life cycle of the micro lending industry in South Africa

The life cycle of a product or industry describes the state and level of its development over time. Most products and industries have a life span of a certain number of years, after which, for many possible reasons, the industry might disappear, be changed dramatically because of new technology or may even get a new lease on life, depending on innovation and changes in market preference. The length of this cycle can range from months to decades.
MICRO LENDING

The life cycle is normally divided into five distinct stages:

- The entrepreneurial or development stage, during which new initiatives and innovations give rise to the birth of a new industry.
- The introduction stage, when a product or service is launched in the market. The length of this period varies according to technological complexity and intensity of demand.
- The primary growth stage is determined by the extent to which a new product or service is accepted. If there are no structural barriers to new entry, the profit potential usually plays a significant role as regards the intensity of new entry and growth.
- The maturity stage sees growth in the industry begin to level off. The length of this period depends on the nature of demand and whether new technology or innovation can inject new dynamism, which may see a new growth period following the maturity stage.
- The declining or stagnation stage sets in if there is no new innovation or technology, and leads to the product or service declining until it disappears completely or is replaced by a new product or service.

According to these stages, the entrepreneurial period or development of the micro lending industry in its current format started taking shape during the years 1988 to 1992 in the Northern Province. Hendrik Smit and Louis Buys are commonly recognised as being the founders of the modern franchising concept of the micro lending industry. This concept came into fruition with the exemption of loans smaller than R6 000 from the Usury Act in 1992. When the concept was introduced into the market, it took only one year to spread across the whole country.

The primary growth stage was entered during 1993 and has increased almost exponentially in size until the end of 1999. The end of the primary growth stage can be placed during the early 2000s. The common characteristics of a life cycle at the end of the primary growth stage include the following:

- Increasing competition through new entrants as the profit potential becomes apparent;
- Many unscrupulous new entrants with a short time horizon enter the industry;
- Product innovation and new technology is introduced;
- Mergers and takeovers occur;
- Larger firms and corporations start positioning themselves for possible involvement in the industry;
- Towards the end, less efficient operators dwindle and are eliminated;
- The quality of service of the survivors increases, as better service becomes more important.

The introduction of corporate governance principles in the micro lending industry might also be an indicator of maturity.

The above symptoms are all already visible in the industry. Most of the formal groups are putting out feelers to the formal financial sector in an effort to establish some form of working arrangement, especially as regards access to new capital. As this restructuring continues to develop, the cycle should move into the maturity stage, which could last until around 2005. During this period, the position of government should become clear and the future of the industry should be either established or terminated, at least in a legal sense. Should the former evolve, as is expected, the large formal financial institutions will certainly exercise their options and take up significant stakes in the micro lending industry.

This might lead to a position where the industry does not enter into the decline stage, but rather starts a new life cycle, albeit in a different format. Should government decide on terminating the industry, or to impose control of such a nature that survival becomes difficult, the industry might decline, but will certainly not disappear. The informal sector will then again flourish. And many of the currently transparent micro lenders will go underground.

Profile of the micro lender in South Africa

Geographical distribution and location

The distribution of micro lender respondents reflects their high concentration in the Gauteng area. As for the remainder of South Africa, the distribution is fairly even. Location is one of the strong selling points of the industry, in that they are close to their clients, usually within walking distance of the major employers, making it very easy to access their services. In the industrial areas, many have representatives on foot who solicit business and assist clients and potential clients in the working and procedures of the service.

Locations vary from the neighbourhoods of the corporate headquarters of the formal banking sector in Johannesburg, to the downtown business districts, industrial areas and close to points of concentrated commuter traffic and residential areas of clients. One of the outstanding features of the industry is that the facilities and services are brought to the clients, saving them the inconvenience of travelling long distances, which takes time and money.
Biographical particulars
Age, gender, educational qualifications, and number of years involved in the micro lending industry were researched. The age distribution (see figure 2) among micro lenders showed a large concentration of respondents in the younger age groups, with 55% of all respondents being younger than 40.

From figure 3, we can see that more than 40% of the respondents have at least a matriculation (school-leaving) qualification, and over 30% have some form of tertiary education, in the form of a Technikon diploma or post-matric certificate.

A significant percentage also have a degree or post-graduate qualification. This reveals that micro lenders in South Africa are well-educated, especially when compared with the general population, and that educational programmes focusing on the needs of the micro-lending industry might be well received by them.

Moreover, in 1999, the majority (64%) of “formal” micro lenders were registered as close corporations, while only a small percentage of private and public companies were directly involved. This situation has since changed dramatically, as banks, private and public companies entered the industry, becoming major role players.

The turnover per annum of the respondents is shown in Figure 4. Only 20% of respondents indicated that their annual turnover is less than R300 000, while 50% have turnovers of more than R1 million a year.

Assessment of the training needs in the micro lending industry
This assessment is based on 342 questionnaires received from micro lenders in South Africa. As figure 5 shows, the legal environment and especially detailed information about the Usury Act is of vital importance to the micro lender. The interest generated by a recent court case of the MLA against the Department of Trade and Industry confirms the importance of legal issues for the industry.

There is also a pressing need for more information about the industry itself. Interviews with micro lenders highlight the need for structured and factual feedback on issues like the following:

- Role and structure of the micro-lending industry;
- Profile of the clients of the micro lending industry in South Africa;
- Impact of the market environment on the micro lending industry;
- Analysis of the legal environment and the Usury Act which regulates the industry;
- Driving forces of long-term growth in the industry;
- Basics of entrepreneurship.

The importance of communication skills and especially multi-cultural communication was also expressed during the interviews.

In addition, there is a need for a basic understanding and analysis of financial statements, fair lending practices, financial planning, the time value of money, capital budgeting techniques and effective cash management, as shown in figure 6.

Effective cash management and financial planning are perceived as the two most vital areas, although almost 60% of the respondents also noted that budgeting skills are very important to stay in the micro lending business.

Interviews with micro lenders also reveal the following financial training needs: the basics of management accounts, how to approach a bank manager, and determining the value of a micro lending office or branch.

The importance of the market positioning of micro lenders is critical. Research demonstrates that the marketing of new products is of great importance for micro lenders, and that training programmes to address this need will add value to the industry.

Information and case studies about the marketing environment in South Africa, marketing information regarding the micro lending industry, the positioning of markets in the industry, and market measurement and forecasting are of immediate interest to role players in this industry.

Another area of some importance was the management of labour relations and conflict, with 35% of respondents indicating that managing conflict and adhering to the Labour Relations Act are very important issues for the industry. Issues such as negotiations with trade unions, collective bargaining and the history of labour relations are seen as being of lesser importance. However, these issues will become more important as the industry grows and larger financial institutions enter the micro lending market.

In summary, figure 7 displays the perceptions of the respondents regarding the priority of the 44 training aspects discussed in the questionnaire. From a practical point of view, only the top 15 elements are focused on. More than 85% of the respondents indicated that these 15 training aspects are very important, and even vital, for the micro lending industry.

As expected, cash management is the number one priority in the micro lending industry, and although longer term loans are gaining momentum, cash loans will dominate the industry for the next few years. The emphasis on financial planning for the micro lending office is welcomed, and it is expected that new innovative computer-based programmes will build additional capacity for the micro lending industry.
MICRO LENDING

Marketing skills to advertise and sell micro lending products is vital for the industry, and programmes to address this need will also add value to the business acumen of micro lenders in South Africa.

More than 90% of the respondents also indicated that basic financial skills and a basic knowledge of the legal environment are very important for the industry. Training programmes to teach and inform managers and owners of micro lending offices must be practical and industry-oriented, with the focus on basic skills like budgeting, cash flows, account management and the implications of the new Usury Act.

Conclusion

Micro lending has become a far bigger business than a few loan sharks dealing with the poorest of the poor and ripping them off. It is now worth something like R15 billion nationally, and around R1.125 billion is being repaid each month. It affects employers whose workers take out small loans, people who are unable to get credit from their banks, and a large group of wage earners who perennially need to relieve short-term debts.

The majority of the "formal" lenders in the micro lending industry were registered as close corporations in 1999. However, the number of private and public companies has grown, and they are now the biggest role players in the industry. Their numbers will only increase as the industry develops along the normal life cycle.

It has also become clear that the training and skills development needs of micro lenders are not restricted to financial and legal issues, but include vital elements such as marketing, technology, new product development and ethical issues. It has been established that the ten most important training needs are cash and debtors management, financial planning, marketing of new products, legal issues, basic financial skills, analysing of financial statements, time value of money, information technology, detailed information about the micro lending industry, and budgeting for the micro lending office.

These training needs will have to be addressed as a matter of urgency to establish the micro lending industry's importance in the financial services sector, to adjust to the new legal environment, to add value to their own pool of expertise and to ensure sustained growth and profitability in an increasingly competitive environment.

Johan Hough is a professor in the Department of Business Management, University of Stellenbosch.

The support of the Institute of Micro Financiers in funding this research, and of the Micro Lending Association (MLA) and the Association of Micro Lenders and Associated Consumers (AMLAC) in sending out questionnaires to their members is hereby acknowledged.

Notes & references

10 See ibid. for a detailed discussion on this topic.