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Chapter 1: Introduction

1.1 Background to the study

In economic development of rural areas the state has the responsibility of ensuring that poverty levels are decreased and the base and size of rural incomes increased. In this instance, the state has to follow a maximisation strategy in selecting and prioritising development projects that promote these objectives. State supported Rural Finance Intermediaries (RFIs) are examples of institutions that have to account to the state how they are maximising the impact of their activities on the intended market.

The concept of measuring the performance of state supported institutions is a prerequisite for the justification of future support by the state. Should a certain institution enjoying state support through subsidies, grants and other direct and indirect forms of support not be performing, the state has the prerogative to allocate those resources elsewhere where they will yield a greater return to society.

Rural Financial Intermediaries that depend on state funding for their survival must clearly demonstrate that they are reducing rural poverty and simultaneously increasing the base and size of rural incomes. Measurement of the social costs and benefits of economic agents can be done at four levels namely the environment, the people, private entities and state supported institutions. This thesis focuses on one of the four above namely the evaluation of state supported institutions.

Routine accounting analysis typically focuses on the profitability of the intermediary involved as reflected in financial profitability ratios.

Rarely, however, is supplementary information provided on the value of funds that flow into the financial institution's coffers, in the form of subsidies. There is no routine, standardised methodology that requires the assessment and measurement of the development finance institution's dependence on such funds. However, much of a financial institution's presented "profit" could often not have been obtained without significant subsidisation.

The purpose of this study is to review and apply the Subsidy Dependence Index (SDI) methodology in measuring the performance of rural financial intermediaries (RFI). RFI's are defined as state supported institutions that carry out financial lending in rural areas mainly to support consumptive and productive purposes.

The Subsidy Dependence Index is defined as the percentage by which the average onlending rate of a RFI must be increased in order to eliminate all subsidies given to the relevant RFI (Yaron 1992). Subsidies are all direct and indirect forms of financial and non-financial support given to a state supported RFI, which would normally not be given to other financial intermediaries operating under normal market conditions.

Extensive consideration was given to the need to identify a mechanism to measure the financial performance of KwaZulu Finance and Investment Corporation. In this particular assessment of the performance of KFC the factors considered are outlined below.

Firstly the potential contribution that RFI's can make in stimulating growth in rural economies and the huge fiscal support that they receive in the form of subsidies, makes the measurement of their performance a matter of great interest to

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economists. As such the SDI has the potential of making a significant contribution to the thought process of transforming South Africa's rural financial intermediaries. Secondly, until the late 1980s prior to Yaron's model of 1992, development economists had generally failed to come up with a widely accepted mechanism of measuring the performance of rural financial intermediaries. It was essential, however to have a method which took into consideration the cost to the state of keeping RFI's afloat given the significant amount of various subsidies these institutions received as instruments of economic development.

Thirdly, this study was conceived at a time when the Strauss Commission was carrying out its investigations on the provision of rural financial services in South Africa. The SDI methodology was used as part of the framework for comparing South Africa's RFI performances to international institutions. The background work of calculating the subsidy dependence indices for various RFIs was carried out by the Strauss Commission's secretariat assisted by RFI officers. Therefore there was less work on the part of the author to do in terms of calculating the various indices, some of which could have been impossible to do.

Fourthly, the contribution of the Subsidy Dependence Index to the work carried out by the Development Bank of Southern Africa (DBSA) on the evaluation and appraisal of rural financial intermediaries around 1994 was a ground breaking exercise which reinforced the importance of the index. It demonstrated how the SDI could make a significant contribution to the transformation of South Africa's rural financial intermediaries. Some of the questions the SDI has helped answer were for example how much and for how long a financial institution still needed subsidisation.

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Finally, KwaZulu Finance and Investment Corporation (KFC), now Ithala[1] Development Finance Corporation, which the author of this study used to work for between April 1991 and August 1994, provided intimate background knowledge on the internal workings of a development finance corporation involved in rural financing. During the Strauss Commission (1996) investigations KFC turned out to have relatively more up to date and comprehensive information on their operations in comparison to other RFIs and were generally more forthcoming with requested information. Also an untested opinion held by a number of economists is that the KFC is probably the best managed amongst development corporations, as such it was also of interest and a logical choice to focus on as a case study.

The KFC provided financial services to rural communities of the former KwaZulu homeland, which now forms part of KwaZulu-Natal (KZN) province as from April 27 1994. Operations of the KFC currently cover the whole KZN province, and are generally focused on the KwaZulu part of the province. The Natal part of the province is primarily served by the Land and Agricultural Bank and a whole array of commercial banks. KwaZulu is the "homeland" of the Zulu people, the single largest ethnic grouping in South Africa. The population of KwaZulu/Natal was 9.071 million in 1995 and grew at 2.6% per annum between 1980 and 1995. It had a functional urbanization level of 45.9 (DBSA, 1998). The population density was 99.1 people per square kilometer (1997) and is the second highest in South Africa. The labour force in 1995 was 2.724 million people, 19% of South Africa's total labour population. Formal employment accounts for 52.4% of the labour force, informal employment 14.5%, and unemployment 33.1%. This implies that 62% of the households and 69% of the individuals are living in poverty.

[1] The name KwaZulu Finance and Investment Corporation was changed to Ithala finance (Pty.) Ltd. on March 2 1999. The name (KFC) will continue being used here as the work done here refers mostly to the period before the name was changed.

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Geographically, the KwaZulu part of KZN is defined by pockets of land scattered all over KZN province and subdivided into 26 districts. Every district has a traditional chief who presides over a number of traditional roles. One of these roles is the allocation of land for settlement and agricultural purposes.

Personal income per capita in 1994 was R5924, and the real GDP per capita in 1994 was R4124. Part of the income is derived from agricultural activities with some of it being earned by family members employed mostly in urban areas and within KwaZulu/Natal and other provinces especially Gauteng. Sugarcane, maize, cotton and cattle rearing are the leading income earners in areas with or without irrigated agriculture.

The banking industry in the rural areas of KwaZulu is mainly limited to the operations of the KFC's banking arm, Ithala. In the Natal part of KZN banking is a large industry with all the big commercial banks, the Land Bank and many other private financial institutions represented. The greater portion of the KwaZulu part of KZN, just as other rural areas in South Africa are classified as being commercially unbankable due to high transaction costs faced by financial institutions, which have opened up operations there or attempted to do so. Agencies, which have been set up by the four big commercial banks (ABSA, Standard Bank, FNB and Nedcor) to operate in the rural areas, have been mostly under income pressure, culminating in their closure in most areas.

Financial services to the poorer segment of the population in KwaZulu have therefore been dominated by the KFC and the Financial Aid Fund (FAF) a RFI specialising in financing of sugar cane production loans, and to a lesser extent non-governmental organisations (NGOs) and informal financial bodies.

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1.2 The role of the banking sector in economic development

The lack of financial services in the KwaZulu part of KZN poses great challenges for the economic development of the province. The lack of support for potential agricultural and commercial enterprises contributes to reduced economic opportunities and high unemployment levels. Thus KwaZulu has a large portion of the male population working in urban areas. This leaves women as the de *facto* household managers. The lack of financial services and depressed rural economic activity does not help the prevailing situation at all.

KFC was created primarily to stimulate rural economic activity, create jobs and reduce poverty levels through the provision of finance to support productive enterprises and consumption needs. The measurement of the success of the KFC thus becomes a matter of great interest to economists, ordinary citizens, politicians, government and other local and international development institutions.

Some important questions that can be revisited on the measurement of development performance of an RFI such as the KFC are as follows:

- Can development banking bring about a desirable impact of stimulating and growing economic activity, provide jobs, and reduce poverty levels?
- Do the policies and structure of the RFI promote the achievement of the desired objectives?
- Can the achievements of the desired objectives be measured?

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1.3 Rural Finance Institutions in South Africa

RFIs in South Africa are mostly parastatals with a mandate to promote economic development through the provision of loans and financial advice to rural communities. Due to the fact that rural financial intermediation aimed at the poor rural communities is generally unattractive and typified by high transaction costs and low or even negative margins, commercial finance institutions normally shy away from these markets. Commercial bank branches will only be justified on the net economic demography of the service area of a branch (Deloitte & Touch, 1995). State intervention in support of RFIs, therefore, has been justified under these circumstances. However the support given to RFIs over time and their reliance on state funded subsidies in operation has increased to levels which endanger their ability to keep themselves in business should state funding dry up.

The political justification for the support given to RFIs goes back to the turn of the 20th century when the government decided to separate the political, economic and social aspects of South African life on racial lines. The social objectives of RFIs derive primarily from concerns about market failure, which has manifested itself as poor access to financial services in rural areas. The economic objectives on the other hand derive from the realisation that viable rural economic activity can be encouraged by the supply of financial services. The background to South African political developments at the turn of the century provides an insight to the birth of the subsidy dependency syndrome of RFIs and the reason for their continued support by the fiscus.

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1.4 The birth of development finance institutions and their subsidy dependency

The South African government's aims and objectives when creating Rural Finance Intermediaries at the turn of the 20th century and during the apartheid era, between 1948 and 1990 were very clearly articulated in the political philosophy of the government of the day. From 1910 when the Union of South Africa was formed, these policies came out in a number of statutes and legislative instruments. Between 1910 and 1986 no less than 87 bills were enacted by Parliament relating to land being divided along racial lines. The most influential legislation, which gave rise to and reinforced the policy of "separate development" included among others the Acts listed below.

The Land and Agricultural Bank Act of 1912 amalgamated the previous colonial land banks. The Land Act of 1913 prohibited a "Native" from owning or renting land outside the scheduled Native areas or reserves without approval of the governor-general. The Native Trust and Land Act of 1936 made the governor-general the trustee of all land tenure arrangements in black areas. The Bantu Authorities Act of 1951 made the chiefs paid servants of the Government; this obviously had implications for land policy in the Bantustans. The Marketing Act of 1937 regulated in one form or another the production and/or marketing of more than 90 percent of agricultural production. The Co-operative Societies Act of 1922 with its many amendments has resulted in an extensive agricultural co-operative structure serving almost exclusively the commercial agricultural sector. Soft credit from the Land Bank and monopoly agencies for control boards under the Marketing Act bestowed considerable competitive advantages on the commercial agricultural sector. An important consequence was considerably lower transaction costs in white compared with African agriculture.

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The Tomlinson Commission Report in 1955 made numerous recommendations regarding economic and agricultural development in areas occupied by blacks (Kassier & Groenewald, 1992).

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Arising from the above political considerations and especially after passing the Bantu Authorities Act in 1953 the state "constitutional development" program instituted tribal, regional and territorial authorities in African areas. The constitutional status of these areas developed from "self management" to "self government" and in some cases to independence. The Promotion of Bantu Self-Government Act of 1959 used the territorial base provided by the Land Acts to establish a new political dispensation of "ethnically" differentiated homelands to be developed as separate ethnic units (Fischer, 1992).

These homelands or "independent states" were literally run by South Africa and they were not recognised by the United Nations (UN) and other similar world bodies as sovereign states. They were frequently referred to as puppet regimes among a host of other ridiculing names.

What also emerged out of the policy of separate development was a strategy to create parastatal Development Finance Intermediaries (DFI) whose mandate was to execute development work within the Homelands. With the establishment of the Development Bank of Southern Africa (DBSA) in 1983, investment in developing (homeland) agriculture was considered one of its main functions. This mandate was interpreted as integrated rural development through entrepreneurial support, the optimising of linkages and support for broad-based participation by beneficiaries within the regional development policy (Van Rooyen, 1995).

Different provinces opted for different versions of development corporations. In the then KwaZulu the KFC was the only Development Corporation assigned to

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develop the "state" under the legislation of the KwaZulu Parliament. In other states different development corporations were set up for each sector interests, for example agriculture, small business, housing, industrial development and so on. For purposes of clarity, in line with the focus of this study RFIs will be taken as being synonymous with DFIs and RFI will be used to denote the specific interests in rural finance.

RFIs in Homelands were given a lot of financial support as they were seen as the only viable way of developing underdeveloped economic sub-sectors. However while some Homelands tried to use the allocated resources to support their RFIs, the majority of administrations were ridden with corruption, which ranged from using loans to buy political support of friends and constituencies to inefficiency, non-accountability and general abuse of company resources. A vicious cycle of self-destruction would ensure ultimately leading to the neglect of clients and eventual collapse of these institutions. Huge transfers of funds none the less saved these institutions, and thus they lived beyond their economic usefulness with vaguely defined goals and objectives. The RFIs resembled the specialised credit institutions of the conventional, or supply led era, in rural finance. Although the underlying motivations for forming these institutions were more complex, the outcomes and eventual history of these institutions were more or less the same as in the rest of world.

1.5 Justification for use of the Subsidy Dependence Index (SDI)

The new approach in the provision of rural financial services emphasises institutional sustainability and development impact (Coetzee, 1997). Sustainability and outreach can be measured by applying the range of measures as illustrated in table 1.1.

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Table 1.1: Indicators for measuring efficiency in rural financial institutions.

Outreach indicators	Productivity indicators	Profitability indicators
Number of branches	% loans in arrears (volume)	Return on assets
First year of operation	Loans/staff	Int.earned per aver. Portfolio
Non-financial services	Volume lent/staff	Gross financial margin
Deposit accounts	Loans/loan officer	Non-int. exp./aver. Portfolio
Average deposit size	Volume lent/loan officer	Accounting profit index
Number of loans outstanding		Typical deposit rate
Average loan size		Typical loan rate
Agric. loans outstanding		Subsidy dependence index
Aver. agricultural loan size		Implied aver. Loan rate

Source: Strauss Commission 1996a.

The SDI concept aims to provide an objective assessment and measurement of a specified credit institution's financial performance. This involves taking account of the total cost of operating a development finance institution, including the actual value of all subsidies received. Subsidies are calculated in both financial and economic terms. This in essence makes it a unique measurement as very few (if any) of these measurements incorporate both financial and economic indicators. It is important to note that the SDI measures inflows of all subsidies into the organisation but does not in any way make a judgement on the application of subsidies. The SDI is not the only measurement of sustainability. However, it incorporates most other measures and it identifies subsidy flows both in economic and financial terms (Graham, Von Pischke, 1995 in Coetzee, 1997). This is not true of other methods.

As an analytical tool, the SDI assists in planning the total amount of subsidies received by a DFI in the context of its activity level as represented by the subsidy received measured against the interest earned on the loans extended to its targeted clientele. It can also be applied to measure a DFI's subsidy dependence over time, thereby using the SDI methodology as a planning and

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monitoring tool. Another application is as a comparison between the subsidy dependence of different DFIs providing similar services to a largely similar clientele. The SDI calculation will be reviewed in greater detail in chapter three.

1.6 The problem statement: subsidy dependency

RFIs operating in the former Homelands have generally failed to achieve most of their development goals and objectives, which relate to poverty alleviation and entrepreneurial development. This failure has been due to an ever increasing dependency on state supported subsidies at the expense of implementing viable policies which improve operations. By far the most important indicator of failure is the continued dependency on state supported subsidised loans and grant capital. Other indicators of failure have been poor financial performance, huge operational expenses, high loan defaults and diminishing loan book sizes, also contributing to high subsidy dependence.

The main problem arising out of subsidy dependency is that prior to the formulation of the SDI technique the total scope of the direct and indirect costs of keeping an RFI afloat had not been documented. This lack of focus towards the costs of keeping RFIs afloat has been as a result of inadequate conventional financial accounting methods of performance appraisal being used on RFIs. Conventional financial accounting methods are inadequate tools for evaluating the performance of RFIs because of the social and economic objectives of these types of institutions. Due to inappropriate performance appraisal techniques of RFIs being used the sub-problems outlined below have come about.

- The total direct and indirect costs of keeping RFIs afloat have not been accounted for;

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- A chronic dependency on state supported subsidies exacerbated by poor performance and inefficient policies have rendered RFIs vulnerable to withdrawal of state support.

The fact that the state has no idea of the total direct and indirect cost of keeping an RFI afloat has encouraged inefficient institutional structures to extend their life spans beyond usefulness without justification on efficiency and equity criteria.

On the operational policy side interest rate subsidies have been abused by RFIs as a generic way of helping the poor "decrease their costs of production" and easing their entry to commercial agriculture. In the process nonviable projects have been made to look worth supporting.

RFI funded projects and programmes have generally excluded the smaller and poorer farmers as well as women clients due to various requirements like collateral and "bigger and safer" loan requirements. On the other hand low interest rates have attracted well off members of the community who have seen RFI credit as a source of "cheap" finance. Poverty alleviation and entrepreneurial development have generally lost out as RFIs seek to meet performance targets measured as high loan disbursements and low bad debts provisions and write-offs.

1.7 Importance of the Study

The main purpose of the study is to illustrate the methodology with which to quantify the subsidy flow from various agencies, be they government or non-governmental organisations, to the KwaZulu Finance and Investment Corporation. The study will also contribute towards the current and future

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debates on how to measure the performance of RFIs and DFIs. Of equal significance is that it will inform the RFIs and the government on how to make DFIs viable operations with the least possible dependence on the state. The cost of reaching a particular level of outreach would be shown.

1.8 Outline of the study

In Chapter two, literature on the use of the Subsidy Dependence Index is reviewed. This literature incorporates past attempts by scholars elsewhere who used this tool and the results that they came up with. In Chapter three the SDI as a measurement tool is reviewed in detail. Chapters four and five focus on the calculation of the SDI for KFC and also a description of the activities of the institution is undertaken. In the sixth and final chapter conclusions of the study are presented. Recommendations are made to policy makers on the way forward for institutions like the KwaZulu Finance and Investment Corporation.