CHAPTER 4

AN OVERVIEW OF THE MICRO LENDING MARKET IN SOUTH AFRICA

4.1 INTRODUCTION

Research into the micro lending industry in South Africa is limited to a few reports. The most prominent studies were by Professor Du Plessis (The Micro Lending Industry in SA: 1995 & 1997); the research by Paul Aveyard (Microlenders-The effects of a changing regulated environment upon stakeholders with particular reference to strategies for independent micro lenders: 1999) and the recent study done by DTI (Determining the costs and interest rates for the small loan sector: 2000).

The micro credit market can be divided into two functions, the demand for, and supply of, small loans. The demand side comprises of the borrowers while on the supply side we find the lenders. In any country there are un-served or underserved enterprises and households, ranging from the ultra-poor, who may not be economically active, to small growing enterprises that provide employment in their communities (Ledgerwood, 1999). This constitutes the demand side of micro credit. Often the supply side does not offer a corresponding continuum of services. The micro lenders need to supply services that fill the gaps and integrate the unserved groups into the market.

The next section presents the demand for microfinance services. This section will be followed by the supply side of microfinance, where issues such as size of industry, and types of lenders are explored. Thereafter, the last section of this chapter will look at cost, revenues and profits experienced in a micro lending business.

4.2 DEMAND FOR MICROFINANCE SERVICES

Access to financial credit is a rare commodity to the majority of the population, particularly the poor and the low-income. Various factors, including the formal banking sector's shift from the low income markets, a growing gap between real income and inflation, urbanisation, increasing unemployment and the growth of the informal business sector has fuelled demand and led to the growth of alternative financial service providers, the money lenders (DTI, 2000).

Many South Africans do not have access to the financial services offered by the formal banking sector (limited to savings only). Therefore micro lending institutions are instrumental in catering for various social and financial demands of the broader community (Marais, 1992).

Small loans are required by the majority of people for a variety of reasons. They may be required for productive (borrowing to finance a business) or consumption (borrowing to finance consumption). One of the micro lending institutions operating in the Northern Province did a survey of its clients and found that 96% of their loans are used for productive purposes (DTI, 2000), while many micro lenders in urban areas concentrate solely on consumer finance.

The survey showed that finance, is required for a wide variety of reasons. The list below identifies some the reasons mentioned during the survey.

- Education
- Personal loan
- Housing/Home improvements
- Small businesses
- Entertainment
- Transportation
- Buying food

- Occasions

A survey carried out in the peri-urban areas of Pietersburg in the Northern Province came up with following results for the purpose of loans (DTI, 2000):

Table 4.1: Purpose of loans

Purpose	Percentage
Installments	27.8
Paying School Fees	38.9
Household needs	22.2
Agriculture	5.6

Source: DTI (2000)

The Micro Finance Regulatory Council has improved their information system and the quality of the data captured on this system tremendously. Part of their database is compiled on the basis of quarterly returns submitted by the member institutions. The next part of the analysis is based on this data set. The table below shows allocation of loans based on the data from the MFRC.

Table 4.2: MFRC quarterly return data in 2000 (fourth quarter) (N=507 institutions)

Purpose	Valid N	Mean	Total	%
Education	225	284	63,900	2%
Consumption	262	4,595	1,203,890	37%
Housing	190	8,255	1,568,450	48%
Business	124	203	25,172	1%
Furniture	163	400	65,200	2%
Other	219	1,643	359,817	11%
Total	1183	15380	3,286,429	100%

Source: MFRC (2000)

4.3 SUPPLY OF MICROFINANCE

There are many different types of individuals and companies involved in supplying small finance to the poor and low-income individuals. Some of the suppliers are in the formal sector, however, many are in the informal sector. The informal sector refers to those who are not within the jurisdiction of laws, taxes and other regulations. In this section types of lenders and size of the industry are some of the issues, which will be looked at.

4.3.1 Size of Micro Lending Industry (MLI)

The MLI is geographically distributed throughout South Africa. The industry is divided into three distinct groups of micro lenders, namely, the formal sector, the semi-formal sector and the informal sector, and they all operate in every city, town and area where there is a concentration of people (Du Plessis, 1997). The formal sector of the industry consists of operators who are observable; their services are openly advertised in the communities they operate. The semi-informal and informal sectors do not operate from fixed premises, and they are relatively unknown therefore difficult to investigate and research.

The groups are briefly discussed below:

- Formal registered firms - include commercial banks, section 21 Companies, private companies, close corporations, natural person, trusts, co-operatives, mutual banks and public companies.
- Semi-formal moneylenders - include small-unregistered moneylenders who are conducting this business as their main livelihood, and pawnbrokers, who are not formally included in the money lending statistics.
- Informal moneylenders - include township moneylenders (mashonisas), stokvels, burial societies and (Rotating Savings and Credit Associations) ROSCAs.

While the lenders in the second and latter sectors are mainly opportunists operating on their own, those in the former sector often operate as part of a group or franchise. Prior to the 1992 exemption of the Usury Act there were no statistics available about the industry. The research available on the size of the industry was done after 1992 by Du Plessis (1995). The Association of Micro Lending commissioned these reports in 1995 and 1997. The results obtained should be taken as estimates only; the actual figure could be higher.

Table 4.3: Size of Micro Lending Industry in South Africa in 1995 and 1997

	Number of micro lenders		Turnover (Rand billions)	
	1995	1997	1995	1997
Formal	1,200	3,500	2.5	7
Semi-formal		2,000		1.6
Informal	4,000	25,000	1.5	1.5
Total	5,200	30,500	3.7	10.1

Source: Du Plessis (1995 and 1997)

The estimated annual turnover by 1997 was in the region of R10.1 billion, which shows that the industry had grown since the exemption of 1992. But currently the industry's annual turnover is estimated to be R25 billion Rands (DTI, 2000). This shows that the industry has grown since 1997, and could also be attributed to the 1999 Exemption of the Usury Act, which increased the amount of the loan exempted from Usury Act from R6000 to R10 000.

Up-to-date accurate information is available on the formally registered money-lending firms. This was made possible by the creation of the Micro Finance Regulatory Council (MFRC), but the data that is available within the MFRC cannot be taken as the exact figure for the whole country because there are some micro lenders who are not yet registered. The table below breaks out the registered lenders by legal status.

Table 4.4: Breakdown of registered lenders by legal status

Type of Institution	Number of registered firms
Banks	8
Section 12 Companies	16
Co-operatives	1
Mutual Bank	1
Public Companies	9
Private Companies	166
Trust	75
Close Corporation	919
Natural Person	44
Total	1239

Source: MFRC Annual Report (2000)

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

Table 4.5: Estimated numbers of the informal lenders in South Africa

Type of lenders	Number of lenders	Outstanding book	Number of clients
Mashonisas	25,000	150,000	500,000
Pawnbrokers	5,000	300,000,000	100,000
Stokvel/ROSCAs	800,000	240,000,000	8,000,000

Source: Du Plessis, NASASA, Ass. Of Pawnbrokers (1995 and 1997)

4.3.2 Types of Lenders

Micro lenders can be divided into different categories based on the type of lending in which they are involved. For the purpose of this study the industry is differentiated into short-term and long-term lenders and these groups lend to customers who are mainly employed or self-employed with bank accounts and regular salaries. Their disbursement method is almost the same; the customer is given money in the form of cash. These micro lenders obtain capital from a number of sources e.g. own money, loans from friends and relatives and loans from the formal financial sector.

Access to capital is limited by both the individual circumstances of the micro lender and the legal form the business takes. Unlike the banking sector, the micro lending sector does not have one rate or cost of capital. The cost of capital varies from one micro lender to another due to the different sources of capital each uses.

- **The short-term lenders**

The short-term lenders focus on loans of up to 30 days, or the next pay day. It is assumed that people earning between R900 and R2500 per month are the potential borrowers from this category. They charge a flat interest rate of approximately 30% with no fees charged. Some have reduced their interest rate for the last 2 years to between 20% and 25% per month.

The short-term lenders have historically been users of bankcards as security and some lenders still keep bankcards even though it is illegal. They argue that the government should come up with a better method, which would not expose them to high risk. The 30-day lenders rely on clients to repay the loans at their offices since the capturing of bankcards is no longer allowed. The loans offered by these firms as recommended by the MLA must not exceed 50% of the client's net monthly salary.

The DTI study (2000) found that; "It is important to note that the rate charged by 30 day 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 bankcards and pin numbers, the default rate on loans was in the neighbourhood of 2.5

to 5 percent. Now that the use of bankcards and pin numbers has been eliminated, this rate has tended to double among the lenders".

- **The long-term lenders**

The long-term lenders focus on loans for periods of between 6 and 36 months. They target government employees who earn between R2500 to R5000. This category started through the use of Persal, the government's central payroll system. They use debit orders to get repayment 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, however, it has often been restricted by cash to lend. The commercial banks are becoming increasingly involved in this segment of the market, buying up the long term micro lenders to develop their access to the market, while reducing the financial constraints on their lending partners (e.g. ABSA buying controlling stake in Unibank)[1] (DTI, 2000).

The long-term lenders charge interest rate ranging from 2.57 to 10 percent per month. They also have charges such as administration fee, funeral cover and insurance on death and retrenchment. These charges push up the interest on loans to very high levels. The interest rates charged on the loan look to be low, but when the other fees are added they could be high. Most of the lenders who fall under this category are the affiliates of the Alliance of Micro-enterprise Practitioners (AMEP).

[1] Note that most of the research for this study took place until the end of 2001. in the beginning of 2002 larger microlenders such as Unibank and Saambou experienced severe problems. These were mainly due to methodology applied, lack of proper incentive systems and poor governance and management. The detail is not discussed in this study.

4.3.3 Other Suppliers in the Industry

The information that follows is drawn from the study by DTI (2000) Apart from the lenders noted above there are other lenders, who are also actively involved in this industry.

- **Furniture/Retail Lenders**

The furniture and retail store lenders are the latest entrants to the market, coming to the fore since the creation of the MFRC. Historically, furniture sales have been made under the Credit Agreement 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 creation of the MFRC and a clearer more transparent regulatory environment for micro lending, many of the furniture lenders as well as other retail stores such as Woolworths have also entered the market.

- **Township Lenders/Mashonisas**

These 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, sometimes depending on the agreement between the lender and the borrower. 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.

- **Pawnbrokers**

Pawnbrokers comprise one of the oldest industries in South Africa. They use durable and semi-durable goods as collateral against the money that they advance to individuals in need of short-term loans. These are often used to finance emergencies, or short term cash-flow deficiencies in their daily lives and businesses. The advances are made against the pledged item(s) at a rate of 25 to 30 percent per month, and the borrower has up to three months to reclaim his item(s) by paying off the advance or else forfeits the item(s) which he has pledged.

Future Competitors in the Industry

The larger commercial banks have been slow to move into this industry because they see such lending as unprofitable due to the high costs of administrating these small loans and the high-risk profile of the target market. But recently they are becoming increasingly involved in the industry due to political pressure, especially from Congress of South African Teachers Union and the South African Communist Party, which have expressed their displeasure with the lack of services offered by the commercial banks to members of the lower socio-economic segment. The banks lately have been entering the market indirectly via purchasing interests in established companies, which have a large presence and market share in the industry.

4.4 COSTS, REVENUES AND PROFITS IN A MICRO LENDING BUSINESS

Given the vital role of interest rates in a micro lender's structure, this section focuses on its components to clarify the real costs of delivery of credit to the low income sector. The approach of this study in calculating the cost components of the micro lenders will follow the approach taken by (DTI, 2000), which is based on the assumption that the profit margin is also a contributor to the level of interest rate. In addition the capital cost component, risk cost component and operating cost capital are studied.

4.4.1 Operating Costs

Operating costs for micro lenders tend to be the largest component contributing to the total interest rate. Even among efficient institutions around the world, operating costs range from 10% -20 % of the loan portfolio (CGAP, 1996). Due to the small loan size, micro lending is labour intensive. South African micro lenders usually hire people with matric or higher as loan officers. Even if these staff members have proper educational background, they seldom have any experience in micro lending (AMEDP, 1996). Under these circumstances there are substantial costs that the micro lenders must bear to train and develop these people, which lead to high actual costs of training plus the imputed costs of low productivity, especially in their early days.

In general operating costs include administration and office expenses, salaries and staff benefits, information technology and software.

4.4.2 Cost of Capital

Cost of capital can be defined as all those costs which have to do with obtaining capital. AMEDP (1996) defines cost of capital as a weighted cost of NGO funds, commercial rate money, equity, client savings, grants and other liabilities. Any cost incurred to mobilise and compensate capital used in allocation to borrowers can be considered as part of the cost of capital. Changes in interest rates and risk perceptions of the sector by investors would impact on the cost of capital (DTI, 2000). Bank charges also form part of the cost of capital.

4.4.3 Risk

Although the risk component is argued on the basis of organisational and systematic risk it is difficult to price for it (DTI, 2000). After studying the expenses of micro lenders it was found relevant to include collection fees, legal costs, security costs, and bad debts provision as the risk cost component.

4.4.4 Profit Margin

The difference between annual income and expenditure was taken as the surplus component of the total structure of the micro lending business.

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 increases the administrative cost component as well as the risk component. Increasing the risk component would also impact on the cost of capital (increased costs due to higher perceived risks) while all of this would decrease the surplus component.

Providing services to entrepreneurs, whose repayments are 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.

4.4.5 Cost of Lending based on MFRC Information

Based on the data from the DTI (2000) study, a cost component for different institutional groups was calculated. These institutional groups were differentiated as cash lenders, one to six month lenders, and the term lenders. The cost component was calculated based on the financial statements of these institutions, and information was grouped into four categories, operating costs, cost of capital, risk costs and surplus before tax.

Table 4.6: Cost components for different groups based on the MFRC data

	Cash lenders	Term lenders
Administration costs	63%	56%
Cost of capital	9%	3%
Risks costs	11%	3%
Surplus before tax	17%	38%

Source: DTI (2000)

When studying the two groups in table 3.6 above, it is clear that risk costs and the cost of capital are not as significant as the administration costs. It is also very clear that there is a marked difference between the cost elements of the cash lenders and term lender groups.

Administration costs of term lenders 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 associated with term lenders are normally lower (3%) than for cash lenders.

4.5 FINANCIAL IMPACT ANALYSIS ON THE MICRO LENDING BUSINESS

The Usury Act and its amendments where merely designed to protect the borrowers from perceived exorbitant interest rates. It is not clear whether the architects of this Act considered the viability and sustainability of micro lending institutions. The then Deputy Minister of Trade and Industry (1997) acknowledges that the Usury Act constrains delivery of financial services to micro enterprises as well as the low-income population. Therefore, interest rate ceilings if enforced will surely make sustainable microfinance impossible and even limit outreach to the poor.

There are some costs involved in operating a micro lending business. A transaction cost is one of the costs that is incurred in this type of business, and this includes costs of application and monitoring clients to prevent default. Risk costs also rise as result of defaulting clients. Since no collateral is taken the micro lender reduces risk through effective screening. As already shown administration costs also play a role, which contribute the largest proportion to the cost structure of a micro lender. The micro lenders argue that when the government places a ceiling on the rate that they should charge, it makes it difficult for them to make a reasonable return on their investment (Pritchard, 2000).

The financial impact analysis was performed to determine the effect of a change in the maximum interest rate that could be charged by the micro lenders. This process was performed to help understand the costs, revenues and profits of a micro lending business. In the example provided below estimates, which are based on the micro lender's financial statements, were analysed and evaluated on the basis that the statements reflect the financial position of the micro lender charging an interest rate not exceeding 30%. Calculations were then made to reflect their financial position in the event of them being allowed to charge a maximum rate of 20%, 12.08% and 10% per month.

The rate of 12.08% per month was calculated by taking the current prime lending rate (in 2000), which is 14.5 and multiplying it by 10 to equal 145 (as the Usury Act Exemption). The analysis in Table 3.7 below evaluates the potential impact of a maximum monthly rate of 12.08% on the profitability of short-term loans granted by a micro lender.

Table 4.7: Profit and loss of a micro lender

	ACTUAL	**PROJECTED**		
	30% P/M	20% P/M	**12.08% P/M**	10% P/M
Loan Book	230,770	230,770	230,770	230770
Interest	**69,230**	**46,154**	**27877**	**23,077**
Expenses				
Bad Debts @ 5%	15,000	13,846	12932	12,692
Office Rent	2,000	2,000	2,000	2,000
Two Staff	4,000	4,000	4,000	4,000
General Expenses	1,000	1,000	1,000	1,000
Owners Wages	5,000	5,000	5,000	5,000
Total Expenses	**27,000**	**25,846**	**24,932**	**24,692**
Tax @ 35%	14,781	7,108	1.031	
Net Profit After Tax P/M	**27,450**	**13,200**	**1,914**	**-1,615**
Return on Investment p/m	11.89%	5.72%	0.83%	-0.70%
Return on Investment p/a	142.68%	68.64%	9.96%	8.40%

Source: Own calculations

From the example above one can observe that a micro lender make a profit when charging rates of 30 and 20%. But when the interest rate reduces to 10% the micro lender is losing. As is shown in the above example, the bottom line for micro lenders is greatly influenced by their turnover, as a large portion of their costs are fixed. Therefore one micro lender might earn economic profits at 12.08% per month, while another might just break-even.

Therefore the interest rate ceilings can act as a constraint to the sustainability of microfinance institutions. The micro lenders offer small amounts of credit to a large number of people. Interest rate ceilings may not only ration consumers out of the legal market, but they also drive smaller lenders from the market and thus could diminish competition.

4.6 SUMMARY

There has not been enough research conducted on the micro lending industry. The most recent research was done by the DTI (2000) and estimated the industry's annual turnover to be in the region of 25 billion Rands. It is very difficult to give the exact figure in terms of the number of companies and individuals involved in the industry because of the difficulty in researching this particular industry. Some of the industry participants are difficult to trace since they operate in remote areas or illegally.

People borrow small loans for a variety of reasons. Loans may be borrowed for either production or consumption purposes. Consumers normally borrow money for the following transportation, businesses, buying food and education. The formal banks due to various reasons do not offer these types of small loans. But companies and individuals that are in the position to supply these kinds of loans are being constrained by government laws, mainly the Usury Act.

The micro lending industry is geographically distributed throughout South Africa. The industry is divided into three distinct categories of micro lenders, namely the formal, semi-formal and informal sectors. One of the key factors influencing the lack of supply of credit to small enterprises and low-income earners is the non-recoverability of costs. Charging a rate of interest on credit is the main source of income for micro lenders. This is the only way by which micro lenders can recover their costs. If the lenders are not allowed to charge full-cost recovery interest rates, the majority would have no option but to close down their businesses or go underground.

A microfinance business is very costly. Administration costs contribute the largest proportion of the total cost structure. Among efficient institutions around the world, administration costs range from 10% to 20% of the loan portfolio. As expected the risk cost for cash lenders is found to be high as compared to term lenders. This could be attributed to the accessibility of the latter to the government payroll systems.