University of Pretoria etd – Mohane, H T (2003)

CHAPTER 1

INTRODUCTION

"Availability of credit to the poor greatly enhances the strength and economic manoeuvrability of the poor. It immediately improves their income situation. It is very difficult to argue against this premise"(Yunus, 1993)

1.1 BACKGROUND

Access to loans and credit facilities has been, and still is, a major problem for a large portion of the South African society (Aveyard, 1999). The problem is significant in the disadvantaged and rural areas where the majority of people do not have access to formal banking services. The lack of physical access to banking facilities, and the unattractiveness of this large poor section of society to the conventional banking sector, has contributed to millions of unbanked and under-banked South Africans (Wood, 1999) cited by DTI (2000).

There is strong demand for financial services by the general population in South Africa. Many different forms of money lending have risen to respond to the needs of the population for small amounts of credit. There is also a wide spectrum of institutions and individuals involved in money lending, from township moneylenders to formal micro lenders, involved in both short and long term lending. According to the Department of Trade and Industry (2000) interest rates vary from formal commercial lending rates of 14 percent per annum to micro lenders in cities and townships lending at rates of up to 50 percent per month.

Access to credit allows financial leverage, and financial leverage creates wealth. That is what the development of the micro lending industry in South Africa has meant to many

University of Pretoria etd – Mohane, H T (2003)

small and medium micro-enterprises and millions of South Africans (AMDEP, 1996). It is widely accepted that the micro lending industry has a vital role to play in the economy of South Africa (Jonck, 1997). Operators in the industry make credit available to a large number of people who are unable to obtain credit from the formal banking sector. These are low-income earners and owners of small, medium and micro enterprises.

It is believed that microfinance can help to alleviate poverty and empower the poorest strata of the economy (Grant, 2000). The majority of the people use micro loans for a wide variety of reasons, either for productive or consumption purposes. In the case of productive purpose, people borrow money to finance small, medium and micro enterprises. In terms of consumption, finance is required to meet basic needs and emergencies. Grant (2000) identify consumption lending as forming the biggest part of South Africa's microfinance sector. The difference between these two forms of lending is the source of funds for repayment. The former lending repays their loans from revenue they received from their informal businesses, while the latter repays their loans from salaries obtained from the formal sector employment.

The money lending industry in South Africa is unique. It is conservatively estimated that the industry has an annual turnover of between 20 and 30 billion Rand (DTI, 2000). This multi-billion industry is governed by an important law, called the Usury Act (No.73 of 1968). This legislation is of immense significance to the micro finance sector, its aim is to protect the borrowers from exploitation and it therefore plays a critical role in consumer protection. The Act imposes interest rate ceilings on loan finance provided by money lending institutions. Consumer groups argue that clients of the micro finance industry are in particular need of protection, which is why usurious interest must be effectively prevented (Marsh & Navkiran, 1999).

An exemption from the Usury Act was promulgated in the Government Gazette Notice (number 14408) on the 31st December 1992. The notice gave exemption (i.e. no interest rate ceilings) to money transactions on the condition that they satisfied the following rules:

University of Pretoria etd – Mohane, H T (2003)

- The loan does not exceed R6000;
- The term of the loan should not exceed 36 months, and lastly;
- The borrower is a natural person or an association of natural persons.

The exemption created a formal microlending industry overnight. New entrants to the industry, as well as micro lenders who were previously operating outside the rules of the Usury Act, established businesses all over the country (Aveyard, 1999).

The micro lending industry couldn't get rid of its bad connotations. Several industry participants were still exploiting consumers thereby tarnishing the image of the industry as a whole. Due to public pressure on the Government to regulate the industry, a Gazette Notice (number 20145) of exemption from the Usury Act was issued on the 1st June 1999. The notice repealed the 1992 exemption, replacing it with a new exemption notice. The new exemption stipulated the following rules:

- A regulatory institution shall be established to regulate the industry;
- The loan shall not exceed R10 000;
- The term of the loan shall not exceed 36 months, and lastly;
- The interest rate shall not exceed ten times prime rate (which was 14.5 percent when this study was conducted).

This was a rate, by which the Government considered a competent micro lender could earn adequate returns from their investment (Aveyard, 1999). A ceiling of ten times the prime rate implied that the lenders could lend at about 13% per month in 2000. The Micro Lenders Association (MLA) and other micro lending groups contested this legislation in court. The interest rate ruling was overturned, based on the premise that it was not calculated on scientific grounds (Court Case No: 23453/99).

Studies both nationally and internationally Du Plessis (1995), Aveyard (1999) and Eisenbeis & Murphy (1974) have shown that interest rate controls could have a negative impact on the micro lending market. Any plans to cap interest rates could severely impact

University of Pretoria etd – Mohane, H T (2003)

on this multi-billion rand industry and therefore deny the poor their only access to credit. The stakeholders within the industry are unsure of the effects that the interest rate ceilings will have on the industry. Will the interest rate cap drive formal lenders out of business, leaving consumers as prey to informal sector operators, or will it achieve its objectives of cleaning up the industry? These are burning questions, which affect all the stakeholders in this multi-billion industry.

1.2 PROBLEM STATEMENT

In a study by Aveyard (1999) the statement is made that an interest rate ceiling may hurt the micro lending industry and the borrowers, the people whom the government is trying to protect with this legislation. Furthermore, the findings of the court case in 1999 ruled in favour of micro lenders on the interest rate ruling, based on the premise that it was not calculated on scientific grounds. The 2000 study by the Department of Trade and Industry looked at all these angles, but the question still remains, in what way will interest rate ceilings hurt the industry?

In this study the impact of an interest rate ceiling on the micro lending industry is studied. Interest rate ceilings cannot be imposed without adequately studying their impact on the micro finance market.

1.3 OBJECTIVES OF THE STUDY

Consumer groups and certain influential media groups argue that interest rate ceilings should be implemented in order to protect consumers from usurious rates. This notion leads us to the main objective of this study, which is to examine the impact that interest rate ceilings will have on the micro lending market. To achieve this broad objective, it is necessary for the study to highlight its specific objectives.

University of Pretoria etd – Mohane, H T (2003)

The specific objectives of this study are:

- To review literature on the impact of interest rate ceilings both nationally and internationally and also review the role of microfinance in economic development in South Africa.
- To analyse the size of the micro lending market in South Africa with emphases on the supply and demand of small credit.
- To demonstrate the effect of change in the maximum interest rates that could be charged by a micro lender using financial statement
- To analyse the impact, which interest rate ceilings have on the characteristics of loan services and the market structure of a micro lender.

1.4 STUDY OUTLINE

In Chapter two, an overview of existing literature in the field of micro finance and interest ceilings is presented. Aspects such as the role of microfinance in economic development and the argument for government intervention in the financial markets will be elaborated. Thereafter, the experience in micro lending around the world and practical experience from South Africa will be explored, focusing on the responses towards the exemption from the Usury Act.

Chapter three covers the methodology of the study, discussing the data used and model specification. Chapter four describes the micro finance market with particular attention to demand and supply in the micro finance industry, different participants in the industry are discussed. Aspects such as arguments for full cost recovery and revenues, as well as the costs and profits experienced in the micro lending business are also covered.

In chapter the results from the various models employed are presented. Discussions, concluding remarks and recommendations are made in chapter six.