

The Effects of Interest Rate Ceilings on the Microfinance Market:

A Case Study of a Micro lender

by

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Abstract

Access to loans and credit facilities has been, and still is, a major problem for a large portion of the South African society. The problem is particularly significant in the disadvantaged and rural areas where the majority of people do not have access to formal banking services. Against this background the government further exacerbated the problem by prescribing legislation, which is thought to protect borrowers from perceived usurious rates. This particular law in contention is the Usury Act (No. 73 of 1968). The Act imposes interest rate ceilings on loan finance provided by money lending institutions.

The objective of this study was to examine the impact that interest rate ceilings will have on the micro lending market. This was done through looking at a case study based on information obtained from a micro lender. Firstly the study undertook the financial

impact analysis on a micro lending business to determine the effect of a change in the maximum interest rate that could be charged by the micro lenders. This process was conducted to help understand the costs, revenues and profits of a micro lending business.

The data, which were 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 per cent. Calculations were then made to reflect their financial position in the event of them being allowed to charge a maximum rate of 20 per cent, 12.08 per cent and 10 per cent per month.

The results showed that micro lenders could make a profit when charging rates of between 30 and 20 per cent. However when the interest rate is reduced to 10 per cent the micro lender start to lose. The bottom line for micro lenders is greatly influenced by their turnover, as large portions of their costs are fixed. Therefore one micro lender might earn economic profits at 12.08 per cent per month, while another might just break-even.

Simple and multiple regression techniques were used to analyse the data pertinent to the study. The analyses were performed to show the impact, which ceilings on the interest rate have on the market structure, company size and on the characteristics of loan services. The results were evaluated according to their significance. The findings showed that interest rate ceilings can have positive significant effect on risk and the market structure.

Based on the findings of both methods applied to this study, it is evident that the interest rate ceilings could act as a constraint to the provision of credit to low-income earners and operators of small and micro enterprises. The micro lenders offer small amounts of credit to a large number of people, therefore interest rate ceilings may not only ration consumers out of the legal market, but also drive smaller lenders from the market and thus diminish competition.

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List of Acronyms

ABSA	Amalgamated Banks of South Africa
AMDEP	Alliance of Micro-Enterprise Development Practitioner
CGAP	Consultative Group to Assist the Poorest
CISA	Consumer Institute South Africa
DTI	Department of Trade and Industry
EU	European Union
GDP	Gross Domestic Product
MFIs	Microfinance Institutions
MFRC	Micro Finance Regulatory Council
MLA	Micro Lenders Association
MLI	Micro Lending Industry
NGOs	Non Government Organisations
PIN	Personal Identification Number

RDP	Reconstruction and Development Programme
ROSCAs	Rotating Savings and Credit Associations
SA	South Africa
SMMEs	Small, Medium and Micro Enterprises
USA	United States of America

Financial inclusion of creditworthy poor growth enhances the strength of economic growth in the poor. It empowers, improves their economic situation, and provides a platform for economic growth (Wood, 1999)

1.1 BACKGROUND

Access to loans and credit facilities has been, and still is, a major problem for a large part of the South African population (Averard, 1999). The problem is significant in the developing world where a large proportion of people do not have access to formal financial services. Lack of financial services, banking facilities, and the high transaction costs of borrowing are a real barrier in the conventional banking sector, particularly for individuals who are poor and under ranked 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 financial institutions, all of both short and long term lending. According to the Department of Finance (2000) interest rates vary from formal commercial lending rates of 12 percent per annum to street lenders in cities and townships lending at rates of 20 to 30 percent per month.

Access to credit allows financial leverage, and financial leverage is a key element in the development of the money lending industry in South Africa (Department of Finance, 2000).

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

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:

- 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

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.

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.

CHAPTER 2

MICROFINANCE AND INTEREST RATES: A REVIEW

2.1 INTRODUCTION

It has been estimated that there are about 500 million economically active, poor people in the world operating small businesses (Women's World Bank, 1995). Most of them do not have access to adequate financial services (Ledgerwood, 1999). This could be attributed to the fact that most of these people do not have collateral to substitute for credit, or their only form of security is low income. Microfinance has evolved as an economic development approach intended to benefit the low-income population.

Growth in the scale of micro finance activities in most parts of the world is limited by a variety of existing laws, including those dealing with organisational forms, prudential standards, interest rate limits and secured finance (Meagher & Mwiinga, 1999). Most micro lending firms are able to operate due to selective non-application of such rules with tacit agreement of government, or they function efficiently while adhering to the existing laws. The overall political and economic environment of a country affects how micro finance is provided (Ledgerwood, 1999). A Government's economic and social policies, as well as the level of development of a countries' financial sector, influences micro finance organisations in the delivery of financial services to the poor.

Micro finance lending can be divided into two broad categories, consumption and productive lending. Consumption lending is what drives South Africa's micro lending industry (Grant, 2000). Consumption borrowing is defined as borrowing to provide cash flow for consumption purposes e.g. food or transport. The latter category, productive lending is defined as borrowing by informal traders and small businesses to provide capital and cash flow for trading purposes. While lending for consumption purposes is

not the same as lending for enterprise development, the two are closely linked within the financial services sector. They both target clients from similar income levels, i.e. low-income individuals.

The next section will present the overview of existing literature, followed by the role of micro finance in economic development in South Africa; thereafter the experience in micro lending around the world will be explored, followed by experience from South Africa.

2.2 THE ROLE OF MICROFINANCE IN ECONOMIC DEVELOPMENT IN SOUTH AFRICA

The goal of microfinance institutions (MFI's) as development organisations is to service the financial needs of un-served or under-served markets as a means of meeting development objectives. These development objectives include one or more of the following (Ledgerwood, 1999):

- To reduce poverty
- To empower women or other disadvantaged population groups
- To help existing businesses grow or diversify their activities
- To encourage the development of new businesses.
- To create employment and income opportunities through the creation and expansion of microenterprises.
- To provide access to financial services to people excluded by the formal financial sector, thus effect deepening in the financial sector.

One year after the democratic election, the then President of South Africa, Nelson Mandela, appointed the Commission of Inquiry into the Provision of Rural Financial Services. This Commission (Strauss Commission) submitted its interim report in March 1996 and the final report in September of the same year. The report first looked at the

demand for financial services in rural areas, described the financial services of the different financial institutions, and made extensive recommendations based on this. The recommended measures were primarily aimed at improving access to financial services in rural areas where it was found that there was a lack of supply.

The microfinance sector is also receiving increasing attention from the government and the Central Bank. A year after the submission of the Strauss Commission report in September 1996, a workshop on micro lending was held at the South African Reserve Bank and both the Deputy Minister of Trade and Industry and the Register of Banks took part. In his speech the Registrar of the Banks, acknowledged that there is an urgent need for social upliftment in South Africa, and that much hardship is caused by unemployment (Wiese, 1997). He further stated that as a country they should aim to enable the poor and the unemployed to empower themselves financially by promoting the development of small business.

Small businesses have a major role to play in the South African economy in terms of employment creation, income generation and output growth. One of the problems with far-reaching political and economic repercussions is high unemployment, particularly in the townships and rural areas. Small and micro businesses in the informal sector are frequently the only source of employment for the urban black majority of the population (Reinke, 1996) cited in DTI (2000). The Reconstruction and Development Programme (RDP, 1994) stated specifically that small businesses, especially those owned and operated by black entrepreneurs, must form an integral part of the national economy.

Small, medium and micro enterprises are the vehicle by which people in the lowest-income groups in society gain access to economic opportunities, at a time when the distribution of income and wealth in South Africa is amongst the most unequal in the world. In the current macroeconomic context, it is imperative that significant investment is made in SMMEs in order to create both short and long term capacity for labour absorption and output growth, as well as to improve income generation and

redistribution. Small enterprises employ on average five people, therefore contributing to the job creation.

One of the key stumbling blocks preventing the dynamic growth of this sector is the lack of access to small, short-term loans. The commercial banking sector in South Africa ignores the micro enterprise sector and has failed to recognise that lending to this sector can be profitable (Mlambo-Ngcuka, 1997). The exclusion of many small and medium enterprises from access to, and use of, formal financial institutions was due to the perception of lending institutions that small-scale entrepreneurs had a general lack of adequate collateral, security, equity capital and business track record, against which to measure their credit-worthiness (AMEDP, 1996).

Micro lending institutions in South Africa arose and have tried to meet the financial service requirements of this sector of the economy. However, in order for these institutions to survive, the government must recognise that integral to ensuring increased access to credit, is a policy framework, which creates an enabling environment for the establishment and sustainable operation of micro lending institutions.

Micro lending is costly and even among efficient institutions, administrative cost range from 10% to 20% of average loan portfolio (CGAP, 1996). Therefore, if the aim is to create sustainable and efficient micro lending institutions, the government must recognise that the Usury Act could constrain delivery of financial services to micro enterprises and the majority of low-income population.

2.3 INTEREST RATE CEILINGS AND CREDIT RATIONING

Usury regulation is a topic with a long history of discussion, nevertheless the debate over the merits of usury regulation continues to the present day. There is little doubt that usury laws effectively lower the finance rate to many borrowers obtaining loans from moneylenders. The notion that high-risk borrowers are rationed out of the market for

credit as a result of legally established ceilings on interest rates has been a prevailing conclusion of previous studies dealing with this subject, Goudzwaard (1968), Greer (1974), Benston (1977) and Peterson (1983). It is said that the lower the ceilings the greater the number of rationed potential borrowers (Villegas, 1982).

The formal economic model of the impact of usury ceilings was outlined by Blitz and Long (1965). In their study they demonstrated how usury ceilings could lead to credit rationing. The financial market literature also attempted to explain credit rationing by considering legal and social constraints, high screening costs and most convincingly, asymmetric information in credit markets. These are elaborated in detail in Jaffee and Modigliani (1969), Jaffee and Russell (1976), Azzi and Cox (1976), Stiglitz and Weiss (1981) and Bester (1987).

One of the principal conclusions of the National Commission on Consumer Finance in the USA, was that the imposition of interest rate ceilings on consumer loans results in a reduction in loan supply with otherwise creditworthy borrowers being rationed out of the market (Eisenbeis & Murphy, 1974). Therefore, it is particularly important that the credit availability and credit rationing impact of rate ceilings be thoroughly understood by the architect of the proposed legislation. Setting a relatively low price ceiling will result in some borrowers being rationed out of the formal market and they will then become prey to illegal lenders who charge exorbitant interest rates as these borrowers still need to satisfy their demand for financial services.

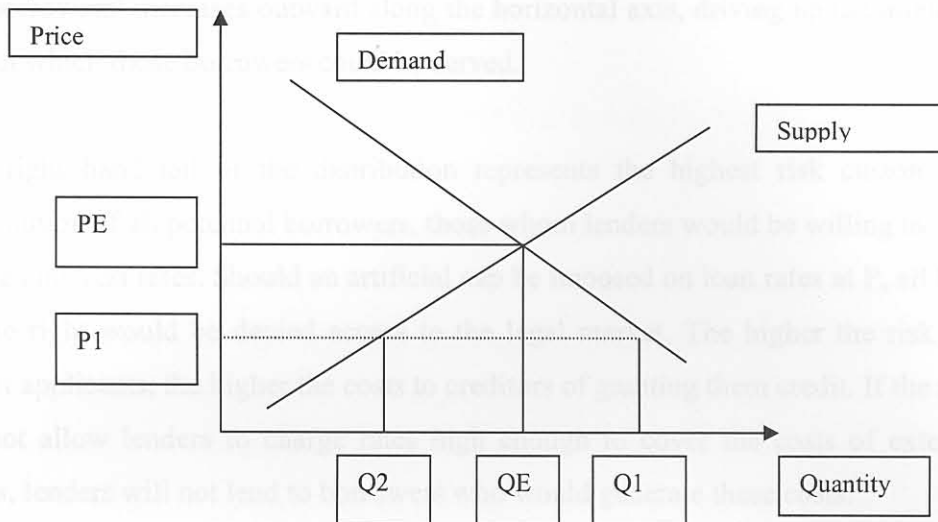
As Gonzalez-Vega (1977) points out that if restrictions are imposed on rates of interest, lenders may practice credit rationing, i.e., granting smaller loans than those demanded at the rate charged. From the point of view of the individual borrower, rationing implies an excess demand for credit at the rate of interest paid (Jaffee, 1971 and Eckaus, 1973) cited by (Gonzalez-Vega, 1977). Generally a lender restricts the size of a loan if the marginal cost of granting it is higher than the imposed rate of interest. Since the marginal cost is an increasing function of the size of any individual loan, the lender can reduce his marginal cost and equate it to the imposed rate by reducing the size of the loan. If this rate

becomes sufficiently low, dropping below variable cost, rationing takes the form exclusion from the lender's portfolio.

The possibility that a borrower will be rationed depends on the relationship between the marginal cost and the demand functions faced by the lender and on the nature of the restrictions. The slower the marginal cost rises as the size of loan increases, a function of risk, and the faster the quantity of credit demanded increases as the rate of interest declines due to the behaviour of the value of the marginal product of the inputs, the less likely is rationing. Gonzalez-Vega (1977) further states that the low ceilings imposed on rates of interest for loans in low-income countries have led to the widespread rationing.

The effects of rate ceilings on credit allocation can also be presented with the aid of a diagram (table 2.1) below. According to the conventional theory of markets, conditions of perfect competition yield a market situation in which demand and supply schedules intersect at equilibrium, with no excess demand or supply (Greer, 1975). The rationing effect is often demonstrated in conventional supply-demand diagrams by a price ceiling, which falls below the intersection of competitive supply and demand functions (figure 2.1)

Figure 2.1: The effect of an interest rate ceiling on the supply of loans



Source: (Black et al, 1997)

The interaction of supply and demand determines the equilibrium interest rate at (PE, QE), but the interest rate ceiling sets the rate at P1. At P1 there is a shortage of loans supplied. Since interest rates are not allowed to rise above P1, there is no incentive to expand the quantity of loans offered, and thus the supply is rationed. Some suppliers may in fact leave the market altogether so that the supply curve shifts inwards and the shortage will become even more acute (Black et al, 1997).

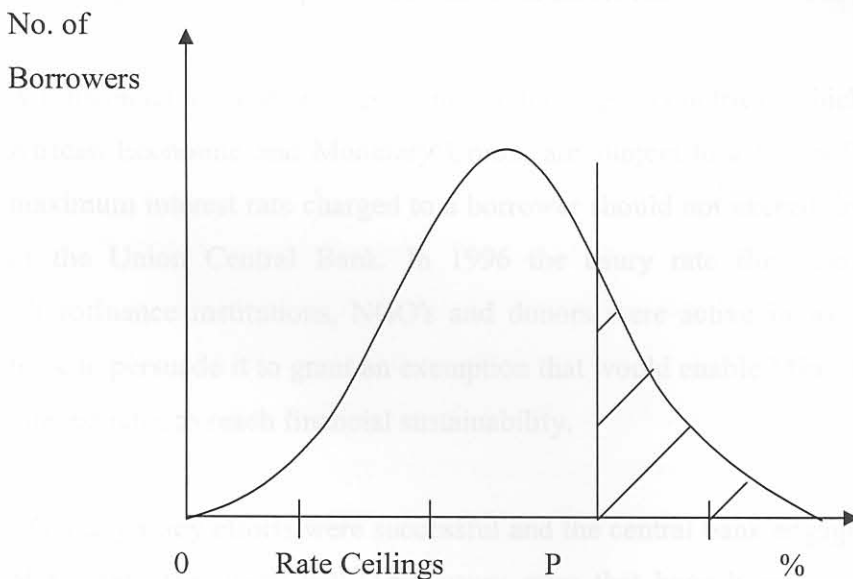
The rationale for interest rate ceilings is for consumer protection, but as these consumers need cash urgently they often resort to informal moneylenders who charge interest rates far higher than P1 or even PE. Therefore the imposed price ceiling does not achieve its objective.

Staten and Johnson (1995) also showed the impact of rate ceilings on the availability of cash credit to high-risk borrowers as illustrated in figure 2.2 below. The borrowers are arrayed along the horizontal axis according to the minimum percentage finance charge at

which creditors will be willing to extend to them. A small number of low-risk borrowers comprise the left tail of the distribution of all borrowers. Repayment risk associated with the borrowers' increases outward along the horizontal axis, driving up the minimum loan rate at which those borrowers could be served.

The right hand tail of the distribution represents the highest risk customers in the distribution of all potential borrowers, those whom lenders would be willing to serve only at high interest rates. Should an artificial cap be imposed on loan rates at P, all borrowers to the right would be denied access to the legal market. The higher the risk posed by credit applicants, the higher the costs to creditors of granting them credit. If the regulators do not allow lenders to charge rates high enough to cover the costs of extending the loans, lenders will not lend to borrowers who would generate these costs.

Figure 2.2: Effect of rate ceiling on availability of cash credit to borrowers



Source: Staten and Johnson (1995)

A rate ceiling does not only ration high-risk borrowers out of the market, but also tends to ration out borrowers seeking small loans. In addition to the costs associated with credit risk, there are administrative costs in granting loans and managing subsequent collections. Since many of these costs are fixed and unrelated to the amount of loans

generated, they are proportionately higher for smaller amounts of loans. If these costs are not covered by the permitted finance charge, credit will not be extended, even to low risk borrowers.

2.4 MICRO LENDING EXPERIENCE AROUND THE WORLD

Microfinance institutions have emerged around the world in response to the need for financial service provision in developing economics. While many individual organizations are growing, the legal and regulatory environment in which they operate has not caught up (Meagher & Mwiinga, 1999). Pushing governments to develop legal frameworks for microfinance may, in at least some countries, risk setting a process in motion the result of which could be the imposition of interest rate controls (Christen & Rosenberg, 1999). Interest rate controls can make sustainable MFI's impossible or at least discourage outreach to poorer customers if enforced.

All financial institutions operating in the eight countries, which make up the West African Economic and Monetary Union, are subject to a Usury law providing that the maximum interest rate charged to a borrower should not exceed double the discount rate of the Union Central Bank. In 1996 the usury rate fluctuated around 13 percent. Microfinance institutions, NGO's and donors were active in working with the central bank to persuade it to grant an exemption that would enable MFI's to charge high enough interest rates to reach financial sustainability.

Their advocacy efforts were successful and the central bank engaged itself in the process of revising the usury law. Two usury rates that have been proposed are one for the Commercial banks (18 percent) and one for 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 (Ledgerwood, 1999).

When modern microcredit emerged in Latin America, almost all of the countries had legal limits on interest rates. These limits were set far too low for sustainable microcredit delivery. Most of the microcredit pioneers practised regulatory avoidance by mounting their operations in NGO's. If the laws had been enforced literally in some of these countries the usury limits and even a requirement of financial licensing would have applied to all microcredit operations. However, the microcredit NGO's were left alone, the authorities being unaware of, or unconcerned with their existence (Christen & Rosenberg, 1999), or allowing them to operate outside the law due to their development role

Innovation flourished, and masses of successful MFI's, which were strong enough to justify a formal financial license, emerged. In the meantime, government policy and public attitudes about interest rates had changed, because of the demonstrated demand for these high interest rate loans. By the time strong MFI's were ready for licensing; interest rate repression was no longer an issue in most of these countries. Christen and Rosenberg (1999) point out that all this happened because the governments involved, were not prematurely forced to take a public position on microcredit interest rates.

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.

2.5 MICRO LENDING IN SOUTH AFRICA

2.5.1 Usury Act (No.73 of 1968)

Banking legislation in South Africa is promulgated in the form of acts (Staschen, 1999). These can be supplemented and specified by Government notices published in the Government Gazette. The important relevant laws are the Banks Act and the Usury Act.

For the purpose of this study we will concentrate on the latter, which is of importance to the microfinance industry. The Usury Act imposes interest rate ceilings on loan finance. The main objective of this study is to investigate the impact of the Usury Act and the imposition of the interest rate ceilings on microlending loans.

The Usury Act, (No. 73 of 1968) was approved on the 20th June 1968 and commenced on the 1st April 1969 (CISA, 1998). The purpose of the Act was the limitation and disclosure of finance charges on money lending transactions, credit transactions and leasing transactions. The Usury Act (No.73 Of 1968) as amended, regulates and controls the price of money and the nature of credit relationships. The Act is further supposed to protect the borrower from exploitation and usurious rates and therefore serves a major goal of regulation.

On the 30th June 1994 the Minister of Finance announced in the Government Gazette (Notice 15836) that he was considering repealing the Exemption (Aveyard, 1999). The Minister's actions were as the result of the outcry from both public and consumer groups. It was believed that the micro lending industry was getting out of control and consumers were being severely exploited

In 1997 the DTI began a process of modifying the Usury Act largely because it was dissatisfied with the level and consistency of consumer protection supposedly afforded by the Act (DTI, 2000). The Minister invited written representations from the public and various stakeholders regarding the intention to repeal the Exemption. In response to the process that began in 1997, on the 1st June 1999, the DTI issued a Notice in terms of section 15A of the Usury Act 1968 (No.73 of 1968) to exempt the category of money lending transactions. The new exemption stipulated the following (Government Gazette, 1999):

- A regulatory institution must be established to regulate the industry, known as the MicroFinance Regulatory Council (MFRC).
- A micro lender must be registered with the regulatory body and must comply with the rules set out by the body.

- The loans shall not exceed R10 000 with loan term not exceeding 36 months.
- The interest rate shall not exceed ten times the prime rate

2.5.2 Background of the Micro Lending Industry

There still exists a high level of un-informedness regarding the micro lending industry. Therefore, it is considered appropriate to provide a general background to the industry. Operators in the industry make credit available to millions of individuals who are unable to obtain loans from the formal banking sector.

With the new South Africa of the 1990s people had high hopes in terms of economic development. It was argued that one of the major hindrances to the development of this disadvantaged sector was the lack of access to finance. Due to the structural changes taking place in the South African economy, a large number of unskilled workers find it impossible to be employed in an economy, which is more focused on the services sector by the day. The government realised that the only way to provide employment for the unemployed was through the creation of small and micro businesses. But this couldn't be realised without access to support services and also finance.

Access to finance for the majority of the population came through the evolution of the microlending industry. The industry flourished as a result of its exemption from the Usury Act. The amendments of the Usury Act together with high margins, low barriers to entry, and the vast demand for finance, which has not been met by commercial banks, fuelled this growth. The industry has exploded over the last few years attracting an estimated 30 500 micro lenders from both formal and informal markets (Thordsen & Nathan, 1999).

Du Plessis (1997) describes the formal and informal micro lenders as follows; the formal micro lenders are those operating from fixed premises, in addition they have the normal and most modern electronic infrastructure, and lastly they openly advertise their services in the areas they operate. The informal micro lenders are those who do not operate from

fixed premises, do not have listed phone or fax numbers and they prefer not be identified by any other than their clients. They are operated underground i.e. not within jurisdiction of laws, taxes and other regulations.

Between 1992 and 1999 the industry was constantly being accused of unscrupulous practices, charging exorbitant interest rates, lenders not registering for tax and using illegal collection methods (some lenders accused of keeping borrowers bank cards and personal identification numbers (PIN)). In 1997, the DTI began a process of modifying the Usury Act largely because it was dissatisfied with the level and consistency of consumer protection supposedly afforded by the Act. Submissions from various stakeholders within the industry were brought forward, and this led to the government issuing a new exemption notice in 1999.

The Association of Micro Lenders (MLA) challenged the appointment of the MFRC as regulatory institution, the interest rate calculation and the Exemption Notice in the High Court. In his judgement on the 11th November 1999 the presiding judge, Judge Mynhardt, held that the Minister did not act outside his powers in terms of Section 15A of the Usury Act 1968 in issuing the Exemption Notice and in appointing the MFRC as the regulatory body. The judgement ruled that the keeping of bankcards and PIN numbers, as security was illegal. However, it also ruled that the definition of the Usury rate at 10 times prime needed to be examined as the government did not study the issue of interest rate ceilings and their impact on the industry before deciding on this interest rate ceiling.

The DTI was therefore faced with the task of determining whether there is a reasonable rate of interest which can be charged by lenders and still earn an adequate living from the service provided. Based on this, the DTI initiated a study on the costs and interest rates of small loan sector (DTI, 2000). The purpose of the study was to help the DTI understand the overall structure of costs of various lending institutions, to determine their actual interest rates and to investigate which criteria should be applied in decisions on interest rate controls.

The study came up with a number of recommendations on the interest rate ceilings. Its first reaction was to not recommend setting any interest rate ceiling at all, because it realised that setting interest rate ceilings will restrict the flow of credit into the system by forcing marginal lenders to close or go underground. But the study further proposed that if the DTI insists on setting interest rate ceilings, they should not be based on the cost of money, but based on administrative costs of making the loans. The study recommended the DTI to set the interest rate ceiling as high as possible and should set it as a fixed rate. Placing a fixed rate of interest will allow investors to do their calculations and determine where they wish to invest their money.

The study further recommended that if rate ceilings are being set based on 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 method of operation and risk profile of their clients. It proposed that the ceiling for the short-term lenders be placed at 30 percent (effective interest rate) initially, and the ceiling for the term lenders at 10 percent (effective interest rate), with targets for gradual reduction over the period of one to two years.

2.6 THE ARGUMENT FOR FULL COST-RECOVERY INTEREST RATES

Many industry observers believe that micro lenders' interest rates are excessively high. A perspective however needs to be taken. As micro lenders are not deposit-taking institutions they are in effect retailing their own money, which is therefore a commodity and their stock-in-trade (Jonck, 1997). Micro lenders in South Africa accept and acknowledge that their interest rates are high as compared to the formal banking sector, but argue that higher risks that they carry because their loans are unsecured should not be ignored (Jonck, 1997).

Most people, especially those who are at the forefront in accusing the industry seem not to understand the risks involved in operating a micro lending business. It should be understood that the cost of administering a small loan is the same if not higher than that for a bigger loan, this is the reason why micro lending is unattractive to the formal banking sector. "Many of those appearing before the Committee argued that the banks were unfairly treating and indeed abandoning lower income customers. This was also seen as the context within which the small loans industry had mushroomed. The latter was providing much needed credit to people who would otherwise not have access to credit or banking services" (Report of the Portfolio Committee on Trade and Industry, 1999).

Interest rates charged by micro lenders are higher as compared to commercial bank rates. These could be attributed to a number of factors. Firstly the micro lenders have higher incidence of bad debts because of the target markets' higher risk profile. In low-income market in particular bad debt feeds upon itself in that once borrowers see that other clients are not paying their loans, they quickly adopt the others' behaviour (AMEDP, 1996). Secondly, the average loan is low while the costs of granting and administering a loan are high and fixed.

The micro lending institutions on the other hand, do not require conventional collateral to lend, they generally practice character-based lending. They rely more on a client's willingness to repay when assessing loan applications, and it is rare to find an application taking more than a day to be processed. 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 (AMEDP, 1996). The interest charge on credit is the main source of income for micro lenders. When the government implements interest rate ceilings on loans provided by micro lenders without first determining the cost structure of these institutions, the results could be detrimental.

The majority of the people, especially organisation such as the consumer groups, believe that an interest rate ceiling would be simple and straightforward and would protect

consumers (Jonck, 1997). The industry argues (Jonck, 1997) that if lenders were not allowed to charge full-cost recovery interest rates, the majority would close down businesses as a result of non-recoverability of costs. Therefore consumers would be left as prey to the unscrupulous loan sharks that form part of the informal sector of the industry. The most important argument in the field of microfinance is that the poor demand access to credit, not cheap credit (Morduch, 1998).

Although full-cost recovery interest rates may be an economic requirement for the sustainability of micro lenders, some people argue that the poor still deserve to be protected by an interest rate ceiling. It is argued that poor people cannot afford to pay exorbitant rates of 40% or 50% or even more (AMEDP, 1996). Many studies around the world have shown that effective rates of full-cost recovery credit are often lower than those charged by informal moneylenders.

2.7 SUMMARY

Small businesses have a major role to play in the economy of South Africa in terms of employment creation and income generation. But one of the key stumbling blocks preventing the dynamic and growth of this sector is the lack of access to small, short-term loans. Micro lending institutions rose to fill this gap. Due to public outcry concerning activities of some of the operators within the industry came the Usury Act which act as a constrain to the delivery of financial services to micro-enterprises and the majority of low-income population.

The Usury Act (No.73 of 1968) as amended regulates and controls the price of money and the nature of credit. The sole purpose of the Act was to protect the borrowers from perceived exploitation. In 1992 the government Gazette Notice 14498 was issued, which exempted loans of under R6000 from the Usury Act. Due to public and consumer outcry, during 1999 the government issued the Gazette Notice 20145 repealing the 1992 exemption.

The Association of Micro Lenders challenged some of the clauses in the 1999 Usury Act amendments in the High Court. In his judgement, Judge Mynhardt held that the Minister did not act outside his powers in terms of Section 15A of the Usury Act (No.73 of 1968) in appointing the MFRC as the regulatory body. However, he also ruled that the definition of the Usury at ten times the prime rate needed to be examined, as the government did not study the issue of interest rate ceilings and their impact on the industry.

As the study has been conducted with a purpose to study various aspects of the industry, it is necessary to ensure that the data obtained is representative of the industry. To this end, various methods are employed in this study. The study employs both quantitative and qualitative research methods, and relies on several sources for information.

2.2 SOURCES OF DATA

The study used a number of sources to obtain data on the industry. The Department of Trade and Industry study conducted in 2001, which studied various aspects of the small business and small loan finance sector, is further supplemented by various other sources. Documents in this field. The study focused on information from the industry, industry organisations and reports submitted by various micro-lending organisations.

The study employs data consisting of monthly observations of various aspects of the micro-lending company. This is the data obtained from the MFRC, which is used to estimate the cost structure and interest rates of small loan sector. The data is used from March 1999 to March 2000 and it is used in this study to estimate the impact of rate ceilings on the small-lending market. Data on financial statements of various companies is also sourced from the Department of Trade and Industry as a complement to the

CHAPTER 3

METHODOLOGY AND MODEL SPECIFICATION

3.1 INTRODUCTION

Many studies view interest rate ceilings in micro lending market as a harmful to the citizens that they were apparently designed to protect. In an attempt to analyse and explore the implications of interest rate ceilings on the micro lending in South Africa, various methods are employed in this study. The study employs both quantitative and qualitative research methods, and relies on several sources for information.

3.2 SOURCE OF DATA

The study used secondary information obtained from the Department of Trade and Industry study conducted in 2000, which was determining the cost and structure of small loan finance sector. This study is further supplemented by various studies and research documents in this field. The study focused on information from the Internet, journals, industry comments and reports submitted by various micro-lending institutions.

This study employs data consisting of monthly observations of operational statistics of a micro lending company. This is the data obtained from the DTI (2000) study, which determined the cost structure and interest rates of small loan sector. The data employed is from March 1999 to March 2000 and it is used in this study to demonstrate the impact of rate ceilings in the micro lending market. Data on financial statement of micro lenders is also sourced form the Department of Trade and Industry is employed in this study.

3.3 TECHNIQUES OF DATA ANALYSIS

Two approaches using quantitative data are employed to accomplish the objective of this study. These two approaches were selected in order to show the implications of interest rate ceilings on both the lender and the borrower. In the first approach the study uses the financial statements of a micro lender to evaluate the effect of a change in the maximum interest rate that could be charged by a micro lender. This approach is aimed at showing the impact of interest rate ceiling towards the lender, when interest rate are capped at various levels.

The second approach uses data consisting of monthly observations of operational statistics of a micro lending company. In this approach simple and multiple regression techniques are performed on these data. This approach is explained in detail later in this chapter.

3.4 ANALYTICAL FRAMEWORK

Goudzwaard (1968) applied empirical analysis to this topic by using simple regression analysis to financial data from 32 States Small Loan Licensee Reports of lender operations in the USA during 1964 to demonstrate the credit reallocation impact of rate ceilings. The following variables were used in his study.

Dependent variables:

Y_1 = Average credit losses to average loans outstanding

Y_2 = Average credit losses and salary and administrative expenses to average loan outstanding.

Primary independent variable:

X_1 = average gross finance charges to average loans outstanding

Control variables:

$X_2 =$ Average loan size

$X_3 =$ Average size of loan office- amount of loans outstanding per loan office

$X_4 =$ Lender concentration- number of consumer finance company offices per unit or urban population.

$X_5 =$ Average per capita income

The relationship between risk level and rate ceiling was first tested in the following three equations where the dependent variable, credit loss rate, (Y_1) is presumed a proxy for credit availability.

$$Y_1 = a + b_1X_1$$

$$Y_1 = a + b_1X_1 + b_2X_2$$

$$Y_1 = a + b_1X_1 + b_2X_2 + b_3X_3 + b_4X_4 + b_5X_5$$

Credit losses here represent the degree of lender portfolio risk, and the types of credit standard policies in force at consumer finance companies. Higher credit losses generally mean that lenders have relaxed standards to include marginal accounts previously ineligible for credit allocation. Likewise, lower credit losses indicate tighter credit standards. Therefore average credit loss rate, the percentage of credit losses to average loans outstanding, is the dependent variable representing credit availability at consumer finance companies.

Since salary and administrative expenses may substitute for credit losses, the regression is repeated with the sum of these two expense rates as the dependent variable in the following three equations.

$$Y_2 = a + b_1X_1$$

$$Y_2 = a + b_1X_1 + b_2X_2$$

$$Y_2 = a + b_1X_1 + b_2X_2 + b_3X_3 + b_4X_4 + b_5X_5$$

Another measure of credit risk and credit availability is the sum of credit loss and salary and administrative expense as a percentage of average loans outstanding. This expense rate is the dependent variable in the above equations. Goudzwaard (1968) points out that this variable may not be a precise proxy for credit availability since many other factors effect salary and administration expense. Salary expense would be more appropriate than the sum of salary and administrative expense, but in most cases they are grouped together in financial statements, making it difficult to distinguish between the two in a fair and consistent manner.

The results of the analysis by Goudzwaard (1968) demonstrated that any rate ceiling would very likely affect consumer credit allocation, and that price controls will definitely lead to credit rationing. The regression coefficients showed a strong and significant relationship between average credit loss rate and average gross finance rate, thereby supporting the contention that rate ceilings affect borrower loan eligibility at consumer finance companies.

3.5 MODEL SPECIFICATION

Regression analysis is concerned with the study of the dependence of one variable, the dependent variable, on one or more other variables, the independent variables (Gujarati, 1995). Gujarati (1995) further a state that if one wishes to study the dependence of a variable on only a single independent variable then such study is known as simple regression analysis. And if one wishes to study the dependence of one variable on more than one independent variables then such study is known as multiple regression analysis. The above definition is further explained with the aid of equations sourced form Gujarati (1995)

$Y_1 = b_0 + b_1X_1 + e$, is a simple regression equation and

$Y_1 = b_0 + b_1X_1 + b_2X_2 + e$, is a multiple regression equation, where:

Y_1 is dependent variable,

X 's (X_1, X_2, \dots, X_k) are independent variables

b 's (b_1, b_2, \dots, b_k)

e is an error term

Equation 1

The models considered in this study draws on that of Goudzwaard (1968) on price ceilings and credit rationing, though they have been modified to suit data used in this study. This study employs both simple and multiple regression techniques on the available data. The variables used to specify the models (equation 1 to 6 below) are as follows.

Equations 1 to 6 below were formulated to describe the impact of rate ceilings

Dependent variables:

Y_1 = Debtors in arrears

Y_2 = Number of branches

Y_3 = Average number of loans per branch

Primary independent variables:

X_1 = Interest received

Control variables:

X_2 = Average loan

X_3 = Average number of loans per branch

X_4 = Number of branches

3.5.1 Regulation and Borrower Risk

For the purpose of this study, risk has been measured by debtors' in arrears (Y_1). The relationship between risk level and rate ceilings is first tested in the following two equations. In equation one a simple regression analysis is conducted to test the relationship between risk level and interest received (X_1). In the second equation another variable, average loan (X_2) was added to test whether a positive significant correlation between rate and risk would still hold even if the effects of this variable on risk have been taken into account.

Equation 1

$$Y_1 = b_0 + b_1X_1 + e$$

Equation 2

$$Y_1 = b_0 + b_1X_1 + b_2X_2 + e$$

3.5.2 Regulation and Market Structure

Equations three to six below were formulated to illustrate the impact of rate ceilings on the market structure and size of a micro lender with various outlets. The market structure characteristics, which are analysed, are the number of branches (Y_2) and the average number of loans per branch (Y_3). The number of branches is used as measure of the size of the micro lender and the number of loans extended per branch is used as a measure of outreach.

The relationship between the (Y_2) and rate ceilings is tested in equation 3. This equation is expected to yield a positive significant correlation between the interest received and the number of branches. In equation 4 average number of loans per branch (X_3) is added to test whether a positive significant correlation between interest received and the number of branches would still hold even if the effects of (X_3) on number of branches have been taken into account. The relationship between number of loans (Y_3) extended and interest received is tested in equation 5.

Equation 3

$$Y_2 = b_0 + b_1X_1 + e$$

Equation 4

$$Y_2 = b_0 + b_1X_1 + b_3X_3 + e$$

Equation 5

$$Y_3 = b_0 + b_1X_1 + e$$

Equation 6

$$Y_3 = b_0 + b_1X_1 + b_4X_4 + e$$

CHAPTER 4**AN OVERVIEW OF THE MICRO LENDING MARKET IN SOUTH AFRICA****1.1 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, SA: 1993 & 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 Impact of the Microfinance on the rural development sector).

The micro credit market can be described as the demand for, and supply of, small loans. The demand side (demand for the loan) is on the supply side we find the lenders. In any country there are un-served or underserved segments and households, ranging from the ultra-poor, who may not be considered as a live, to small growing enterprises that provide employment in their communities (Casperwood, 1999). This constitutes the demand side of micro credit. Often the commercial banks does not offer a corresponding continuum of services. The micro lenders provide services that fill the gaps and integrate the un-served groups into the financial system.

The next section presents the demand for microfinance services. This section will be followed by the supply side of microfinance, where various sizes of industry, and types of lenders are evaluated. Thereafter, the last section of this chapter will look at revenues and profit expectations of micro lending business.

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

Source: MFRC (2000)

□ 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.

4.3.2 Types of Lenders

Micro lenders can be divided into different categories, depending on the type of services which they are involved. For the purpose of this study an industry survey

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 administering 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 were 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	230,770
Interest	69,230	46,154	27,877	23,077
Expenses				
Bad Debts @ 5%	15,000	13,846	12,932	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.

5.2 THE RESULTS

The results were obtained from performing the regressions in the equations. These results are evaluated according to their significance. The equation of the relationship between risk level and rate ceilings were tested. In the second equation, the number of branches was added to test whether a positive significant relationship between the number of branches and risk would still hold even if the effects of that variable were taken account of. The same procedure was also applied to equations 3 to 6, in equation 3 the relationship between size of the company and rate ceilings was tested. The relationship between a number of loans extended and a rate ceiling was tested in equation 4 and in equation 5.

The results of the regression analysis using equation 1 (Table 3.1) show that the interest rate has a significant positive impact on risk. Equation 2 shows that this variable is

CHAPTER 5

IMPERICAL RESULTS

5.1 INTRODUCTION

The results of equations 1 to 6 from chapter three are reported and interpreted in this chapter. Various variables were included in the models to determine the impact of interest rate ceilings on the characteristics of market structure, company size and loan services of a specific micro lender. As noted earlier the analyses are adopted from the study by Goudzwaard (1968), though modified to suit the data used in this study. Econometric Views (E-Views) computer software statistical package has been used to analyse the data. The data used is the time series covering period March 1999 to March 2000.

The results from the regressions performed have some important implications for the main conclusion of this study. These are given in the next chapter.

5.2 THE RESULTS

The results were obtained from performing the regressions in linear form. These results are evaluated according to their significance. In equation 1, the relationship between risk level and rate ceilings were tested. In the second equation, number of branches was added to test whether a positive significant correlation between interest rate and risk would still hold even if the effects of that variable were taken into account. The same procedure was also applied in equations 3 to 6. In equation 3, the relationship between size of the company and rate ceilings was tested. The relationship between number of loans extended and a rate ceiling was tested in equation 5 and in equation 6.

The results of the regression analysis using equation 1 (table 5.1) show that the interest rate has a significant positive impact on risk. Equation 2 shows that this significant

positive correlation between interest rate and risk holds even after the effects of average loan on risk have been taken into account. A probable explanation of the positive correlation between risk and interest rate is that the accommodation of higher risk borrower requires higher rates since there are greater losses and other costs of lending to, and collecting from, a riskier class of borrowers.

One of the key factors influencing the lack of supply of credit to low-income individuals and owners of small businesses is the no-recoverability of costs by micro lenders. Charging a rate of interest on credit is the main source of income for many micro lenders. It is the only way they can recover their costs in terms of financial, operating and risk. Since lenders have no control as a result of interest rate ceilings, the low ceilings will force them to reduce costs and restrict lending to better risk classes, thereby discriminating against the less creditworthy borrowers.

Table 5.1: Regulation and borrower risk

Equation	Dependent variable	Constant term	Independent variable	R-square	f-stats
1	Y_1	-1097392	$0.2X_1$ (3.08)*	0.54	9.5
2	Y_1	1746009	$0.3X_1 - 6645.5X_2$ (3.33)* (-1.14)*	0.61	5.6

t-stats in parenthesis

* Significant at 5% level

Equation 1 further shows that 54 percent of the variance in the dependent variable (arrears in debtors) is explained by the interest received (table 5.1). When number of branches is added, (equation 2) the R-square rises to 61 percent.

The effects of rate ceilings and the market structure were tested using the equations 3, 4, 5 and 6. In equations 3 and 4 in table 5.2, the market structure characteristic, which was

analysed, is the number of branches of the company. Equation 3 shows that there is a significant positive correlation between interest rate charged and the number of branches. Equation 4 demonstrates that this positive correlation between interest rate and number of branches holds even after average number of loans per branch has been taken into account. The positive correlation between interest rate charged and the number of branches implies that as lenders are allowed to charge interest rates high enough to cover their costs, the number of branches increases thereby allowing borrowers to have more options to a variety of lenders.

Equation 3 shows that the level of rate charged would affect the number of branches, hence the size of the industry. Rate ceilings tend to prevent new entries into the market, therefore preventing competition. According to economic theory, a competitive market is sufficient to prevent lenders from exercising power over pricing or earning more than a normal return. Therefore, instead of regulating interest rates, a more effective approach to ensure that the rates charged by micro lenders are appropriate is to encourage competition. This will spur innovation aimed at reducing the risks and costs associated with micro lending.

Given the dramatic increase in competition across the spectrum of consumer lending in South Africa, there is no more justification for controlling the price of credit than there is for controlling the price of the goods and services that consumers buy that credit (Jonck, 1997). This is true considering that many studies have demonstrated that competition controls price more effectively than rate ceilings. The long-term effects of binding rate ceilings are worse than the short-term effects because market entry and innovation are discouraged. A market without rate ceilings pays long-term dividends by attracting new entries that become willing to invest in serving a higher risk segment of the market.

Table 5.2: Regulation and Market Structure

Equation	Dependent variable	Constant tern	Independent variable	R-square	F-stats
3	Y_2	-1.1	$1.6X_1$ (14.57)*	0.96	212.4
4	Y_2	25	$1.8X_1$ $-0.08X_3$ (14.34)* (-2.19)*	0.97	158.8
5	Y_3	335.33	$2.45X_1$ (2.68)*	0.47	7.2
6	Y_3	329.6	$0.0001X_1$ $-5.2X_4$ (2.77)* (-2.18)*	0.68	7.7

t-stats in parenthesis

* Significant at 5% level

In equations 5 and 6 in table 4.2, the market structure that was analysed is the average number of loans per branch. This variable signifies the number of loans disbursed to consumers per branch. This can be taken as a good measure on the supply side. Equation 5 shows that there is a significant positive correlation between interest rate and the number of loans per branch. This significant positive correlation holds even after the effects of other variables taken into account in equation 6. In equation 3, 4, 5 and 6 the t-values associated with all the coefficients are significant at 5 percent level of significant.

It is probable that the level of rate charged would affect the number of loans made. Where the rate is low, lenders would reduce the number of loans, hence the supply is rationed. Therefore the consumers whom the government tries to protect will be left without any alternative to finance and will resort to “loan sharks” who are not monitored and normally charge unscrupulous interest rates.

5.3 SUMMARY

The study analysed the impact of interest rate regulation by applying simple and multiple regression techniques to the data obtained from a micro lender. In equations 1 and 2, the relationship between risk level and rate ceilings was tested. The main finding was that the interest rate has a significant positive impact on risk. If government is to aid the poor, it must either give them enough borrowing power to obtain credit within a rate ceiling structure or permit lenders to charge rates sufficient to cover the risk loss.

In equations 3 and 4, the relationship between interest rate and number of branches, which measures the size of the industry, was tested. The findings showed that there is significant positive correlation between rate charged and number of branches. In the last two equations, 5 and 6 the relationship between interest rate and the number of loans made per branch was tested. As expected the results showed positive correlation, and all the t-values associated with the coefficients are significant at a 5 percent level.

CHAPTER 6

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

6.1 INTRODUCTION

The main objective of this study was to analyse the impact of interest rate ceilings on the micro lending market. This was achieved by applying simple and multiple regression techniques to data consisting of monthly observations of a micro lending company with branches. The theoretical analysis from other literature was also applied to this study to show the effects of rate ceilings. This chapter summarises and links the conclusions of the previous chapters to show the importance of microfinance institutions, the evolution and size of the micro lending industry, and lastly the effects of rate ceilings.

6.2 SUMMARY

The goal of MFI's is to service the financial needs of unserved or underserved markets as a means of meeting development objectives. They do it for profit motives, and in the process also contribute to the development of the financial sector. In South Africa (Daniels, 2001; MFRC, 2001) it was shown that a significant improvement in access to financial services occurred over the last decade. Coetzee and Grant (2001) also showed that this is not necessarily only in the consumer credit provision, as a general leakage does occur between consumer and enterprise credit. This contributes to meeting some development objectives as outlined by Ledgerwood (1999). These development objectives include one or more of the following, to reduce poverty, to empower women or other disadvantaged population groups, to help existing businesses grow or diversify their activities, and/or to encourage the development of new businesses.

Small businesses have a major role to play in the South African economy in terms of employment creation, income generation and output growth. The problem of high unemployment, particularly in the townships and rural areas is one with far-reaching political and economic repercussions. Small and micro businesses in the informal sector are frequently the only source of employment for the urban black majority of the population.

One of the key factors that is seen to be preventing the dynamic growth of this sector is the lack of access to small, short-term loans and in general to financial services. The commercial banking sector in South Africa does not serve the micro enterprise sector, and has failed to recognise that lending to this sector can be profitable. Micro lending institutions have risen and tried to close this gap.

Operators in the micro lending industry make credit available to millions of individuals who are unable to obtain loans from the formal banking sector. Micro lending is therefore described as a provision of small loans to individuals who do not have access to formal banking because their only form of security is low-income. Access to finance for the majority of the population came through the evolution of the micro lending industry. The industry flourished due to an exemption from the Usury Act. The amendments of the Usury Act together with high margins, low barriers to entry and vast demand for finance which has not been met by commercial banks, fuelled this growth.

The industry has shown explosive growth over the last few years attracting an estimated 30 500 micro lenders from the formal and informal markets (Thordsen & Nathan, 1999). The formal micro lenders are those operating from fixed premises, in addition they have the normal and modern electronic infrastructure, and lastly they openly advertise their services in the areas in which they operate. The informal micro lenders are those which do not operate from fixed premises, do not have listed phone or fax numbers, and prefer not to be identified by any other than their clients. They operate underground i.e. not within jurisdiction of laws, taxes and other regulations.

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 were not allowed to charge full-cost recovery interest rates, the majority would have no option but to close their businesses, or go underground.

The consumers use loans for a variety of reasons. Loans may be used 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, which are in the position to supply these kinds of loans, are being constrained by government laws, mainly the Usury Act.

There have been many theoretical and empirical studies concerned with the economics of usury laws. Many of these studies tried to highlight the impact of rate ceilings, either theoretically or empirically. Most of the studies concluded that rate ceilings have a negative impact on both the consumer and the lender. Blitz and Long (1965) provided the basis for several studies on the impact of rate ceilings. Goudzwaard (1968) applied empirical analysis to this topic by using simple regression analysis to financial data to demonstrate the credit reallocation impact of rate ceilings.

This study followed a similar approach to Goudzwaard (1968) and developed simple and multiple regression functions that were applied to the data from a micro lender. The data consisted of monthly observations of operational statistics of a micro lender obtained from the DTI (2000) study, which determined the cost structure and interest rates of small loan sector. The data employed is based on observations from March 1999 to March 2000.

For the purpose of this study, six equations were formulated. The first equation tested the relationship between the risk level and interest rate ceilings. In the second equation, another variable, average loan was added to test whether a positive significant correlation between interest rate level and risk would still hold even if the effects of an additional variable have been taken into account. Equations 3, 4, 5, and 6 were formulated to illustrate the impact of rate ceilings on the market structure and size of a micro lender with various branches. The market structure characteristics, which were analysed, were the number of branches and the average number of loans per branch. The number of branches was used as a measure of the size of the micro lending company, and the number of loans extended per branch was used as measure of outreach.

Regression result in the first equation showed that interest rate has a significant positive impact on risk. The second equation showed that this significant positive correlation between interest rate and risk holds even after the effects of average loan on risk has been taken into account. The third equation showed that there is a significant positive correlation between the interest rate charged and the number of branches. The positive correlation between the interest rate charged and the number of branches implies that as lenders are allowed to charge interest rates high enough to cover their costs the number of branches increases thereby allowing borrowers to have more options to a variety of lenders.

The fourth equation demonstrated that this positive correlation between interest rate and number of branches holds even after another variable (average number of loans per branch) has been taken into account. The fifth equation also showed that there is a significant positive correlation between interest rate and the number of loans per branches. It is probable that the level of rate charged would affect the number of loans made. Where the rate is low, to the point that lenders could not recover their costs, lenders would reduce the number of loans, hence supply was rationed. Therefore, the consumers whom the government is trying to protect will be left without any alternative to finance and will resort to “loan sharks” who are not monitored and normally charge unscrupulous interest rates.

6.3 CONCLUSIONS

The main objective of this study was to examine the impact of interest rate ceilings on the micro lending market. Both theoretical and empirical analyses were applied to show the effects of the usury law.

It was shown in theory, that interest rate ceilings can result negative effects for consumers. In the first instance, the rationing effect of a price ceiling was demonstrated in a conventional supply-demand diagram. The interaction of supply and demand determines the equilibrium interest rate, but the interest rate ceiling sets the rate below the equilibrium point. At that point there is a shortage of loans supplied. Since interest rates are not allowed to rise above the ceiling point, there is no incentive to expand the quantity of loans offered and thus the supply is rationed. Some suppliers may in fact leave the market altogether so that the supply curve shifts inwards and the shortage could become even more acute. The study also indicated the effect on the profitability of a microlender if a ceiling is imposed.

Through literature the study also showed the impact of rate ceilings on the availability of cash credit to high-risk borrowers. The borrowers are arrayed along the horizontal axis according to the minimum percentage finance charge at which creditors will be willing to extend to them. A small number of low-risk borrowers comprise the left tail of the distribution of all borrowers. Repayment risk associated with the borrowers' increases outward along the horizontal axis, driving up the minimum loan rate at which those borrowers could be served (chapter 2).

The right hand tail of the distribution represents the highest risk customers in the distribution of all potential borrowers, those whom lenders would be willing to serve only at high interest rates. Should an artificial cap be imposed on loan rates at P , all borrowers to the right would be denied access to the legal market. The higher the risk posed by

credit applicants, the higher the costs to creditors of granting them credit. If the regulators do not allow lenders to charge rates high enough to cover these costs, lenders will not lend to borrowers who would generate these costs.

A rate ceiling does not only ration high-risk borrowers out of the market, but also tends to ration out borrowers seeking small loans. In addition to the costs associated with credit risk, there are administrative costs in granting loans and managing subsequent collections. Since many of these costs are fixed and unrelated to the amount of loans generated, they are proportionately higher for smaller amounts of loans. If these costs are not covered by the permitted finance charge, credit will not be extended, even to low risk borrowers.

The study analysed the impact of interest rate regulation empirically by applying simple and multiple regression techniques to the data obtained from a micro lending company. The main finding of the analysis showed that the interest rate has a significant positive impact on risk. It also showed that the level of rate charged would affect the number of branches, hence on the size of the industry. Rate ceilings tend to prevent new entries into the market, therefore preventing competition and leading to inefficiencies.

According to economic theory, a competitive market is sufficient to prevent lenders from exercising power over pricing or earning more than a normal return. Therefore instead of regulating interest rates a more effective approach to ensure that the rates charged by micro lenders are appropriate is to encourage competition, as this will spur innovation aimed at reducing the risks and costs associated with micro lending. Other findings of the study showed that there is a significant positive correlation between the interest rate and the number of loans per branch. This implies that where the rate is low, lenders would reduce the number of loans, hence supply is rationed.

In fact, interest rate ceilings may well have the opposite effect than intended by government. Instead of being protected against too “high” rates the consumers may have less access to loan finance. This can also lead to rationing by the lenders, thus targeting

the more efficient borrowers with large loans. Once again the poor will be those that suffer the most. An additional effect may be that the poor turn to the “underground” or “informal” lenders who do not obey the interest rate ceilings.

6.4 POLICY IMPLICATIONS

The preceding theoretical and empirical analysis showed that interest rate ceilings have a negative impact on the micro lending market. Many commentators argue that marginal risk borrowers are unaware of high rates, therefore should be protected with a rate ceiling, but Juster and Shay (1968) cited by (Villages, 1982) point out that even with full rate information many poorer risk borrowers would still demand loans at the same rate. This substantiates the belief that, to many borrowers the size of monthly payments is more important than the rate charged.

The fact that borrowers need some form of protection from other practices by micro lenders cannot be ignored, but whether they should be "protected" from paying an economically just price is debatable. It must be realised that this study does not suggest what the optimum maximum rate should be, or whether there should restrictive ceilings at all, but it merely demonstrates what the effect of interest rate ceilings on loan finance could be. The study demonstrated that any rate ceilings would likely effect consumer credit allocation, and that interest rate ceilings have important economic and credit rationing effects on the poor.

When government intervenes between consumers who willing to borrow and lenders who willing to lend, both parties will inevitably seek ways around the impediments placed in their way by the legislation. This is not necessarily either cynical or illegal; it is simply the way of the world. Evasive tactics invariably create additional costs. These costs, which are not productive in any way, will be passed on to customers (not even necessarily those who are borrowing) and to society as a whole. Jonck (1997) highlight the following as the sorts of evasive tactics that can be taken:

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- Lenders going “underground”
- Borrowers resorting to illegitimate lenders, usually extreme loan sharks
- Borrowers buying marketable goods, such as televisions on credit and selling them for cash
- Would be borrowers resorting to criminal activity as a last resort.

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