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THE GRAMEEN BANK MODEL OF MICROCREDIT AND ITS RELEVANCE FOR SOUTH AFRICA

A thesis submitted in partial fulfilment of the

requirements for the degree of

MASTERS IN COMMERCE (FINANCIAL MARKETS)

of

RHODES UNIVERSITY

by

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DEDICATION

This thesis is dedicated to the loving memory of my mother:

Mrs. Abasianyanga S. Edemeka

And to my father:

Mr. S.U. Edemeka

ABSTRACT

Among the reasons for financial exclusion is the fact that the poor, being largely illiterate and unemployed, are traditionally perceived as 'bad credit risks'. This is the dominant perception of the poor in the formal credit markets – a perception that also exists in the microcredit sector. In other words, while information asymmetry is a recognized problem in lender-borrower relationships, lenders consider the problem particularly severe when they contemplate doing business with the poor.

A contrasting paradigm, such as the one adopted by Grameen Bank of Bangladesh, views the poor as possessing economic potentials that have not been tapped – that is, as 'good credit risks'. Grameen Bank's microcredit features appear to have successfully mitigated the problems of information asymmetry and, to a large extent, made it possible for the poor to access microenterprise credit.

Using the Grameen Bank model as a benchmark, this study examined the lending features of private sector microlenders in South Africa and those of KhulaStart (credit) scheme. The aim was to identify how the lending features affect microenterprise credit access. Primary data were obtained through interviews, while relevant secondary data were also used in the study.

A key finding of the study was that while the Khulastart scheme was, like *Grameencredit*, targeted at the poor, the method of its delivery appeared diluted or unduly influenced by the conventional (private sector) paradigm that pre-classifies people as 'good' or 'bad' credit risks. As a result, the scheme was not robust enough to support microenterprise credit access. This has consequences for job-creation and poverty reduction. Based on the findings, the study maintains that a realistic broadening of microenterprise credit access will not occur unless there is a fundamental paradigm shift in microcredit practices, and unless measures designed to mitigate information asymmetries are sensitive to the historical, economic and socio-cultural realities of the South African poor.

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CHAPTER ONE

OVERVIEW OF THE STUDY

1.1 Context of the Study

A major issue with the financial sector is that commercial banks and the capital markets do not satisfactorily perform their 'financial intermediary function of transferring resources from savers to investors' (Annan, 1998:2). Often, due to infrastructure problems, information asymmetry between lenders and borrowers, adherence to conventional, neoliberal commercial banking ethos, and factors in the national policy environment, banks are reluctant to lend to the poor. The result is the exclusion of large groups of people from the financial system. In developing countries, where this problem is particularly severe, the challenge is that of putting in place policies and strategies to bring the excluded into the mainstream of financial and credit services.

In South Africa, the reality of widespread exclusion and unmet demand for financial services and credit extension is glaring (Hawkins, 2001: 32). Although famed for its sophistication (MFRC, 2000:5), with services and standards rivalling those of many industrialized Western countries, the country's financial sector has paradoxically failed to make its products and services available to a vast segment of the population.

A 1998 All Media and Products Survey (AMPS) finding that 58% of the adult South African population had only 'very little access to formal banking' (Hawkins, 2001:30), provides a hint as to the extent of financial exclusion and credit extension in the country. While the microcredit market is ordinarily the last resort for those excluded from formal sector credit, in the South African case, a large number of people, especially the poor, have no access to the services provided in this alternative market. Even so, in the microcredit sector it is not always easy to determine what people *actually do* with the loans they obtain. All this can be summed up in a few key questions. One, how accessible are microcredit services in South Africa? Two, what is the dominant type of credit in the South African microcredit sector and who are the main beneficiaries? Three, to what extent does the microcredit model in use in South

Africa bolster the growth of the microenterprise sector? This thesis seeks to address these various questions.

Research attention is increasingly being focused on the links between microcredit and the growth of microenterprise sector; indeed, on the links between microcredit and poverty reduction. Some have suggested that microenterprise credit is a viable tool for creating employment and reducing poverty, and that this should be the dominant form of microcredit in developing countries (Zeller and Sharma, 2000; Shaw, 2004). Underlining its importance in helping the world's poor to move out of poverty, Mohammed Yunus (cited in Coetzee, 1993:3) refers to microenterprise credit as 'a kind of capitalism from below' and a 'strategy for economic self reliance' (see also Johnson 1992: 275).

Some scholars hold a contrary view, or at best maintain that microenterprise credit should be adopted with caution. For example, Scully (2004:1) and Bates et al (1996) argue that the idea that the poor derive any meaningful benefits from microcredit programmes is a myth, since microloans are usually so small that they can only generate meagre revenues for those who use such loans for business purposes. The persistence of extreme poverty in Bangladesh despite the substantial penetration of microfinance is also sometimes used to challenge the efficacy of microfinance as a poverty-reduction tool (Mcguire et al, 1998; SDC, 2004). Annan (1998:4) argues that without the right complementing packages (such as appropriate technology and skills development) microenterprise credit as a poverty reduction-tool will come to nothing.

According to Fernando (2003), the above limitations do not override the benefits of microcredit. He maintains that microfinance can be made to work for the poor, especially if the state intervenes. However, such intervention must go beyond simply making the 'environment conducive' to microfinance operations: the state must be *actively involved* in the provision of microfinance services.

The first interventionist attempt at broadening access to credit was initiated in Bangladesh in 1976. At first an action research project – known as Grameen Bank Project – the initiative evolved into a statutory microfinance institution in 1983. Its mandate was to provide banking services to the rural poor, eliminate the exploitation

of the poor by informal money lenders, and create opportunities for the unemployed to become self-employed (Grameen Bank, 2004a:1). By reversing traditional banking practices and lending without insisting on collateral, Grameen Bank pioneered a lending model that seemed to be realistically based on mutual trust, accountability, participation and creativity – and thus debunked the general perception that the problem of information asymmetry is necessarily more severe in the microcredit sector (which traditionally services the poor). Arguably on account of these attributes, the bank reportedly recorded, as of 2004, a 99% loan recovery rate and a 100% dependence on own resources for loan finance. It also eliminated the need for future donor support (Grameen Bank, 2004a:1), despite having started out with such support and government subsidies (Morduch, 1999).

In South Africa, the government established Khula Enterprise Finance Limited in 1996 as an intervention agency, with the aim of facilitating access to credit for small, medium and micro enterprises (SMMEs) (Khula Enterprise Finance Ltd, 2001). Although allegedly bedevilled by corruption and lack of sound organisation (Sunday Times, 2001), the KhulaStart scheme is believed to have benefited a fairly large number of microentrepreneurs in the country and helped to create jobs in the informal sector.

Using Grameen Bank as a benchmark, this research examines the lending features of private sector microcredit operators in South Africa. It also examines KhulaStart, the microcredit model upon which it is based, and the operational practices of its retail outlets. The aim is to compare these with the lending features and operational practices of Grameen Bank and also draw some lessons from the Grameen Bank model of microcredit for South Africa.

1.2 Goals of the study

This research examines the Grameen Bank model of microcredit in order to ascertain its relevance in South Africa. Specifically, the research:

1. Explores the KhulaStart scheme and the lending practices of private sector microcredit operators in South Africa.

2. Examines how lending practices affect microenterprise credit access.
3. Examines Grameen Bank's microcredit features and compares these with microcredit practice in South Africa.

In pursuit of the above goals, the study relies on both primary and secondary data. The primary data were obtained through interviews conducted with KhulaStart microcredit outlets in Port Elizabeth and Mthatha, as well as with selected registered private sector microlenders in Grahamstown - all in the Eastern Cape Province of South Africa.

Ten registered private sector microlenders in Grahamstown (out of a total of 15) were selected and interviewed to determine the character of microlending in the private sector. The interview elicited information on, among other issues, loan type, loan eligibility criteria, loan size, interest rates, monitoring of end use of loan, and repayment terms.

The two KhulaStart microcredit outlets selected for the study were Hlumisanani in Port Elizabeth and Libec in Mthatha. The interview sought to identify how the lending features and operational practices of these outlets affect microenterprise credit access in their areas of coverage.

One of the main sources of secondary data on Grameen Bank was a one-hour documentary on the bank done by the cable television network, *Discovery Channel,* which the researcher was privileged to access. Earlier research done on the bank also provided valuable data. Data on specific features of the bank's lending model (such as lending without collateral, group lending, lending to women, and client-seeking) were obtained from the bank's website, and from articles by the bank's founder, Muhammed Yunus. Secondary information on microlending practices in South Africa and statistics from the Microfinance Regulatory Council (MFRC) were utilized to complement the survey of private sector microlending practices.

Using tables and graphs, the study makes a descriptive comparison of the lending features and operational practices of Grameen Bank, KhulaStart and private sector microlenders in South Africa. This helps to show where the main features of the

various microlenders differ, and what aspects of the Grameen Bank model might be applicable in South Africa.

1.3 Structure of the study

This study is organized into six chapters. Chapter two brings into focus the influence of information asymmetry on the provision of formal sector credit, on the design of microcredit products, and on the definition of what constitute 'good' and 'bad' credit risks. It examines information asymmetry and the methods employed in the conventional formal credit markets to mitigate problems associated with it, highlights the peculiar challenges information asymmetry poses to the microcredit markets, and shows how attempts to apply conventional credit risk management measures compound the problems of microenterprise credit access. Overall, the chapter makes a case for moving beyond conventional frameworks and approaches in order to unlock the economic potentials of that segment of the South African population traditionally regarded as a *bad credit risk*.

Chapter three looks at the statutory framework and examines the extent to which microcredit operations help in employment creation and poverty reduction. This is done against the backdrop of what is now commonly referred to as South Africa's 'two economies' – a concept the chapter also critically examines. Some specific features of the South African microcredit industry and the various categories of microlenders are also examined. On the whole, the chapter seeks to show that the present statutory framework for microcredit operations in South Africa not only supports consumption credit but also inhibits the growth of the microenterprise sector.

Central to this thesis is the Grameen Bank microcredit model and its widely reported impact on the microenterprise sector in Bangladesh. Chapter four is devoted to an examination of the lending and operational features of this bank, and in particular, how the revolutionary assumption that people, even the poor, are ***good credit risks until proved otherwise*** drives the bank's everyday microcredit operations. The chapter offers a brief overview of the Bangladeshi economy, traces the history of Grameen Bank, examines some specific organisational and lending features of the

bank, and offers some insights into the ‘successes’ and ‘shortcomings’ associated with the bank’s lending features.

Chapter five is concerned with the presentation and analysis of the various primary and secondary data collected for the study. The chapter analyses the fieldwork findings concerning the lending activities of KhulaStart retail outlets and the registered private sector microlenders in South Africa. Secondary data from the Microfinance Regulatory Council (MFRC) and Grameen Bank are also analysed. Most importantly, the chapter compares the lending and organisational features of the various categories of microcredit operators, and draws attention to some findings concerning the Grameen Bank model that could be of relevance to South Africa.

Chapter six is the concluding chapter. It appraises the research findings discussed in chapter five and comes to specific conclusions based on them. The chapter also highlights the limitations of the research, offers some recommendations based on the findings and also points to some future research directions.

CHAPTER TWO

INFORMATION ASYMMETRY AND ITS INFLUENCE ON LENDING PRACTICES

2.1 Introduction

Among the factors associated with financial exclusion is information asymmetry. This is because the poor, being largely illiterate, unemployed and lacking assets that can be used as collateral, are traditionally perceived as 'bad credit risks'. This perception of the poor is deeply entrenched in the formal credit markets - and it is the main reason the poor find it difficult to access the services provided in this sector. Especially in the developing countries, where the problem of poverty is enormous, and where, in many cases, financial institutions lack adequate infrastructure and the capacity to cater for the financial needs of the population (Kitchen 1986: 115, Schreiner, 2000), banks typically restrict their credit services to those they perceive as having good economic standing. Banks have traditionally mitigated the problems of information asymmetry using standardized measures such as collateral, credit rationing, screening, monitoring and enforcement of restrictive covenants. However, these measures are part of a mindset that pre-classifies people as either *good* or *bad* credit risks.

The problem of information asymmetry is generally believed to be particularly severe in the microcredit sector. This is not merely because information is not available about the target market; that is, people with little or no access to formal sector credit. Rather, it is mainly because lenders in this market do not have information about the productive potentials of the poor, who constitute the majority of those traditionally excluded from formal credit. This chapter - indeed, this thesis - brings into focus the influence of information asymmetry on the design of microcredit products and the definition of what constitute 'good' and 'bad' credit risks. Most importantly, the chapter shows how information asymmetry reinforces the exclusion of the poor from the financial system.

The chapter is divided into five sections. The next three sections examine information asymmetry and the methods employed in the conventional formal credit markets to

mitigate problems associated with it. These three sections also highlight the peculiar challenges information asymmetry poses to the microcredit markets and show how attempts to apply conventional credit risk management measures compound the problems of microenterprise credit access. Section five highlights the imperative of moving beyond conventional frameworks and approaches in order to unlock the economic potentials of that segment of the South African population traditionally regarded as a *bad credit risk*. Concluding remarks are reserved for the last section.

2.2 The Role of Information in the Financial System

For financial institutions to effectively perform their intermediation function, information of reliable quality and quantity is essential. In addition to helping lenders and borrowers to make efficient financial decisions, accurate information helps investors to know what returns their investments would bring (Hubbard, 1997:40). Before granting a loan, a lender wants to have as much information as possible about the potential borrower. This includes information on business involvements, economic assets and reasons for seeking a loan – in short, as much detail as will help the lender to ascertain the applicant's credit-worthiness. On the other hand, potential borrowers know that their chances of obtaining a loan depend on their ability to present as positive a picture as possible about themselves. This 'game' – as Molho (1997:13) calls it – is a common feature of lender-borrower transactions.

Imperfect information is considered a major factor in market failure and missing markets, and partly explains why information disclosure forms a major part of financial regulations worldwide. In South Africa, the Banking Act requires banks to publish their accounting information and make it readily accessible to the public (BCSA, 2004). Although information disclosure in the banking system is often criticized as insufficient - given its critical role in the system - the mandate for banks to publish their accounting information still serves the intended purpose of helping interested parties to make efficient decisions. Independent institutions also have specific requirements. For example, it is compulsory for companies wishing to raise equity capital to comply with specific disclosure obligations (JSE, 2004). As Goodhart (1989:21) has pointed out, 'where sufficient information exists and is freely

available, efficient and successful markets can be established but where this is not the case, markets will not work perfectly'.

2.3 Information Asymmetries in Formal Credit Markets

As pointed out earlier, information asymmetry is a situation whereby important information is not available, or is partially available. Kreps (1989: 8-9) defines it as a situation in which one party 'possessed of superior information, attempts a transaction with a second party who lacks that information'. In a financial transaction, borrowers tend to have an informational advantage because they know more about themselves than the lenders. The situation plays out in the following way: first, borrowers misrepresent their risk characteristics in order to get access to credit and to secure more favourable terms. Second, if the lender views the potential borrower as a *bad credit risk*, unfavourable loan terms will be presented as a way of adjusting for the perceived bad risk. Third, the borrower accepts the terms, not knowing that a high price has been put on his risk status; indeed, he believes he has played his game right!

The most important consequence of the above game, as originally identified by George Akerlof (1970: 495), is adverse selection - also sometimes referred to as pre-contractual opportunism or *market for lemons.* Adverse selection leads to a high probability of loan default. In reality, because of the problem of adverse selection the financial system operates rather cautiously, as though the market were an endless mass of people who lacked the ability or integrity to repay loans, when perhaps there are as many good credit risks as there are bad ones (Mishkin, 2004: 32).

Information asymmetry in the financial system also necessarily brings about a self-fulfilling prophecy known as moral hazard (or post-contractual opportunism). It is often the case that borrowers change their risk profile after they have secured the loan simply because it is difficult, or costly, for the lender to monitor their behaviour. More specifically, there is a high probability that borrowers will undertake business activities that are more risky than first presented. The consequence is that borrowed money does not get repaid in time, if at all. This reality may discourage lenders from giving loans and reinforces the notion of the average borrower as a credit risk. For this reason, Hillier (1997:5) suggests that lenders should monitor the activities of

borrowers after a loan has been granted even if by engaging the services of auditors. Hillier, however, notes that this may raise loan administration costs, and could even introduce legal complications, especially if post-lending monitoring had not been spelt out in the lending contract.

The problems of adverse selection and moral hazard affect the efficient functioning of the credit market (Studart, 1997: 42). They sometimes also give rise to 'financial panic' - a situation whereby 'providers of funds to financial intermediaries withdraw their funds out of both sound and unsound institutions' because they no longer trust the 'health' of the intermediaries (Mishkin and Eakins, 2003: 30). If this situation arises, it may produce large losses for the public and cause serious damage to the economy.

Government regulations help to mitigate the problems of adverse selection and moral hazards in the financial sector. For example, such regulations permit only credible individuals or groups to set up financial institutions (Mishin and Eakins, 2003: 30). Regulations also make financial disclosure mandatory, and define permissible limits within which banks can compete with one another.

On their part, banks and other financial institutions have developed risk management measures for dealing with the problems of adverse selection and moral hazards. These include screening, specialization in lending, monitoring and enforcement of restrictive covenants, long-term customer relationships, loan commitments, collateral and compensating balances, and credit rationing. However, as shown in the next section, the use of these various measures is based on the **underlying assumption** that people are *bad credit risks* until proved otherwise. (Chapter four of this work shows that Grameen Bank's success is principally a function of the bank's revolutionary adoption of an opposite position – that is: people, even the poor, are ***good credit risks until proved otherwise.***) This is the fundamental problem of conventional notions of *credit risk*, and why the poor are always excluded from formal sector credit. It is also the main problem with uncritical adaptation of conventional measures to tackle risk-related problems in the microcredit sector. In other words, some of the measures explained below automatically screen out the poor, and make it difficult for – as the cliché goes - credit to go to where credit is due.

2.3 Conventional Credit Risk Management Measures

2.3.1 Screening

Screening is meant to prevent, or mitigate, adverse selection and is carried out by means of interviews, supporting documentation and other checks on personal risk characteristics of borrowers. Scoring systems are often used to ascertain the credit worthiness of the potential borrower. The higher the score the better the rating and people with the highest scores get the lowest interest rates (Curry, 2003). Also, credit bureaus are used to check the credit history – and, hence, the credit-worthiness - of the potential client. It is highly unlikely that the poor will meet many of the conventional criteria for ascertaining credit-worthiness.

2.3.2 Specialization in lending

Banks sometimes lend only to specific industries or sectors of the economy. Specialization in lending makes them knowledgeable about certain industries, such that identifying 'good' and 'bad' credit risks becomes relatively easier. Over time, this lending relationship provides the banks with a store of information that would otherwise be unobtainable, or obtainable at a considerable cost. Banks prefer this approach not only because it saves the cost of obtaining information about new firms, but also because it reduces the possibility of adverse selection (Rodriquez and Carbo, 2004: 9). Specialization in lending, however, puts the poor outside the reach of formal credit.

2.3.3 Monitoring and enforcement of restrictive covenants

Certain provisions in the loan contract prevent borrowers from engaging in particular businesses. Such provisions include: instructions as to end-use of the loan, prerequisite periodic accounting and income reporting, and prohibitions of behaviour considered risky (Mishkin, 2004:225). Acceptance of the contract means a borrower gives the bank the authority to monitor compliance. This reduces moral hazard.

2.3.4 Long-term customer relationships

Maintaining a relationship with borrowers helps lenders to understand their credit needs and credit-worthiness. It also lowers the cost of collecting information from existing borrowers, and makes it possible for people to access loans relatively easily and possibly at lower interest rates. Generally, borrowers consider long-term customer relationships valuable and may not want to engage in activities that may breach existing trusts. In this way, moral hazards may be reduced (Mishkin, 2004:225).

In cases of severe competition among banks, *relationship lending* may be beneficial in fostering a strong bond between a bank and its clients to the extent that the bank enjoys continuous patronage and loyalty from its clients, and vice versa (Degryse and Ongena, 2003:31). Whether the poor have the formal *credentials* upon which *relationship lending* in its conventional sense can be initiated at all is a different matter entirely.

2.3.5 Loan commitments

Loan commitments are arrangements and obligations that banks enter into with existing borrowers. Essentially it involves banks promising to provide credit to preferred customers whenever the need arises and at an agreed interest rate. This commitment obliges borrowers to constantly and regularly supply the banks with information that could be used in assessing their financial standing or credit needs. Clearly loan commitments are made only to preferred bank customers.

2.3.6 Collateral and compensating balances

This is one of the most frequently used risk management tools – and, arguably, one of the most obvious ways by which the poor are excluded from formal sector credit (Ghosh et al 2000:390). By requiring borrowers to provide collateral - usually property - as security against default, banks not only establish borrowers' credit-worthiness, but also indirectly place a check against reckless use of borrowed funds. Because the borrower knows that the collateral will be forfeited in the event of

repayment default, the likelihood is that he or she will channel the funds only to the contracted business ends.

A related way by which adverse selection and moral hazards are mitigated is that banks require large firms to hold compensating balances, usually a certain proportion of the loan, in the borrowers' account. In the event of loan default, such balances could be used to compensate for losses incurred by the bank.

Although there is no conclusive evidence that collateral is an infallible security against loan default (see Berger and Udell 1990: 40), it has historically been seen as an important tool for mitigating moral hazard in credit-related banking transactions. Such was the fear of moral hazard that some banks in the United States of America in the past encouraged slave trade by asking for and accepting slaves as collateral (*Finance 24,* 2005). Even in pre-colonial Africa, borrowers often pledged their children or relatives as collateral (Law, 1999: 25).

2.3.7 Credit rationing

Through credit rationing banks refuse, in some cases, to issue loans even if the borrower is willing to pay a higher interest rate or accept a smaller loan than required. Large amounts, lenders believe, encourage moral hazard and so credit rationing (despite the obvious effect of reducing bank's profits) help them to manage credit risks.

According to Stiglitz and Weiss (1981:1), credit rationing arises because 'prices do not do their job'. Where the market is in disequilibrium there is bound to be excess demand for, or short supply of, loanable funds. This excess credit demand comprises both potentially good credit risk and bad credit risk. Since prices do not adjust to bring about a new equilibrium, banks ration credit in the short term to be able to cope with these pressures. They, thus, only grant credit to those they consider good credit risks, again effectively excluding the poor.

Finally, conventional credit risk-management measures effectively screen out possible beneficiaries of loans for microenterprises. For example, banks may require

borrowers to provide collateral, or maintain compensating balances, in order to qualify for loans. Potential and existing microenterprise clients rarely have any bankable collateral and the compensating balances may be burdensome (Rhyne and Otero, 1994: 25). Because microenterprises serve a developmental purpose in the economy, Rhyne and Otero urge governments to encourage banks to adapt standards governing loan collateral approval and documentation to accommodate microenterprise credit.

2.4 Information Asymmetries in Informal Credit Markets

Microcredit is informal credit that operates mostly in a non-bank market. It arises mainly because, as earlier shown, the formal credit sector pre-classifies some borrowers as *bad credit risks* and uses the measures discussed above to screen them out. It is against this background that microcredit emerged. Microcredit helps people to meet their short-term consumption needs, and is also an important source of funds for microenterprises. In many developing countries, it is seen as a vital tool for promoting microenterprises, creating employment and reducing poverty.

Information asymmetry is compounded in the microcredit markets because most potential clients of this market are *rejects* of the formal credit sector, and they are rejects mainly because of the conventional assumptions about credit risks and the measures used for risk mitigation in the formal markets. While many microcredit clients are salary and low-income earners, the great majority of potential clients are typically people with no reliable sources of income, no fixed business premises, and no reliable physical addresses. These attributes present information asymmetry. Lenders prefer to deal with people that can be easily traced to places of employment or residence, and people with regular income streams. People that do not meet these parameters are considered special cases of adverse selection and moral hazard. Ironically, potential microenterprise borrowers are the ones most often seen in this light.

As the data in Chapter Five of this work show, loan products in the microcredit sector are often designed in such a way that they do not get entangled in the problems of asymmetrical information. Indeed, this explains the dominance of *consumption credit*

as the *preferred* type of microcredit in South Africa: consumption credit clients are mostly people in formal (government and private sector) employment. It may even be argued that the South African microcredit sector flounders because of its *unwillingness* (MFRC 2000) to mitigate the problems of adverse selection and moral hazards and open up the microcredit sector to microenterprise borrowers.

As indicated earlier – and demonstrated with empirical and secondary data in Chapters Four, Five and Six of this work - the South African microcredit sector operates largely with the same fundamental assumptions of the conventional (formal) lending sector: it sees the poor as *bad credit risks,* to be either avoided or courted with caution. Because people are assumed as 'bad credit risks' until proved otherwise, the South African microcredit sector faces a major challenge of developing lending and credit management mechanisms that effectively bring the poor into the mainstream of economic activities.

2.7 Conclusion

This chapter has examined the problems associated with information asymmetries in both the formal and microcredit sectors. It has showed that in trying to tackle the problems of information asymmetry, institutions in the formal financial sector have over time developed measures that have had the consequence of excluding the poor from formal credit. The chapter pointed out that these measures are rooted in the conventional notion that the poor are bad credit risks – an assumption that also drives lending practices in the microcredit sector.

Proper microcredit intermediation is essential to stimulate economic activities in the historically excluded segments of the South African population. If microcredit were principally for short-term consumption purposes, there would be little point in going beyond conventional lending practices and risk management techniques. Indeed, there would be little point in portraying microcredit as a tool for employment creation and poverty reduction.

CHAPTER THREE

THE SOUTH AFRICAN MICROCREDIT INDUSTRY AND ITS STATUTORY ENVIRONMENT

3.1 Introduction

According to the 2000/2001 *World Development Report,* lack of access to financial services (such as savings and credit) is one of the principal causes of poverty (World Bank 2001). The further away people are from the financial services available in an economy, the report points out, the greater the likelihood that they will sink into poverty. The concept of microfinance emerged as a strategy to bring the excluded into the mainstream of financial life, and has been utilized in different countries with varying degrees of success.

The main objective of this study, as stated in Chapter One, is to examine existing microlending practices in South Africa as they affect access to microenterprise credit. In line with this, the present chapter examines the statutory framework for microcredit operations in the country and its influence on actual practices. The section immediately following overviews some features of the South African economy, with a special focus on what is now commonly termed 'two economies'. This puts the role of microcredit in perspective. Section three sketches the history of the South African microcredit industry, and examines the statutory framework for microcredit operations in the country. Section five discusses the various categories and modes of operation of microlenders in the country. On the whole, the chapter seeks to show that the present statutory framework not only supports consumption credit but also inhibits the growth of the microenterprise sector.

3.2 The South African Economy – An Overview

The World Bank (2004a) classifies South Africa as a middle-income country, with characteristics associated with developing economies. Although having a per capita income of $2,610 (the fourth highest in Africa), South Africa is currently the world's most unequal country (Bauman, 2001: 4). Thirteen percent of the population (about 5.4 million people) live in 'first world' conditions while 53% of the population (about

22 million people) live in 'third world' conditions. The basic cause of widespread poverty in the country is its apartheid history. Before 1994, the population was divided into racial groups – with whites enjoying all privileges and the black majority 'relegated to stark, inhumane servitude' (World Bank, 2004a). The post-apartheid government is thus faced with key challenges of reducing inequality and poverty, and tackling unemployment, which is regarded as among the highest in the world. It is also faced with the task of correcting these historical imbalances by 'channeling resources towards developing the informal sector, focusing on education and training, job creation and small business assistance' (World Bank, 2004a).

In 1996, the government adopted a Growth, Employment and Redistribution (GEAR) strategy, with the aim of fostering a more balanced economic growth. Although the government has ensured macroeconomic stability through this strategy, some analysts believe that the goals of GEAR have remained largely unrealized, and that GEAR is out of touch with the unique South African situation. GEAR, the argument goes, promotes reduced government expenditure, which implies reducing expenditure on social welfare programmes upon which the poor ordinarily rely as a safety net (Roux, 2002:169). Others like Kingsnorth (2004) believe that GEAR has brought about more job losses than anticipated.

South Africa has a strong formal sector. By contrast, the informal sector is underdeveloped, and stimulating it has remained a difficult task for both the government and the private sector. Informal businesses are run by low-income and self-employed people, commonly operating from inelegant surroundings. These businesses are generally patronized by low-income people and the unemployed. Toomey (1998:56-58) identifies retail bias and lack of sufficient human capital as factors that inhibit the growth of this sector. While the Department of Trade and Industry's (DTI's) policy framework for the development of Small, Medium and Micro-Enterprise (SMME) sector in South Africa recognizes the need to create vibrant SMMEs within the manufacturing sector, existing structures seem to support only the retail sector, especially those one might refer to as *survivalist retailers*. Yet, manufacturing has a greater survival and employment potential than retailing (Toomey 1998:56-58). The country's relatively strong social welfare sector has also been criticized as hampering the development of entrepreneurial skills in the large

segment of the population currently drawing social welfare support from the government. In a word, the growth of the microenterprises will strengthen the SMME sector as a whole, and this depends, to a large extent, on the availability of skills and broad-based access to credit.

3.2.1 South Africa and the concept of 'two economies'

The term 'two economies' is now popularly used, especially in South African political circles, to describe the obvious contrast between the country's sophisticated 'first world-like' industrial, mining, agricultural, financial, telecommunication and transport sectors, and the 'third world-like' informal and underdeveloped sector. While this phrase appears a simple and straightforward way to describe the contrast, the reality of that contrast is not that simple. Although this work will not delve into the debates surrounding this concept, it suffices to say that the 'two economies' concept is derived from the dualist theory of economic growth as formulated by Arthur Lewis. The theory erroneously saw developing countries as characterized by *two* sectors, each governed by a different set of laws:

> These are the so-called 'traditional'/'subsistence' and 'modern'/'capitalist' sectors. The former is supposed to be characterized by surplus labour, unchanging production techniques and zero net savings. In contrast, efficient labour utilization and high savings rates are believed to be the diagnostic features of the modern sector. Within this basic schema growth is construed as a gradual shift from the 'traditional subsistence' sector to the 'modern capitalist' sector. In the transitional period it is ascribed to the 'subsistence' sector the role of labour supplier and to the 'capitalist' sector the role of creator of employment opportunities through progressive capital investments, accumulation and introduction of advanced technologies (Mafeje 1978:48).

The main problem with the 'two economies' thesis as used by government functionaries in contemporary South Africa is the same problem that trailed Arthur Lewis's and other modernization theorists' use of the concept, and it should be emphasized in this work that the so-called 'two economies' developed ***not autonomously,*** but through a ***relationship*** in which the 'subsistence'/'traditional' economy was *forced* by colonial and apartheid forces to function as a pool of cheap migrant labour for the 'modern' economy.

In other words, there are no 'two economies' but two branches of the same economy; the 'second' branch created by the first branch and used by that branch for its own advancement. The 'second' branch *has remained* subsistent and underdeveloped mainly as *a consequence* of the logic of this relationship. Seen in this light, the notion, according to Mbeki (2003), that the 'second' economy contributes nothing to South Africa's wealth is not exactly correct. The country's wealth is created by *both* the sophisticated formal sector and by millions of people in the second branch of the economy (farm workers, factory workers, domestic workers, mine workers, and rural women who raise the children of absentee fathers, etc.). For the purposes of this research, the concept of 'two economies' serves to highlight the fact that the South African financial system was deliberately developed to exclude those who inhabit the 'second branch' of the economy, a situation that has remained substantially unchanged since the end of apartheid in 1994. The concept also serves to highlight the role that microcredit could play in job-creation and poverty reduction, alongside job-creation initiatives like the expanded public works (EPW) programme (Mbeki, 2005).

3.2.2 Microcredit and poverty reduction

The South African microenterprise sector comprises microbusinesses and survivalist businesses. The Department of Trade and Industry (DTI, 1998) defines a microbusiness as one that employs less than five people and has a turnover of not more than R150,000. This amount exempts such a business from value added tax (VAT) registration. Spaza shops, mini taxis, and home-based industries are examples of microbusinesses, and over 75% of these businesses are located in four provinces, namely Gauteng (34%), Kwa-Zulu Natal (18%), Western Cape (14%) and Eastern Cape (10%). Together they account for about 6,8% of employment in the country (DTI, 1998).

Survivalist businesses, on the other hand, are those businesses with no paid employees, often with revenues below the minimum income standard, and which operate at subsistence levels. Examples are hawkers, petty traders, and subsistence farmers. Kwa-Zulu Natal, Gauteng, Eastern Cape and Limpopo provinces account for about 72% of survivalist businesses in the country. It is estimated that these businesses contribute approximately 3,0% of employment in the country (DTI, 1998).

Clearly, the South African microenterprise sector is struggling. In terms of both the quantity and quality of employment it creates, the sector does not at present play any significant role in poverty reduction. The general consensus among development experts (Shaw, 2004:1, Morduch and Haley, 2001) is that broad-based access to credit is one of the keys for lifting the microenterprise sector above subsistence levels. Muhammad Yunus (2004e) puts it bluntly: 'if financial resources can be made available to the poor… on terms and conditions that are appropriate and reasonable, these millions of small people with their millions of small pursuits can add up to create the biggest development wonder'. This assertion is supported by data from India, El Salvador, Vietnam and Bangladesh.

In India, one NGO, Society for Helping to Awaken Rural Poor through Education (SHARE), has reported that about 50% of its clients have graduated out of poverty. In El Salvador, the weekly income of FINCA clients increased on average by 145%. In Vietnam, clients of a **Save the Children** partner organization reduced food deficits of their clients from three months to one month (CGAP, 2002). In Bangladesh, Grameen Bank clients experienced changes in income, employment, and increases in assets - more than households without microenterprise credit access. There was also improvement in nutrition, wage increases and school enrollment of children in households that accessed Grameen Bank credit (World Bank, 1994). This echoes Wright's (2000:14) assertion that apart from reducing poverty, microcredit improves the welfare of participating households and also enhances their capacity to sustain improvements in living conditions over time.

In Bolivia, BancoSol has recorded significant successes in its microenterprise credit programs. By 1992, it had reached more than 650,000 clients, whose quality of life has reportedly improved (Koenigsfest, 2001). In its 1997 report, the Asian Development Bank (ADB) also affirmed that microenterprises reduces poverty, empowers women, generates employment and leads to the growth of the microenterprise sector, which the Bank considers to be an end in itself.

There are, however, contentions around the poverty reduction potentials of microenterprises. Some researchers believe that although there should be broad-based access to microcredit for productive purposes, the 'very poor' are not always reached because microcredit programmes are not always designed in such a way as to make

them accessible to the poor. For Scully (2004:1) and Bates et al (1996), the idea that microcredit programmes help the poorest of the poor or that microenterprises reduce poverty is a myth. Their argument is that microloans are usually so small that they can generate no meaningful revenues. It has also been argued that despite the substantial microfinance penetration in Bangladesh, about 50% of the population are poor (Mcguire et al, 1998; SDC, 2004). Annan (1998), therefore, suggests that microenterprise credit should be complemented with aggressive programmes aimed at promoting appropriate technology, markets and skills, and ADB (1997) cautions against promoting microenterprise credit at the expense of education, healthcare and sanitation – all of which are crucial for poverty-reduction.

As one of its millennium development goals (MDGs), the United Nations seeks to halve poverty by 2015 (UNDP, 2004). However, it is believed that without broad-based access to savings and credit, it will be impossible for the poor to achieve the MDGs on their own terms (CGAP, 2002).

That there is wide research support for microenterprise credit as an employment creation and poverty alleviation tool is not to underplay the importance of other needs of the poor, such as skills and improved links to buyers and suppliers of goods and services (Toomey, 1998). However, arguments that the poor lack motivation to successfully manage a business and, hence, should not be further burdened with loans (Adams and Von Pichke, 1992: 1468; Zeller and Sharmer, 2000; Scully, 2004: 1; Bates et al, 1996; Mcguire et al, 1998) should be viewed with caution, as they could be based on a faulty assumption that the poor cannot be productive no matter what. Such views ignore the fact that in many developing countries, the microenterprise sector – with its foundations laid on the economic pursuits of the so-called 'unproductive poor' - actually serves as a *safety net* for people displaced or not adequately accommodated by the formal economy.

In Nigeria, for example, research has shown that were it not for what some scholars call the 'social cushion' role of the vibrant microenterprise sector, the Nigerian economy would have collapsed in the face of decades of mismanagement, corrupt leadership, massive retrenchments, unemployment and poverty (Ukpong 1996: 140). However, the Nigerian microenterprise sector has remained vibrant in spite of the

absence of microcredit. The argument, therefore, should not be whether the poor need microenterprise credit, or whether financial assistance would further stunt their ability to be productive. Rather, the argument should be whether the statutory framework guiding microcredit operations is one that promotes broad-based microenterprise credit access and discourages opportunistic lending.

Some points need to be made at this point concerning interest rate - or indeed, the cost of borrowed capital - as it is an issue that is frequently raised by some analysts who believe that microenterprise credit will further hurt the poor (see Adams and Von Pichke, 1992: 1468). The issue of interest rate is a concern not only to prospective borrowers, but also to people wishing to invest in interest-yielding banking products. The notion that microenterprise hurts the poor is hinged on the fact that if the cost of capital is high, expected returns on investment will be low (Rose, 2003:118), which then increases the probability of loan default. It is also a fact that microentrepreneurs, being poor, are sometimes desperate to obtain credit to start a business or expand an existing one, and, therefore, will accept unfavourable credit terms (Ledgerwood 1999:138). This eventually could lead to loan default, and could even plunge them into a debt trap. Finally, because the poor lack collateral, the immediate recourse of lenders is to ‘price for the risk’ (Joffe, 2003a), which then arbitrarily raises the cost of borrowed funds.

These concerns often lead to the debate that interest rates should be subsidized if microentrepreneurs and indeed the poor are to benefit from microcredit. Meyer and Nagarajan (1997:4) argue that interest rate subsidies will only favour the wealthy who already have access to other forms of credit. Adams and Von Pischke (1992:1465) share this opinion. They illustrate that experience in the 1950s and 1960s showed, especially in the formal financial markets, that subsidized interest rates only encouraged those with no financial difficulties to capture the loans. Others like Mohane et al (2002:4) believe that subsidizing interest rates can distort the market, limit growth and encourage dependency. Therefore sustainable interest rates must be charged in order to cover all the necessary cost, while providing additional capital to support further credit demands.

The above concerns and debates only underscore the imperative of having a regulatory framework that recognizes the developmental potential of microenterprises and the need to direct the microcredit sector towards realizing that potential.

3.3 Statutory Environment of Microcredit in South Africa

Although microcredit has a long history, in its official form, it is one of the newest businesses in South Africa (Niekerk, 2002:2). It could be traced to the 1992 Usury Act Exemption Notice, which exempted loans of less than R10,000 from its demanding provisions. The aim was to open up the credit market to small borrowers (Mohane et al, 2002: 1). In the last few years, the sector has experienced what Niekerk (2002: 2) calls 'rapid expansion', a phenomenon he attributes to 'pent up demand' from people hitherto excluded from mainstream credit services. The reality, however, is that the 'rapid expansion' has not translated to *broad-based expansion*, because the 'expansion' has only occurred within the salary-earning segment of the population. The 'pent-up demand' has also occurred mainly within this segment. In other words, the *pent-up demand* in the historically excluded segment of the population remains largely unaffected by the 'expansion'.

What further brought about 'expansion', as Niekerk (2002:2) acknowledges, was the fact that microlenders were allowed access to the government's payroll system (Persal), which made it possible for borrowed funds to be deducted from borrowers' salaries. With the guarantees of the Persal system, microlenders 'grew' their book rapidly and charged excessive interest rates, and in the process borrowers became over-indebted. The ensuing crisis of reckless interest charges and over-indebtedness of civil servants made government, in 2000, to stop the use of the Persal system for loan recovery. It should, however, be noted that government employees still form the bulk of the clientele of the microlenders (Niekerk 2002:2, Meagher and Wilkinson 2001).

That civil servants and other salaried individuals constitute the preferred clientele of microlenders is an indication that the South African microcredit sector has a strong consumption bias (see Section 3.4 below). This bias has its roots in the statutory/regulatory framework guiding operations in the microcredit sector.

3.3.1 Microfinance Regulatory Council (MFRC)

The Microfinance Regulatory Council (MFRC), established under the Usury Act Exemption Notice of June 1 1999, was one of the major steps towards streamlining the South African microlending sector, monitoring the activities of microlenders and protecting the interest of borrowers. The Council is incorporated under Section 21 of the Companies Act and recognized as the official and single regulator of all money lending transactions that fall within the scope of the Usury Act Exemption Notice of June 1, 1999 (MFRC, 2004a). All microlenders are required to register with the MFRC in order to be entitled to the exemptions of the Usury Act, such as freedom to determine their lending rates.

The Usury Act Exemption Notice allows the Finance Minister to make regulations in respect of lending, credit, leasing transactions and interest rate charges on amounts below R10,000. The new regulations compelled micro-lenders to belong to the MFRC, which is a self-funded 'regulatory institution'. MFRC would register and accredit microlenders, monitor and enforce compliance, handle complaints, educate the borrowing public, and provide the Minister with an annual report on its membership and activities (MFRC, 2004a). Exemption from the requirements of the Usury Act provisions is conditional on lenders adhering to the rules set by the MFRC.

However, registered microlenders began to take advantage of their exemption from the provisions of the Usury Act by charging interest rates of *more than ten times* the prime lending rate on loan amounts under R10,000 (Ensor, 2003). An attempt by MFRC to cap the interest rate at ten times the prime lending rate met with resistance from the microlenders, as they considered it too low. In 1999, they successfully challenged the MFRC in the high court, on the grounds that a low interest rate ceiling would drive them out of business (Ensor, 2003).

What is not obvious from the above interest rate contestations is that by giving microlenders the freedom to decide what interest rates to charge on loan amounts below R10,000, the law inadvertently closes the door against people requiring credit for microenterprise purposes. This is because microenterprise credit is interest rate-sensitive, and a high interest rate regime ordinarily makes it difficult for businesses – especially microbusinesses - to break even. Microlenders know this, as well as the

fact that a flexible interest rate regime, which best serves their purposes, makes sense only if credit is for short-term consumption. This may be the hidden dynamic behind MFRC's (1995) insistence that South Africa 'accept the reality of consumption finance'.

The exemption of loans of below R10,000 from Usury Act regulation and the inadvertent legitimisation of exorbitant interest rate charges raise an important question: who really is the Usury Act Exemption Notice protecting? It becomes difficult to pinpoint the regulatory function of the Exemption Notice, especially when in everyday microcredit operations, some lenders charge a monthly interest rate of as high as 40% while others charge only 10% (see Chapter 5 of this work). Joffe (2003b) has argued that with such a wide differential in the interest rates charged by lenders, the Usury Act Exemption Notice is of no use to the borrowers. The regulation stifles innovation in the low-income credit market, and does not address the indebtedness problem of 'unsophisticated borrowers'.

MFRC moved to address the problems of reckless lending and over-indebtedness through the introduction, in 2001, of a National Loans Register (NLR), a database of people that utilise microcredit services (MFRC, 2004b). The new 'reckless lending rule' mandated microlenders to refer to the NLR before granting loans, so that new loans would not be issued to already indebted persons. It also put the responsibility on lenders to avoid situations that would lead to bad debts, as well as ensure that loan repayment instalments did not wipe out borrowers' normal living expenses.

However, as of 2004, only about sixty percent of the 1388 registered microlenders were on the National Loans Register (Experian, 2004), because some microlenders felt that disclosing information about their clients amounted to a breach of confidentiality. Some microlenders even sued the MFRC for making the so-called 'reckless lending rules' compulsory (Clayton, 2004). This attitude may not be difficult to explain. Microlenders know only too well that disclosing information could drive their clients to competitors. But some lenders could also be capitalising on the Usury Act Exemption to exploit borrowers, especially by issuing multiple loans - in so far as each loan is below R10,000 - and charging multiple administration and insurance fees. Such a practice becomes even easier if lenders could have the

loans linked to borrowers' salary accounts such that repayment becomes a matter of having the relevant instalments deducted at source!

The powerlessness (Maposa, 2001) of the MFRC in enforcing its rules could be an indication that the Council is caught in its own contradictions. By accepting what it calls the 'reality of consumption finance' and promoting it as the South African 'microfinance benchmark' (MFRC 1995), the Council overlooks the fact that a microcredit model that is essentially focused on consumption (as opposed to production) will tend to encourage opportunistic and exploitative lending. The reason is that being targeted at government and private sector employees and pensioners (that is, people who are considered 'good credit risks') consumption finance does not readily run into the conventional problems of adverse selection, and thus is relatively easy and cost-effective to administer. Indeed, the present regulatory and operational environment of microcredit in South Africa is little more than an institutionalised system of emergency salary advance.

3.4 Microcredit Practice in South Africa

Although there is no universally accepted definition of the word 'poor', the term is used in this work to refer to low-income earners - whether employed, self-employed, or unemployed. Ordinarily, the credit needs of the poor include short-term consumption finance and micro enterprise credit. Consumption finance comprises education-related loans, loans for the purchase of household assets, as well as credit meant for building renovation. In many countries, microcredit has increasingly come to mean *microenterprise credit* as opposed to consumption credit. What this means is that microfinance is increasingly defined as small loans for productive purposes.

Consumption credit may satisfy an immediate need; however, in most cases, the economic condition of the beneficiary remains largely unchanged. Some scholars, like Zeller and Meyer (2002:4), support the idea of consumption credit on the grounds that the poor need some form of consumption smoothening. To these authors, it is only after consumption needs have been met, can microcredit be used productively. However, an acceptance of this view at the regulatory level could mean wasting the productive potential of microcredit. Besides, only people with regular income streams (such as government workers, most of whom are unlikely to engage in

business) constitute the target market of consumption credit, and the poor can never hope to access it (Schreinder et al, 1995).

3.4.1 Private Sector Microlenders

In South Africa, consumption finance is the main product offering of ***registered private sector*** microlenders. Lenders in this category include banks, private companies, close corporations, trusts and co-operatives. According to Niekkerk (2002: 26-27), private sector microlenders avoid microenterprise credit for reasons associated with high transaction cost, high risk, low returns, low volumes of business, and lack of subsidy. It is also believed that banks do not yet have the requisite 'specialized knowledge' for dealing with recovery of small loans, and that the legal instruments to deal with defaults are not yet properly developed. There are about 1388 private sector microlenders with a total of 7232 branches in the country (MFRC, 2004d). These lenders control over 90% of the South African microcredit market (MFRC 2004d).

Another category of private sector microlenders comprises lenders operating outside the direct regulatory control of MFRC, because they are not registered with the Council. ***Unregistered private sector lenders*** include *stockvels,* pawnbrokers and township lenders. Like their registered private sector counterparts, they do not offer microenterprise loans but focus on the (emergency) needs of people left out of the service of the registered microlenders. Many unregistered microlenders, like those operating in the townships, have no fixed premises and no listed telephone or telefax numbers. They do not observe fixed business hours and usually visit their clients at predetermined places and times. Some can be found at factory gates, under trees, on shop floors, in office complexes, operating from cars, in farms and virtually everywhere. Indeed, many prefer not to be identified by any other persons than their clients (Du Plessis, 1998 in Niekerk, 2000:14). Pawnbrokers, who typically keep clients' assets as security, operate retail networks, selling new and second-hand goods - often items confiscated from loan defaulters (Niekerk, 2000:15).

The clients of unregistered private microlenders include very low-income earners and the informally employed, who may or may not have bank accounts. Security is vital in this sector and this could range from personal belongings to identity documents and

pin codes. (It should be noted here that MFRC prohibit its members from securing loans using these methods). Pawnbrokers, as earlier mentioned, sell defaulters' pledged assets to recover costs, although transportation, storage and insurance costs often make this approach both burdensome and unprofitable. Unregistered microlenders often resort to illegal measures to ensure loan repayment (Niekerk, 2000:15).

Despite the obvious risks of lending and borrowing in the unregistered microcredit market, the sector survives because, probably more than anything else, the microlenders are often part of the communities they serve. As opposed to banks and other registered private sector microlenders (who may seem a bit formal and distant), the unregistered microlender appears to the average borrower as an everyday person willing to assume the risks that formal microlenders avoid. It matters little to the potential borrower that interest rates in this field of alternative finance are sometimes substantially higher and the operations a lot more complicated.

3.4.2 NGOs and MFIs

Non-governmental organizations (NGOs) and other non-profit lenders collectively known as microfinance intermediaries (MFIs) also provide microcredit services in South Africa. Both groups are registered with MFRC as ***Section 21 companies.*** Indeed, NGOs and MFIs must be registered with MFRC for them to legally offer microcredit services. Because of the pro-poor and 'developmental' nature of their activities, they are mostly located in the rural areas and in townships – that is, in close proximity to their target clientele. They typically provide loans for small business start-up and expansion, as well as credit for the construction of low-cost housing. There are about seventeen NGOs and MFIs (operating from fifty-four branches) in South Africa (MFRC, 2004d).

South African non-profit microlenders source their funds from government and other domestic sources, as well as from foreign donors. As with most NGOs operating in other sectors, they are often constrained by the preferences and prescriptions of fund donors. This hampers their effectiveness by rendering them inflexible and unable to respond to realities they encounter in the field. This is in addition to the fact that the interventionist activities of most NGOs in developing countries are hobbled by lack of

funds, donor dependency, lack of expertise and low productivity. The prevalence of bad debts in this sector, and the traditional view that the operations of NGOs are not sustainable, are to a large extent predicated on these constraints.

According to Bauman (2003), the problem of skills shortage in the South African economy is even more severe in the non-profit microfinance sector. Operators in this sector find it extremely difficult to attract qualified staff, let alone have the right incentives for people to work in the rural areas. Bauman argues further that the South African educational system does not sufficiently cater for microfinance related skills because development courses in the universities are theoretical, general and geared toward urban issues such as trade unionism. The result is that most microfinance training in the country occurs on-the-job and staff poaching among competitors is rampant.

But the constraints of funding and staffing only partially explain why NGOs and MFIs in South Africa do not adequately reach the poor and the poorest of the poor. Despite claims to the contrary, many non-profit lenders do not seek to reach the 'very poor' as a matter of policy (Bay Research and Consulting Services, 2003). The problem of asymmetrical information casts the 'very poor' as *bad credit risks.* Non-profit lenders – even those claiming to be Grameen Bank replications (Maykuth, 2003) - circumvent this problem by designing their lending methodologies in such a way as to select out this segment of the target market.

3.4.3 Khula Enterprise Finance

The direct involvement of government in microcredit in post-apartheid South Africa dates back to 1996, with the establishment of Khula Enterprise Finance Limited as an agency of the Department of Trade and Industry. The primary role of Khula Enterprise Finance was to facilitate access to credit for SMMEs through commercial banks, retail financial intermediaries (RFIs) and microcredit outlets (MCOs) (Khula Enterprise Finance Ltd, 2004a). It also provides mentorship to entrepreneurs in various aspects of business management.

Of particular interest to this study is Khula Enterprise Finance's involvement with MCOs and RFIs, which are the retail outlets that service the microenterprise sector. This involvement is formalized through the company's microcredit scheme known as

KhulaStart. In reality, many of the MCOs and RFIs are outlets created by existing NGOs and community-based organizations (CBOs) specifically to administer KhulaStart loans. The reason for this is that a number of NGOs and CBOs - especially those already providing business training and advice to local SMMEs - already have established presence and links within the community and can easily, at least in theory, reach the categories of borrowers that the KhulaStart scheme targets.

The KhulaStart scheme is based on the United Nations model of microcredit, which in turn is based on the Grameen Bank model. Thus, it targets South Africa's historically disadvantaged communities, particularly women in rural and semi-urban areas. At least 70% of KhulaStart loans are given to women (Enterprise Finance Ltd, 2004b). KhulaStart sets the lending policies that guide the operations of the MCOs and RFIs it works with. For example, the group lending methodology employed by the various retail outlets is policy of Khula Enterprise Finance, and it derives from the United Nations/Grameen Bank model mentioned above.

A major weakness of the KhulaStart scheme is that the number of retail outlets the scheme utilizes is abysmally small. As at 2004, only about 17 MCOs and 20 RFIs were in operation nationwide (Enterprise Finance Ltd, 2004b). Because of the country's history of segregation and exclusion, the microenterprise credit need of South Africa is huge, and requires extensive, even revolutionary, intervention if any visible impact on employment creation and poverty reduction is to be felt. Also, as shown in Chapter Five, there is more to the inadequacies of the KhulaStart scheme than the mere fact of limited number of retail outlets.

3.5 Conclusion

The view that the South African microcredit industry has experienced 'rapid expansion' in the last few years may appear to be true when observing only the total value of loan disbursements (see Table 1). However, such statistics of 'rapid expansion' disguises the fact that over 95% of disbursements involves transactions that may well be described as institutionalised salary advance. The great majority of South Africa's historically excluded continue to subsist on the margins of even the microcredit sector. The reason for this is that the regulatory framework for microcredit operations in South Africa, being overwhelmingly biased towards

consumption, promotes a lending model that is anti-poor. A contrasting approach to microcredit is the model adopted by Grameen Bank of Bangladesh, and this is examined in the next chapter.

CHAPTER FOUR

GRAMEEN BANK

4.1 Introduction

As indicated in Chapter Two of this work, probably the most *revolutionary* thing about Grameen Bank vis-à-vis conventional banking practice is its assumption that people, even the poor, are ***good credit risks until proved otherwise.*** The main purpose of this chapter is to examine how this assumption drives the bank's everyday microcredit operations, and in particular, how this underlying assumption is embedded in the bank's organisational and lending features. More importantly, the chapter shows that a good understanding of a society's social and cultural norms is indispensable if microcredit operators are to address the problems of adverse selection and moral hazard, and at the same time broaden access to credit, especially for microenterprise purposes.

The rest of this chapter is structured as follows: section two offers a brief overview of the Banglasdeshi economy, while the third section traces the history of Grameen Bank. In the fourth and fifth sections, the organisational and lending features of the bank are examined, while section six offers some insights into the 'successes' and 'shortcomings' associated with these features. Section seven examines the possibility, using the BancoSol experiment in Bolivia, of blending the developmental underpinnings of nonprofit microfinance with the commercial ethos of conventional banking to lay the foundation for a new microcredit paradigm.

4.2 Economic Overview of Bangladesh

Compared with South Africa, Bangladesh (literally: 'land of the Bengalis') is poor, overpopulated and ill-governed (Geography IQ, 2004). At least 80% of the country's 135 million people live in poverty, which makes it the poorest country in South Asia and one of the poorest in the world (World Bank, 2004b). Its economy is largely agro-based, and agriculture employs about 74% of the country's workforce. Rice, of which Bangladesh is the world's fourth largest producer, is the single most important agricultural product (UNCDF, 2004, Geography IQ, 2004). Other crops, like jute, sugar cane, tobacco and wheat are also produced UNCDF, 2004; Geography IQ,

2004; Lye, 2000: 33). The service sector, however, generates half of the country's GDP.

Besides economic mismanagement and poor institutions, Bangladesh's poverty is largely blamed on its history. Before independence on March 26, 1971, Bengali East Pakistan (the region that was to become known as Bangladesh) was a deeply marginalized region of Pakistan. Three decades of domination and marginalization by West Pakistan led to economic stagnation and degradation in the Bengali region. By the end of the 1960s, widespread discontent and agitation in the region had reached a point where the Bengalis felt only an armed rebellion would lead to their liberation from the Western Pakistanis:

> In the fall of 1970, a powerful opposition movement emerged in East Pakistan. During the 1971 civil war, a number of factional paramilitary bands, which included communist forces dedicated to a rural-based revolution along Maoist lines, fought against each other and engaged in terrorism. The strongest of the new paramilitary bands, and the one that would have the greatest impact on future events, was organized under the Awami League's military committee headed by Colonel M.A.G. Osmany, a retired Pakistan Army officer. This band was raised as [Sheikh Mujibur Rahman's, or] Mujib's action arm and security force. As the political struggle between East Pakistan and West Pakistan intensified, the Awami League's military arm assumed the character of a conventional, albeit illegal, armed force (Heitzman and Worden, 1988).

After independence, the country was saddled with the devastation caused by economic exploitation during the Pakistan era and the destruction of 'critical infrastructure' during the War of Liberation (Virtual Bangladesh, 2004). Also, the 1970 cyclone (the worst of its kind in the world, in which over one million people died), the 1974 famine, the devastating floods of 1988 and 1998, the Tsunami flood of December 2004, and periodic storms have become part of the country's chronicle of natural and social disasters, contributing significantly to Bangladesh's endemic problem of poverty (Lye, 2000: 32).

There are, however, reports that poverty levels are declining in Bangladesh, especially among the poorest of the poor. The declines are attributed to factors such as increased access to microcredit among farmers, and other intervention activities by the nonprofit sector. Although many microcredit programmes have tended to encourage a shift from agricultural microenterprises to petty trading, microenterprise loans are mostly used for agricultural purposes (USAID, 2004).

It should be mentioned here that microfinance, as a specialized subfield of development economics is only about three decades old. According to Bell (1989: 1), although the post-World War II period aroused the interest of developed nations towards conditions of poverty, illiteracy, disease and mortality, in countries that were then considered 'agrarian', never was it then conceived that credit could be used as one of the tools to fight poverty. Bangladesh is regarded as the first country where microcredit has been used as a poverty-reduction tool, although there have been disagreements as to its impact on the overall poverty levels in the country.

4.3 History of Grameen Bank

In 1976, Muhammad Yunus, then Professor and Head of Rural Economics at Chittagong University at Jobra, Bangladesh, started Grameen Bank as a research project. His aim was to examine the possibility of designing a credit delivery system that would provide banking services to the poor (Yunus, 2004a). The project began at Jobra and during 1976-1979, was extended to some of the neighbouring villages. One of the strongest propelling factors for the establishment of Grameen Bank was the 1974 famine in Bangladesh in which hundreds of thousands of people died. The level of human suffering has been recorded in a Television documentary:

> [I saw] skeleton-like bodies… Young people looked very old; old people looked like kids. And they were going from their… kitchens to find some food to eat so that they could survive for another day… So you wonder: 'why don't people have enough to eat?' I [became] totally frustrated with the textbook economics that I was teaching my students, and the reality that I [saw] outside. But as an economist I [couldn't] have anything to do, other than, as a human being, to make myself useful to other human beings (quoted in Discovery Channel, 2003).

Given this reality, Muhammed Yunus embarked on a regular tour of the village in order to further familiarize himself with the reality of poverty at Jobra, and it was on one such occasion that he made a simple observation that was to become the foundation upon which Grameen (literally: 'belonging to the villagers') bank would be built:

> I was just going on the regular rounds that I did in the village, to meet people, to understand their problems, and [to see] if there's anything I [could] do. And

> I stopped at this lady's house; it was such a shabby little house… I stopped because she was making bamboo stools… there were a few [completed] bamboo stools and she was weaving another one… It looked so beautiful… There was a big contrast, between what she was producing and where she lived… The question came to my mind, why is she so poor; and she said she [made] only two pennies a day. Then I couldn't believe that anybody [could survive] on two pennies a day (quoted in Discovery Channel, 2003).

Upon interrogation, he found that the woman produced her bamboo ware from small loans she obtained from a local moneylender, and that in addition to the exorbitant interests she paid for the loans, she was compelled to sell her ware to the moneylender at a price fixed by him. Yunus saw this as a form of slave labour, and decided to ascertain how widespread such cases were at Jobra by sending a small team of student volunteers to investigate. The feedback was shocking: besides the fact that there were several enterprising women engaged in 'slave labour' in the town, the amount they actually needed to run their small businesses was very small. For example, the total loan required by the 42 women the volunteers interviewed came to an equivalent of $27. Yunus loaned out this amount from his pocket. His personal credo, 'where *you* see a poor person, *I* see an entrepreneur' (Discovery Channel, 2003) appeared to be confirmed by these observations.

In a bid to ensure a sustainable stream of financial assistance, Yunus contacted a local bank branch to convince the manager to grant loans to the local women. This is where he made his most significant discovery, one that would require designing a bank that would run on a different set of principles:

> I went to a bank branch located on the campus, talked to the manager, and when I proposed that he should give money to these poor people in the village, he almost fell from the sky. [He said] 'but they are not credit worthy!' I said, 'how do you know they're not credit worthy?' [He said] 'because they are poor'. I said, 'have you ever given them any money before?' [He said] 'no!' 'Why didn't you?' [He said] 'they're not credit worthy!' When I told him I had loaned my money out to the women, the bank manager said: 'that is the last time you're seeing your money because none of them will come back' (quoted in Discovery Channel, 2003).

As stated in Chapter Two of this work, conventional banks take the problem of information asymmetry literally: the poor are a special case of adverse selection and moral hazard. The poor, in other words, are bad credit risks, and conventional

credit risk management systems do not recognize them even as a potential market. Yunus's idea, on the other hand, is that the poor merely lack the means with which to create wealth. If they are provided with the means, they will create the world of their dreams (Jacques Attali, quoted in Discovery Channel, 2003). Conventional banking does not probe into *potentials.* For Yunus, the poor are *good credit risks.*

Eventually, in 1976, the 'sustainable' financial assistance that Yunus sought came not from any commercial bank, but from Bangladesh Krishi Bank (BKB), which is the government's agricultural bank. Initially, Yunus obtained permission to run a local branch of Krishi Bank based on criteria derived from his field research at Jobra and on his personal convictions about the potentials and credit-worthiness of the poor. The Central Bank of Bangladesh and some commercial banks later supported the project and this facilitated the extension of the project, in 1979, to Tangail (north of the capital city of Dhaka) (Yunus, 2004a). With the success in Tangail, the project later extended to several other districts in the country. In October 1983, what began as Grameen Bank Project transformed into an independent bank through government legislation. Borrowers own 90% of the bank's shares, while government owns the remaining 10% (Grameen Bank, 2004a).

Grameen Bank has undergone three main transitions since inception; that is, from being a project of BKB in 1976, to being a statutory, independent bank in 1983. In 2000, a major operational change again occurred that led to what is now popularly known as Grameen Bank II. The change was linked to the so-called 'flood of the century', which devastated almost two-thirds of Bangladesh in 1998.

Like other villagers, poor people had been severely affected by the flood, and Grameen Bank clients even more so (Yunus, 2002). Crops, livestock and homes were wiped out in the floods and many people earned no income for several months (BBC News, 1998). Up to 50% of borrowers fell behind on their weekly repayments. Grameen Bank decided to intervene by giving borrowers new loans with which to start their businesses all over again and to generate income to repay both the new loans and whatever had been outstanding on initial loans. The new loans were also meant to help with the repair or rebuilding of houses destroyed by the flood. In order

to finance these new loans, Yunus obtained additional funds from the Central Bank of Bangladesh (BBC News, 1998).

But multiple loans introduced their own complications. Borrowers found that the new installments exceeded their capacity to repay, and so many women started to stay away from weekly centre (repayment) meetings (Yunus, 2002). To worsen matters, their husbands teamed up with local politicians to protest against the so-called 'group tax' component of the 'group fund' (See Section 4.5.9 below).

Faced with these problems, Yunus fell back on his understanding of local social and cultural norms in rural Bangladesh and decided to redesign Grameen Bank's conventional lending methodology - known as Grameen Classic System (GCS) - in order to allow some flexibility in loan terms (Yunus, 2002). This was done in 2001, and after a period of field-testing, a new Grameen Generalized System (GGS), or Grameen Bank II, was adopted. Yunus (2002) remarks as follows about the change from Grameen Bank I to Grameen Bank II:

> In the Grameen Bank II, gone are the general loans, seasonal loans, family loans, and more than a dozen other types of loans; gone is the group fund; gone is the branch-wise, zone-wise loan ceiling; gone is the fixed size weekly installment; gone is the rule to borrow every time for one whole year, even when the borrower needed the loan only for three months; gone is the high-level tension among the staff and the borrowers trying to steer away from a dreadful event of a borrower turning into a "defaulter", even when she is still repaying; and gone are many other familiar features of Grameen Classic System.

As opposed to the old system, GGS would offer *basic loan, housing loan* and *higher education loan.* Note that these loans are not *consumption loans*, in the conventional use of this term, but rather are part of a comprehensive development package. In development terms, these loans are given based on the understanding that a poor person who has received microenterprise (*productive*) loan, should not have to sleep under a tree or under a bridge after a hard day's work. Also his or her children should not grow up to be targets of microcredit.

Other features of the GGS include *flexible loans*, *flexible loan terms, savings programme, loan insurance, provision for destitute members,* and *absence of loan*

ceiling. According to Yunus (2002), the adoption of GGS marked a new era for the Bank. By 2004, the 1998 flood loans had been paid off (Yunus, 2004a).

4.4 Organisational Features of Grameen Bank

Grameen Bank operates through an organizational pyramid in which field workers form the base, and the head office is the peak. Occupying the intervening segments, from the field workers, are bank branches, area offices, and zonal offices. The bank's borrowers, on the other hand, are organized in groups of five, and six such groups make up a *centre* (Jain, 1996: 82). Each group has a chairperson, a secretary, and a *centre chief.* Group members obtain loans on a sequential basis: loans are given first to two members of a group; the next two are eligible only after one month of regular loan repayment and savings deposit by the initial borrowers, and so on (Jain, 1996: 82).

Each field worker – sometimes called a 'foot soldier' - oversees ten *centres.* In a given week, he attends two different centre meetings daily. and ensures that the admission of new members into an existing group or the formation of a new group meets the bank's eligibility criteria. He takes new group members through a seven-day training programme to familiarize them with the bank's rules and norms. He also assesses the suitability of loan requests and business proposals (Jain, 1996: 84).

A bank branch is the main operating unit, made up of a manager, an accountant, about seven workers, and two to three trainees (Jain, 1996: 83). A branch serves about 120 to 150 centres. The branch manager monitors the activities of the fieldworkers by visiting the centres from time to time. If he is dissatisfied with the composition of a group or the quality of training given by a field worker, he may change the group composition and/or provide additional training to borrowers.

Ten to fifteen branches are grouped under an area office, which is headed by an area manager. The area manager supervises the branches with the assistance of a programme officer. Through attending branch review meetings, they are knowledgeable about the performance of the centres and that of branch staff. They also make impromptu visits to the various groups and centres (Jain, 1996: 84).

The zonal offices oversee 10 to 15 area offices, and are responsible for field organization and 'performance appraisal'. They recommend staff promotions and make other administrative decisions. The zonal office hosts an ombudsman, who is appointed by the Managing Director to investigate complaints against bank staff before any internal disciplinary action is taken (Jain, 1996: 85). The Bank's head office provides all resources like manpower, money, physical items and other requirements to the field offices (Jain, 1996:86).

Besides what is often referred to as Grameen Bank's 'strategic credit policies' Jain (1996: 88), some researchers have found the bank's good organizational culture and operational practices to be important contributory factors in the bank's successful performance. Indeed, for Chaves and Conzalez-Vega, (1996:77) organizational thoroughness is a stronger factor in the bank's success, because no matter how well designed a financial policy is, if an organization does not have the mechanism and discipline to implement it properly, such a policy is bound to fail.

Grameen Bank trains its staff almost to the point of indoctrination, and staff behaviour betrays little conflict of interests. Loan decisions are made openly in the presence of borrowers, and corruption is virtually absent among bank workers. It may even be said that bank staff seek every opportunity of transferring their convictions to clients. Transparency and honesty in bank-client dealings thus place a moral obligation on borrowers to reciprocate by not defaulting in their loan repayments (Jain, 1996:81).

Staff salaries and other benefits at Grameen Bank match those of Bangladeshi commercial banks - obviously in line with the belief that incentives induce self-regulation among employees and motivate them to comply with organization's norms. Though performance is the basic criterion for staff promotion, Grameen Bank has been found to have a rapid promotion policy: staff are promoted every 3 to 4 years. Arguably an indication that the Bangladeshi financial sector attaches great importance to the high-level staff training and the ethos of honesty, transparency and commitment at Grameen Bank, the bank reportedly loses about 50-60% of staff to the competition shortly after their initial six-month intensive training (Jain, 1996: 87).

Finally, Hashemi and Schuler (1997) attribute Grameen Bank's success and global appeal to the bank's organizational ethos and humane corporate personality. Grameen Bank, they maintain, has a clear:

> basic concept and guiding vision, strong institutional identity, charismatic and conscientious leadership, disciplined organizational style, highly motivated, socially-cohesive target group, and flexibility based on a faith in human nature and a non antagonistic approach to opponents' among others.

4.5 Grameen Bank's Microlending Features

As stated earlier, Grameen Bank operates a microcredit model that has been replicated worldwide, and which has evolved over many years. The following are the main features of this model:

4.5.1 Lending to the poor

According to Yunus, Grameen Bank is built on the philosophy of 'total trust in human capability': 'irrespective of who or where [a person] is, what kind of social background or family background he or she comes from, everyone has enormous potential inside. If you let this come out, the world will be different' (quoted in Discovery Channel, 2003). In line with this philosophy, the bank targets the poorest of the poor; that is, 'the bottom 50% of those whose income is below the poverty line' (Mathie, 2001). The bank does this by setting strict eligibility criteria to guide client selection, and adopts practical measures to screen out those who do not meet the criteria. Often, those that do not meet the criteria are the 'not so poor'.

Grameen Bank further qualifies the 'poorest of the poor' as those who have less than half an acre of land (Develtere and Huybrechts, 2002: 16). *Grameencredit,* as the bank's loan is called, is based on the premise that the poor have skills that remain 'unutilized or under-utilized' (Yunus, 2004b), and the assumption that it is societal institutions and policies that create poverty. Therefore, rather than regard the poor as perpetual objects of charity, or condemn them to a state of permanent dependency, their skills, energy and creativity should be challenged. This, the Bank believes, is the practical step out of poverty. There is support for this view in the literature. For instance, Morduch and Haley (2002) have argued that 'there is no proof of either an inverse relationship between a client's level of poverty and their entrepreneurial skills,

or minor inclination to save among the poorest'. Justifying poverty targeting on the grounds of equity, Mathie (2001) argues that it was morally imperative to help the poor to restore their dignity, especially if they have been exploited, impoverished or marginalized. He also argues that no meaningful economic development can occur in a society if poverty is not reduced through programmes designed specifically for that purpose.

After granting a loan, Grameen Bank requires that borrowers use the money on a business in which they already have an existing skill, and particularly on very basic income generating activities that will bring immediate returns.

Pro-poor lending strategies have, however, been criticized on the grounds that they do not adequately reach the poorest of the poor, and that loans meant for this target population often end up in the 'wrong' hands (Mathie, 2001). Develtere and Huybrechts (2002) has, for instance, suggested that about 15 to 30% of Grameen Bank members do not belong to the target group. One explanation why the targets are often missed is that sometimes the 'hard-core poor self-select' themselves out of Grameen Bank schemes because 'they are so destitute that they consider themselves not credit worthy'. This category of potential borrowers typically fears debt burdens. Similarly, Evans et al (1999:420) concluded from their study of Grameen Bank that programme-related problems (such as insufficient supply of microcredit), client related barriers (such as bad health), and household preferences also make it impossible for microcredit to reach the very poor.

During Grameen Bank's early years, the concept of lending to the poor was fiercely opposed by many interest groups. The Bangladeshi 'left' felt that the loans were baits by capitalists to make the poor abandon the prospect of a revolution, which, according to them, was what the country urgently needed. Small amounts of money, they argued, would cool the zeal of the poor and make them difficult to mobilize. On the other hand, Grameen Bank supporters held the paradoxical view that the bank was using its small loans to organize the poor to eventually overthrow capitalism. Money lenders, on their part, reportedly intimidated the women by suggesting that they would be forfeiting their right to befitting religious burials should they continue to borrow money from Grameen Bank (CBC-IDEAS, 1991).

Despite these conceptual and ideological challenges, Grameen Bank seems to have remained undeterred in its conviction that the poor are good credit risks, and has continued to make this segment of the Bangladeshi population the focus of its lending operations.

4.5.2 Gender preference

Grameen Bank initially sought to establish a 50-50 ratio of women and men borrowers (GDRC, 2004), but soon found that women occupied a special position in the household economy. For instance, women's economic status affects the health, nutrition, and the general state of the household more than that of men. Women were more dedicated to loan repayment than men, and therefore, were better credit risks (Goetz and Gupta, 1996:45). As Yunus puts it, women tend to be better managers of resources than men:

> Women had a longer vision. They want to build up something. Women benefiting from money always pass it on to their children, so children become immediate beneficiaries. Women are very conscious about the money they have, [and are] … very careful managers of the little resources they have. So [a woman] has bigger mileage from the money that she has compared to men (quoted in Discovery Channel 2003).

The bank found that men were more likely to spend their income on their personal consumption needs even before spending on their family (GDRC, 2004). Because of these reasons, the bank gave greater priority to women in their microlending operations. Another important reason for giving priority to women was that the decision was more in line with the Grameen Bank's policy of lending to the poorest first, and women represent the most marginalized group among the poorest of the poor. This was even more appropriate in Bangladesh, where there is a high incidence of wife and children abandonment as a result of overdependence on men's incomes (GDRC, 2004). Between 1980 and 1983, 39% of Grameen Bank loans were given to women and by 1992 women received about 93.3% of total loan disbursements (Goetz and Gupta, 1996:46).

Several studies have established a positive relationship between microcredit extension to women and women economic empowerment (Pitt et al, 2003:30; Develtre and

Huybrechts, 2002:31; Schreiner, 1999:3). This is in the form of improvement in income, self-employment, greater access to financial and economic resources, greater role in household decision-making, greater social networks and greater bargaining power.

However, research has also shown that lending to women has unintended consequences. In a study conducted in 1994, Rahman (cited in Pepall, 1998), found that far from being empowered, Grameen women borrowers were being exploited as a link to capital. Rahman's women respondents admitted that their men forced them to join the bank simply to acquire funds for their own use, and that they were constantly threatened with divorce if they refused to obtain loans. Women who refused to hand over borrowed funds for their men's use were physically and verbally abused. Overall, the study found that 60% of loans taken out by women were used up by men, and up to 78% of the loans were used for purposes not approved by the bank. The loans introduced tensions to the family fabric, especially as women now frequently kept late at loan-related meetings, returned from such meetings with loan amounts below their men's expectations, and had to put pressure on their men to keep their hands off borrowed funds (Pepall, 1998). There were also cases where 'recalcitrant' women had their livestock confiscated and sold by the men. On the basis of these findings, Rahman questioned the long-term sustainability of women-targeted microlending programmes.

Such reservations might justify the view that women should not be hastily drawn into the vortex of the credit economy, as that might actually worsen their suffering as an exploited gender. Suggestions have been made that socio-economic improvement programmes for women should be holistic. Even so, society should accept that 'improvements in women's productivity, mobility, social status, gender privilege and class acceptance take time and require patience and a willingness to cope with the consequences of challenging entrenched social norms' (Goetz and Gupta, 1996: 61).

Most other observers and researchers that are interested in women targeted microcredit programmes have voiced these concerns. It seems therefore that if microcredit is to benefit women, who are the world's poorest, microcredit programmes should not target them in isolation. Economic empowerment programmes must acknowledge the fact that the dominant form of social relations in

most societies is patriarchy. For women economic empowerment to succeed and be sustainable, microcredit programmes, in particular, must be designed in such a way as not to deny men fair access to credit.

The contestation around women, credit and economic empowerment is, indeed, a protracted one. However, for Grameen Bank, women – especially poor women - are good credit risks, and this seems to have been confirmed by the bank's 99% loan recovery rate from this category of borrowers. The bank seems committed to its founder's thinking that women are disproportionately disadvantaged, and, therefore, deserve priority attention in the bank's lending programmes. As Yunus has remarked: 'when you ask, "who is a poor person?" I say "a woman – an entrepreneur woman"' (quoted in Discovery, 2003).

4.5.3 Collateral requirements

When Grameen Bank claims to have 'revolutionized' banking, easily the most significant aspect of that 'revolution' is granting loans without demanding collateral. Whereas conventional lending is collateral-based, Grameen Bank clients are required to present nothing but a genuine *intent* to obtain a loan, which then necessitates their joining a group. But to ensure the sustainability of the scheme, the bank must find an alternative, even more effective strategy to ensure prompt loan repayment. This is where the bank utilizes its intimate knowledge of the socio-cultural norms of rural Bangladesh and turns to its founder's philosophy of 'total trust in human capability'. Some writers have referred to one of these norms as 'peer pressure'. According to Besley and Coate (1995:16), peer pressure works in much the same way as collateral because group members act as one another's watchdog, such that loan default becomes difficult, if not impossible.

But it can be argued that while peer pressure is a factor in eliciting group members' commitment to loan terms, it is not a *sufficient* explanation for conformity. Peer pressure builds on an already existing deep *sense of community.* It is the creative mobilization of this *sense of community* in Bangladeshi villages, rather than the mere fact of 'peer pressure', that is the unique innovation that Grameen Bank has brought to the field of finance.

4.5.4 Group lending

To constitute a pressure that substitutes for collateral, Grameen Bank adopts a group lending methodology. It lends to women as groups and not as individuals. It is expected of group members to monitor and support one another so that their group does not default in repayments and be seen as 'ailing'. Peer monitoring and support help individual members to stay committed to loan terms – and to the business objectives of the loan (Discovery Channel, 2003); collective responsibility serves as collateral. These strategies have contributed to Grameen Bank's 99% loan recovery rate (Grameen Bank, 2004b), a feat that can hardly be achieved through collateral-based lending.

There have been suggestions that group lending is only effective in communities where people live in close physical proximity to one another. A study conducted in Arkansas (U.S.A.) by Mondal and Tune (cited in van Balstelaer, 2000:10) found that closeness among potential clients facilitates the formation of borrower groups because knowledge of credit worthiness is readily available. The study also found that physical proximity makes it easier to hold regular group meetings. Van Bastelaer (2000:10) has also pointed out that without such proximity, information on credit worthiness of prospective members, peer monitoring, and regular group meetings may become difficult.

However, the above arguments could be contested on the grounds of their narrow understanding of human social ties; that is, their simplistic attribution of social ties to geography. Although Grameen Bank's borrower groups are based in specific villages and communities, the operations of the bank appear to be based more on what might be termed *social and cultural proximity* – rather than merely on 'physical proximity'. If physical proximity alone were to suffice for group formation and microfinance success, then such success would be *automatic* in the world's congested ghettos, such as Harlem in New York (U.S.A.), Soweto in Johannesburg (South Africa) and Ajegunle in Lagos (Nigeria). Yet, there is probably no better place to observe anonymity and social distance than in ghettoes, slums and other crowded urban formations. As mentioned in Section 4.5.3 above, Grameen Bank operations are built on its profound knowledge of the deep *sense of community* in rural Bangladesh. There

is in every society a sense of community that can be tapped into for successful pro-poor microlending operations.

There is research support for the assertion that group lending plays a strong role in loan repayment rate. Group lending provides incentives for members to avoid excessively risky projects, and exposes members to 'social sanction' by the group (Besley and Coate 1995:16). It makes it possible for members to support one another, thus serving as a form of social insurance (Varian, 1990; Coleman, 1998), and helps to reduce monitoring and other transaction costs (Coleman and Brett, 1999:107). Self-group formation means that members self-select themselves into good credit risks, thus saving lenders the cost of obtaining information, screening loan applicants, auditing, and enforcement of contract terms (Ghatak and Guinnane, 1999: 206; Tassel, 1999: 25). Especially in relation to loan-related meetings, group lending reduces the costs that would have been incurred if individual borrowers were to be visited weekly by bank staff (Conlin, 1999:267).

Group lending may throw up certain problems. It could encourage free rider problems in monitoring and auditing (Ghatak and Guinnane, 1999:217) as members may use information on their peers to one another's disadvantage. Although this might not be prominent in a rural, household-based economy (because competition might not be so stiff among rural microentrepreneurs) it is a weakness of group lending nonetheless. If social ties are weak, group solidarity may also be weak and enforcement of repayment may not be achieved (Ghatak and Guinnane, 1999:220). Therefore, the effectiveness of group lending as a factor in prompt loan repayment presupposes the existence of strong social ties.

4.5.5 Loan purpose

The term microcredit is used in a wide variety of contexts – 'from agricultural credit to rural credit, cooperative credit, consumption credit, credit from… savings and loan associations, [credit from] credit unions, [and] credit from money lenders' (Yunus 2004b). To some, it is credit for short-term consumption needs; to others it is loan for small business start-up or expansion. *Grameencredit* is, by definition, credit for income-generating activities, as well as for housing for the poor. It is credit for self-employment, rather than for consumption. Grameen Bank's microcredit is often used

for the purchase of small plots of land for cultivation, paddy husking and lime-making. Manufacturing and processing activities are also targeted, such as pottery, weaving and garment sewing. Other end uses include commercial activities like storage, marketing and transport services (Grameen Bank, 2004b).

There also appears to be a deliberate effort by the bank to respond to concerns around what Zeller (1999:16) calls 'consumption smoothening'. One such concern is a situation whereby borrowers divert microenterprise credit to meet emergency or consumption-related needs because they have no other way of meeting such needs. According to the Asian Development Bank (ADB, 1997), the diversion of microenterprise credit is one of the main challenges to the sustainability of the microenterprise sector.

Grameen Bank has savings facilities to take care of borrowers' emergency and consumption needs. Under the new Grameen Generalised System, an amount equivalent to five per cent of a loan amount is deducted at the point of disbursement as obligatory savings. Half of this five percent goes to the borrower's *personal* savings accounts; the remaining half goes to a *special* savings account (Yunus, 2002). No withdrawal is permitted on the *special* savings account for the first three years, but borrowers have unrestricted access to their *personal* savings account. Thus, a *personal* savings account helps borrowers to meet urgent consumption and emergency demands.

4.5.6 Repayment method

Repayments are due one week after loans have been granted, and the compulsory savings referred to above commence simultaneously with the first loan repayment. While the size of weekly installments is generally small, borrowers have the option of varying it to reflect their actual ability to pay or to reflect the actual performance of their business. For example, a borrower can decide to pay a larger installment during peak business season, and scale it down during off-peak periods (Yunus, 2002).

According to Jain and Mansuri (2003), besides helping to instill 'fiscal discipline' in borrowers, regularly scheduled repayments help the bank to mitigate the problems of information asymmetry, such as moral hazard. More importantly, it makes it

imperative for borrowers to be clear about the viability of their intended business before investing loan funds, since a loan is granted based on the understanding that the business will yield enough returns to make repayment possible within the shortest possible time.

Grameen Bank's weekly loan repayment method has been criticized as imposing undue burden on borrowers. To start with, few microenterprises can generate enough revenues to make repayment possible within one week of investing loan funds. To meet with the tight repayment plan, therefore, borrowers might be compelled to borrow from informal moneylenders to be able to repay Grameen Bank loan, which then exposes them to a cycle of debt. On the other hand, borrowers may be forced to retain part of the loan for use in loan repayments instead of investing the whole loan amount in the business. This makes the entire loan transaction counterproductive. According to Wright (1999:5), clients of MFIs in Bangladesh make their weekly loan repayments not from income arising from the loans, but, in some cases, from household savings: borrowers have no 'grace period' by which loan investment could generate income to fund repayment.

4.5.7 Loan size

Usually, very small loans of between 2000-3000 Bangladesh Taka (approximately US$32-48 in February 2005) are given (Jain (1999:82). This is because weekly installments for a larger loan size may be burdensome and may not be sustained by most borrowers (Jain (1999:82). Another important reason is that *Grameencredit* is targeted at the very poor.

According to Mathie (2001), very small loan size discourages the not-so-poor from seeking Grameen Bank loans. Besides the fact that small loans might be meaningless from a business point of view, few well-to-do people would like to subject themselves to the conditions attached to the loans: weekly group meetings, peer monitoring, recitation of the Bank's *Sixteen Decisions* creed, and extreme time commitments! Coleman and Brett (1999:110) maintain that small loans, the many conditions attached to them, and the stigma of belonging to a poor people's programme are sufficient to make the not-so-poor exclude themselves from *Grameencredit*.

It may, however, be argued that only the not-so-poor who have access to alternative sources of credit would exclude themselves from microcredit programmes. In the absence of such alternatives, they probably will be prepared to tolerate small loans and frequent meetings in the hope of eventually graduating to bigger loans in subsequent loan cycles (see Mathie, 2001)

One long-standing criticism of small loan policies – whether of Grameen Bank or any other MFI - is that the loan amount may not be sufficient to finance a business that would bring meaningful returns, and, thus, only serves the purpose of condemning the poor to perpetual poverty.

4.5.8 Client selection

Conventional banking is predicated on the thinking that people who need banking services will eventually seek out a bank. Therefore, even when banks invest in advertising and other marketing activities, they do so primarily to encourage potential clients to approach them. Even so, it is mainly people who have access to the various advertising and marketing media (such as television, billboards, newspapers, radio, flyers) that encounter the banks' messages. On the contrary, Grameen Bank operates on the principle that banks should go to people, and not vice versa, and that it is only through such an approach that the poor can be brought into the mainstream of financial services (Yunus, 2004b). The idea of taking banking to the people would seem to harmonize with Grameen Bank's policy of making credit available to the poorest of the poor – especially those in rural areas.

Rubinstein (1997) gives a detailed description of the bank's unique and intricate method of client-selection and group formation, and shows, above all, the extent to which Grameen Bank staff would go to convince the poor that they can do something for themselves. His article, 'Microcredit – A Poverty Eradication Strategy that Works', is quoted here at some length:

> When the first Grameen Bank workers come to the village, they announce that they are looking for poor women to lend to. Usually, several women will come and say 'I am poor and I could use a loan.' The bank workers listen politely, but they take no action. Usually these women go away after awhile, when it seems that nothing is happening. After a few weeks, a bank worker starts looking for the first borrowers. She looks for the women who were too timid to come forward. She finds a woman in her hut, and says that the Grameen Bank

> is looking for poor women to lend to. The woman usually responds that they must have meant to speak with her husband. ‘No, we meant to speak with you,’ the bank worker replies. The woman then often says that she doesn't need or want any money. Coming from a desperately poor woman, this is a strong sign that the bank has found a borrower. Almost everything in her life that started out looking like good news has turned out bad, and she's learned from bitter experience to avoid becoming hopeful.
>
> The bank worker explains that many other women as poor as she have taken loans, started small businesses, and generated income to repay the loans and improve the quality of their lives. The prospective borrower finds the courage to seek out four others. They each decide what to do with the money, and learn the rules of the Grameen Bank. The Grameen Bank approves the loans. Soon comes the day that she will receive the money. The night before she gets her loan, she cannot sleep. She worries that her business will not succeed and she will not be able to repay. By morning, she has often decided to cancel her loan request. But the other four women encourage her to go through with it, and convince her that with their support, she will succeed. When she accepts the money, her hands are trembling. She's never seen $30 all in one place, let alone in her own hands. She takes the money and starts her business, and her life is changed forever.

This selection process defies all known loan selection and marketing techniques. In formal credit markets, banks and other credit institutions target wealthy clients not only because of their ability to repay but because they can offer the needed quantity and quality of collateral that is needed to secure the loan. In the event of default, there is an asset to dispose of to recoup part, if not the entire loan. Often during the process of loan screening, perceived *bad credit risks* (typically the unemployed, people below a certain income level, people living in certain residential areas, those with little or no business experience and illiterates) risk being dropped in the initial elimination process. This is because, according to popular belief, failed microenterprises are often those run by poor people (Wright, 2000:10).

Grameen Bank demonstrates through its client selection and group formation methods that, given the right encouragement and motivation, the poor can engage successfully in productive activities, and that the poor have integrity to protect, especially in credit transactions. The bank demands no tangible assets as collateral, but places a demand on the poor’s most important asset – his or her integrity – and empowers its staff to speak to the poor’s social conditions. According to Yunus (2004d), while the rich may escape the consequences of loan default, the poor value access to credit, and would

keep to loan terms because this is the only opportunity they have to improve themselves:

> Even when they default, they never say, ‘Forget it’, or ‘who cares’. They always say: ‘We are sorry we could not pay back, we’ll like to do that as soon as we can’ and given the opportunity, they always do that with a sense of remorse.

4.5.9 Savings programmes

Between 1976 and 1998 – the so-called Grameen Bank I era – each Grameen Bank client group maintained what was called *group fund*. The fund was a form of compulsory savings by members. Group funds were normally used not only to finance personal consumption needs and other economic activities, but also to assist clients to start new businesses in the event of business failure. Also, about 50-60% of these funds were loaned to members while the balance was deposited with Grameen Bank. Generally, decisions as to the use of the funds were made not by the bank but by the clients themselves (Jain 1996:82)

However, as stated earlier the group fund practice soon became controversial. The fund was subject to what was known as ‘group tax’, to which members were liable even if they decided to leave the bank (Yunus, 2002). Under Grameen bank II, the *group fund* was abolished and, in its place, three compulsory weekly saving plans - *personal, special* and *pension deposit* - were introduced. The idea was to ensure that funds were always available for clients to meet pressing personal needs. But because of the need to maintain a minimum balance of BTk2,000 (about US$30) in the *special* deposit account, withdrawal from this account was only allowed after three years of running it. Thereafter, withdrawals could only be made once every three years. Only under very special circumstances would a client be allowed to withdraw the entire amount in the *special* savings account. The account also helped finance borrowers’ long-term investments, such as the purchase of Grameen Bank shares (Yunus, 2002).

Pension deposit served as a pension fund for a specific category of members. Members whose total loans exceeded BTk8,000 (US $ 138) were required to contribute a minimum of BTk50 (US $ 0.86) each month to a pension deposit

account. After ten years, a borrower could receive a lump sum of almost double the amount he or she had contributed. This provided a great incentive for borrowers to save, and became very popular with many borrowers. Indeed, some offered to save up to ten times the mandatory minimum (Yunus, 2002).

Studies show that obligatory saving plans are among the most important features of Grameen Bank lending, and contribute significantly to the bank's high repayment rate. Microenterprise credit, as earlier pointed out, cannot succeed if there is no facility to support consumption and other related needs, and the poor have many pressing needs that compete for attention. According to Wright (2000:9), appropriate financial services 'should provide options to minimize shocks arising from illness, death, crop failure, theft and price fluctuations while also providing funds for investment in income generating activities'. Grameen Bank's *personal* savings plan provides the buffer against some of these shocks and, because of the freedom to utilize the savings, helps to eliminate pressure on microenterprise credit.

4.5.10 Loan terms

One of the main problems of the defunct Grameen Classic System (GCS) was the inflexibility of loan terms. For example, irrespective of a client's actual business needs, there was a limit as to the amount that could be borrowed. Weekly repayment amounts were fixed, and to continue to stay with the bank, clients were required to demonstrate a degree of active participation in the scheme by borrowing continuously for a whole year, even when they only needed loans for a few months (Yunus, 2002). Bank staff had little freedom to exercise their personal judgment when dealing with borrowers.

Under the Grameen Generalised System, loan terms are more flexible. Clients borrow only when they need loans, except that new loans become available to borrowers only if their previous loans have been repaid. A borrower can be granted more than one loan type simultaneously (Yunus, 2004b). Furthermore, bank employees are allowed to design loan products to suit clients' specific needs and to exercise judgment when dealing with loan-related issues. Also, the weekly installment amounts can be varied: clients whose business are seasonal can increase their installment sizes during peak business season, and pay less during the off peak period.

Sometimes, each installment can be of a different size and at other times all installments can be exactly equal. The bank believes that flexibility in loan terms makes repayment less burdensome.

There are other facets to the 'flexibility' of the Grameen Generalised System (GGS). Borrowers are offered two loan types: the *basic* loan and *flexible* loan. A *basic* loan is the primary loan product, which clients typically obtain. In the event of default, borrowers are not necessarily blacklisted, but are required to take up a *flexible* loan. Under the defunct Grameen Classic System (GCS), loan defaulters were not allowed to obtain further loans or renegotiate payments (Mainsah et al, 2004:10). The GGS *flexible* loan regime gives the borrower a second chance to work out a more 'favourable' repayment schedule. Sometimes, to achieve a 'favourable' loan term, a one-year loan may be extended to three years in order to reduce weekly installments to the very minimum, and make it affordable to borrowers (Yunus, 2002).

Critics question the rationale for the *flexible* loan. The Wall Street Journal (2001), for example, argues that Grameen Bank uses its rescheduled *flexible* loan scheme to cast itself as a successful and humane operator with high repayment and low default rates, when in reality the scheme disguises the fact of loan default. Grameen Bank, however, maintains that provision is always made for rescheduled loans, and that the repayment rate of rescheduled *flexible* loans is over 98% (Mainsah et al, 2004:25).

Some might find the above criticism of rescheduled *flexible* loan intriguing. The principle behind the scheme is that of preventing total default. This principle protects the lender from losing its money altogether, and the borrower from losing his/her only source of income and sinking back into poverty. Adjusting loan terms to enable defaulters to pay up is an idea that could be applied in the conventional credit markets to manage loan default, since it may be better for a borrower to pay back little bits of the loan over time, than default completely. Then again, formal lending is collateral-based, and it may well be that loan terms in this sector is deliberately made unfavourable so that borrowers would default and forfeit their pledged assets. Loan terms should be flexible enough to accommodate risks faced by borrowers in the business place; in short, loan terms should be given a human face.

4.5.11 Interest rate

To ensure sustainability, Grameen Bank as a matter of policy keeps its interest rate as close to the prevailing commercial bank lending rate as possible. However, its interest rates vary according to loan type. Although the Bangladeshi government fixes 22% interest rate for government-run microcredit programmes, the bank's microenterprise (or income generating) loans attract 20% simple interest, while housing loans and education loans attract 8% and 5% simple interest respectively. All interests are calculated on a declining balance basis. Loans to struggling clients (such as beggars) are interest-free. On the other hand, the bank pays between 8.5% and 12% interest on clients' savings (Yunus, 2004c). Grameen Bank's 20% simple interest rate on microenterprise loans is comparable to the compound interest rate of 13% to 16% charged by Bangladeshi commercial banks (Kamaluddin, 1993).

There is an ongoing debate as to whether Grameen Bank's interest rates are sustainable enough to help the bank to post significant profits and pay dividends to its shareholders. Kamaluddin (1993) maintains that Grameen Bank is an example of a 'totally self-reliant poverty-eradication initiative that does not need a 'handout' for its survival'. This assertion seems to have been confirmed by the bank's decision in 1995 not to receive any more donor funds - although in 1998 it received the 'last installment' of an earlier contracted donation. In 2003, the bank reported a net profit of BTk357,518,131 (Grameen Bank, 2003).

Morduch (1999:236), on the other hand, argues that what the bank calls 'profitability' was in part a function of the bank's many years of operating as a donor-funded organization, and that it was wrong to underplay this fact when discussing Grameen Bank's profitability. He maintains that Grameen Bank enjoyed subsidies up till 1996. Besides, Morduch adds, the bank constantly moves certain categories of expenses and treats direct grants as income. To post profit by all means, the bank does not fully recognize soft loans. Therefore, while its accounts are monitored and certified by public accountants, they do not conform strictly to international standards. Although Morduch acknowledges that subsidies are falling and that 'break-even rates' are closer to what Grameen Bank actually charges, the impact of earlier subsidies should not be ignored. Furthermore, Morduch asserts that interest rates paid by borrowers on the various categories of loans are heavily subsidized and that if subsidies were

removed, or the effects of subsidies were to wear off completely, interest rates on general loans may have to rise to between 40 and 46%, for profitability to be achieved (Morduch, 1999: 235-246).

The arguments around profitability simply show that whether or not Grameen Bank was profitable and sustainable at inception, it now charges break-even interest rates that make cost recovery and profitability possible. Subsidies from donor funds also sustained the bank up to the point where it could be self-sustaining – an important lesson for any country wishing to replicate the Grameen Bank model.

4.6 Grameen Bank's Risk Management Techniques

As discussed in Chapter Two, the presence of information asymmetries and the pre-classification of the poor as 'bad credit risks' in both formal and informal markets makes it difficult for the poor to access credit for microenterprise purposes. The formal credit market mitigates information asymmetry problems through measures such as screening, monitoring and credit rationing, among others. However, as stated earlier, these measures screen out the poor. Grameen Bank seems to have innovatively adapted the same techniques to produce the crucial consequence of making microenterprise credit available to the poor.

Through its unconventional group lending method, Grameen Bank effectively screens out bad credit risks. First, a bank worker identifies a potential client. Next, this client selects four other people with whom she can form a borrower group. Thereafter, group members receive a mandatory training and are given a loan. This process is called *self-selection.* Although, as noted earlier, the hard core poor may self select themselves out of the Grameen Bank scheme, the converse is also true: the hard core poor could self select themselves into a creditworthy borrower group. Through shared customs, physical proximity and shared social conditions, Grameen Bank's target clients are in a fairly good position to judge one another's credit-worthiness. Given the information advantage they have, it is unlikely that people will knowingly form groups with peers who they believe will expose the whole group to the danger of default and closure. Grameen Bank screens out bad credit risks using the group members themselves, and, thus, incurs minimal screening cost. Formal sector lenders,

who typically lend to individuals, must collect information on a person-by-person basis in order to avoid adverse selection – a process that may be more cost-intensive.

There is also what might be termed specialization in lending in Grameen Bank operations. As mentioned in Chapter Two, relationship or specialized lending exists when lenders focus on specific industries or give out specific loan products over time. This form of lending makes lenders knowledgeable about the industry or loan product, and thus reduces loan administration costs (Rodriquez and Carbo, 2004: 9). Despite the varied credit needs of the poor and the general poverty levels in Bangladesh, Grameen Bank specializes in three loan types; namely, loans for microenterprise, for housing and for education (Yunus, 2004c). The bank started off with microenterprise loans and later, as part of its broader mandate as contained in its Sixteen Decisions, extended its offerings to include housing and education loans. Specializing in this way makes for effective administrative monitoring and coordination of loan products and end use. Besides, the bank lends mainly to women, which makes it easier for their potentials to be harnessed, thus reducing moral hazard.

As opposed to formal sector lenders, which require clients to sign physical contracts with restrictive provisions, Grameen Bank has no written contract with its clients and, as Yunus (2004b) emphasizes, *Grameencredit* is 'based on trust, not on legal procedures and system'. Group members decide on what business activities they want to engage in and monitor one another's progress. Internal cohesion within the groups makes it difficult for members to engage in business activities considered unduly risky and that may lead to repayment default and/or attract censure from other group members (Besley and Coate, 1995:16). In a sense, there is an unwritten (moral) covenant in operation which group members themselves enforce. This reduces moral hazard, encourages high repayment rates, and helps to keep transaction charges low.

Long-term customer relationships, an important credit risk management technique in conventional lending, is also utilised by Grameen Bank, but in a manner that is sensitive to the special circumstances of the poor. Whereas formal sector lenders maintain such relationships mainly to constantly validate clients' credit-worthiness and thus cut down on the cost of obtaining information on clients, Grameen Bank utilizes this technique through its group lending methodology. Borrower groups are

formed mainly on the basis of group member's knowledge of one another's 'credit-worthiness' and moral standing; and so the bank builds on the high level of group self-validation already existing within the group, and grants loans without needing to know individual borrowers over a long time. All possible information that the bank would have required concerning a client before granting any loan has already been mobilized during the group formation process, and is already in operation within the group; therefore, the bank suffers minimal adverse selection and incurs less cost in this regard. Group members' involvement in each other's business activities further reduces moral hazard and serves the important purpose of helping the bank to build long-term relationships with its clients.

Traditional bank lending requires the use of collateral as a guarantee against default. Clients with no collateral are considered bad credit risks and are often screened out during the selection process. Whether clients with collateral are ultimately good to do business with, and whether what is pledged as collateral will actually offset the loan when default occurs, are often ignored. From the point of view of the poor, collateral is a strong deterrent to accessing credit. Grameen Bank's group lending methodology makes a demand not on physical collateral, but on symbolic assets (like trust and integrity) – which the bank believes the poor have – and thus makes it possible for credit worthy borrowers to be selected from a segment of the population that ordinarily lacks physical collateral (see Vigenina and Kritikos, 2004:173). Members of a borrower group monitor one another's activities, put pressure on one another to repay the loan, and generally support themselves in times of difficulty. For the bank, these various 'responsibilities' of borrower group members reduce monitoring cost, adverse selection, as well as moral hazard. It also reduces the possibility of loan default and contributes to the bank's success and profitability.

While financial institutions grant loans as part of their traditional functions, they often ration credit mostly by giving out smaller loan size than borrowers need (Mishkin, 2004:220). In theory, this is meant to check moral hazard by compelling borrowers to make the most judicious use of borrowed funds. But, as mentioned in Chapter Two, banks also use credit rationing to exclude the poor, create loan dependency for the 'creditworthy', multiply the opportunity to charge interests, insurance and administrative costs. Grameen Bank also draws on the conventional practice of credit

rationing. To avoid adverse selection, the bank rations credit by giving out very small loans – amounts that the rich and the not-so-poor would find meaningless. In a sense, Grameen Bank's credit rationing strategy pre-classifies the rich and the not-so-poor as *bad credit risks.* For whatever reasons, Kamaluddin (1993) justifies this practice:

> Those that are rich and not so poor can ignore the consequences of non-payment because they might be able to obtain credit somewhere else. Those that are poor cannot do the same because they are not credit worthy anywhere else except at the 'loan sharks' whose interest charges and conditions attached to the loan impoverishes them. They will therefore do everything possible to retain Grameen Bank credit access by not defaulting in their loan repayments.

In the light of the foregoing, the question might now be asked: what are the specific indicators of success of Grameen Bank? The next section attempts to address this question.

4.7 Grameen Bank's 'Successes' and Shortcomings

In discussing the achievements and shortcomings of any financial institution, it is important to examine both the balance sheet 'achievements' and its impact on clients and the broader society. But from the point of view of microenterprise finance, it is probably more crucial to focus on the latter. This is one of the reasons Grameen Bank's operations – and, indeed, microfinance - have sparked several researches, discussions, replications and academic debates. The following are widely considered some of Grameen Bank's notable successes and shortcomings:

4.7.1 Repayment rate

Grameen Bank's loan repayment rate is currently 99%, a rate considered very high by banking standards, and unmatched by any commercial bank in Bangladesh (Kamaluddin, 1993). Given that a repayment rate as high as this is recorded in a market conventionally regarded as bad credit risk, it is little surprising that there are contentions as to the accuracy of its computation. Recall a Wall Street Journal's argument, reviewed earlier, that Grameen Bank uses euphemistic codes to describe clients who by traditional banking standards would be treated as loan defaulters and would probably have forfeited their pledged assets to the bank. An example is its use

of so-called *flexible loans* to reschedule people who failed to pay back their *basic* loans. But as also indicated earlier, the bank seems to work on the principle that the poor must be assisted to graduate out of poverty at all cost, rather than made to sink deeper into poverty.

Were borrowers merely put under intense pressure to repay their loans – regardless of whether the loans worked for them or not – then certainly, a 99% recovery rate would be nothing but a 'balance sheet achievement' for Grameen Bank. The Wall Street Journal's argument does at least imply that Grameen Bank goes out of its way to ensure that the poor repay their loans without going through the humiliating harassments that traditionally might be expected to accompany loan default. It does seem, then, that Grameen Bank's high loan recovery rate is not at the expense of clients' social and economic well-being.

4.7.2 Transaction costs to clients

In business, transactions costs are not often discussed in terms of their broad social benefits: they often form part of discussions around profitability and/or returns on investment – for the business owner. The core principle of business is to pass costs to the consumer in order for the business to record good profits. In credit-related businesses (whether formal or informal) transaction costs – as part of total costs - include the costs of collecting and analyzing information about present and prospective borrowers in order to ascertain their credit worthiness. This process can be costly, and when such costs are transferred to borrowers, loans become expensive and repayment becomes excessively burdensome. Eventually, borrowers might decide to opt out of the scheme.

Research has shown that compared to commercial banks, or even informal Bangladeshi moneylenders, Grameen Bank's transaction costs are low (UK Society, 2000:1). This is despite the fact that the bank's loan sizes are small. From the array of customer services it renders to its clients (such as business training, weekly meetings with clients, generally taking interest in clients' business growth) it is unlikely that the bank has shortchanged its clients in a deliberate effort to keep transaction costs low, and profits high. Rather, low transaction costs seem to be a function of the unique lending features discussed earlier. The low drop-out rate may

also suggest wide social acceptance of the scheme, and this may be attributed in part to the fact that borrowers do not regard Grameen Bank loans as unduly expensive or exploitative. Schreiner (1999: 15) confirms this assertion:

> People choose to use microfinance because they expect positive net gains. Although the size of net gain is usually unknown because its measurement requires knowledge of both worth and cost, its sign can be inferred from repeated use; if users go back for more, then net gain must be positive. The annual drop-out rate at Grameen from 1986 to 1994 was about 5 percent… This suggests that most users received positive net gains from membership.

4.7.3 Interest Rates

Closely related to the above discussion on transaction costs is the interest charged on loans. Lenders fix interest rates in order to be able to recover costs and make a profit. However, in the quest for 'normal' profits, conventional credit providers often fix interest rates that are excessive. On the other hand, as a way of mitigating information asymmetry – especially in the absence of collateral - informal microlenders 'price for the risk', with the result that interest rates become exorbitant.

As mentioned earlier, Grameen Bank charges lower interests than commercial banks and other MFIs in Bangladesh. The low interest rates are in part a reflection of the bank's low transaction costs, and the fact that the bank sets out to make modest, rather than 'normal', profits. The bank's small loans, low transaction costs, low interest rates, and regime of modest profits have not only resulted in low borrower drop-out rates (Schreiner, 1999: 15), but have had other important social impacts on the Bangladeshi society:

> It takes an utterly destitute [person] six to ten successive loans (one year each) - and a lot of hard work - to cross the poverty line. The first loan is often as little as US$50. Average loan size is a little over US$100. In the process, the borrower builds a secure self-employment, often employing the whole family. 54% of Grameen borrowers have thus crossed the poverty line and another 27% are very close to it. For those who do not perform as well, poor housing in rain soaked Bangladesh and chronic ill-health are identified as the major reasons (GBSG, 2004).

For all the praise it has received and the microfinance initiatives it has inspired worldwide, Grameen Bank has been criticized on the grounds of its inability to reach the poorest of the poor in Bangladesh. Indeed, this is a failing it shares with most MFIs. Some writers have observed that the very process of selecting clients have the potential of leaving out those that matter most. As indicated earlier, the hard-core poor may select themselves out of credit schemes because they consider themselves worthless and unable to manage a loan. On the other hand, especially in the case of Grameen Bank, group members might select out those they consider to be poorer, more vulnerable and worse credit risks than themselves – people they believe could easily default and plunge the group into problems.

Conversely, studies have shown that the not-so-poor often benefit from microloan schemes supposedly meant for the very poor. Develtere and Huybrechts (2002:16) have reported a study on Bangladesh Rural Agricultural Credit (BRAC) and Grameen Bank in which about 30% of members in both programmes do not belong to the target group of 'very poor'.

In the specific case of Grameen Bank, Hashemi and Schuler (1997) have explained the dilemma of 'missed targets'. According to them:

> since the number of members in each centre is limited, and an individual cannot join and receive credit except as a member of a self-selecting group of five, it implies that there exists some systematic selection within Grameen Bank's broadly defined target group, that causes the very poor to be excluded from the group.

Despite the shortcoming of 'missed target', Grameen Bank has remained one of the most replicated poverty reduction initiatives in modern history. One of the more innovative examples of such replications is BancoSol, an experiment in Bolivia that seeks to go beyond Grameen Bank by extending microenterprise credit to the poor on a commercial basis.

4.8 Commercialisation of Microcredit -The BancoSol Experience

BancoSol did not start out as a commercial bank, but as 'a nonprofit microlending entity' called PRODEM (BancoSol 2003) with a small client base – much in the mould of Grameen Bank. This was in 1986. Within just two years, its growth potential amazed even its founders, as Bolivian commercial banks could no longer

meet its demand for loan funds, which now were in excess US$28 million. Spurred by this extraordinary success, and with 45,000 micro-businesses in its clientele, almost none of whom had defaulted in loan repayment (Koenigsfest, 2001), PRODEM joined forces with ACCION International, Calmeadow Foundation, commercial banks and other interests to found BancoSol. This bank is regarded as the world's first private commercial bank dedicated entirely to microenterprise development. It draws on the best-established traditions of commercial banking and the humanistic underpinnings of the nonprofit sector. For instance, in addition to 'rewarding' diligent microentrepreneurs with larger loans, it insists that intending borrowers show some evidence of an ongoing microbusiness. Besides, it markets more than just microenterprise loans – other conventional banking products (including consumption-related loans) are also on offer. On the other hand, as part of its developmental inclinations, it lends to small groups, charges small interests (of about 6.1%), and does not ask for collaterals or personal guarantors outside the borrower group.

By 2003, its branch network had grown to 38, organized under five regional headquarters, with a combined 'active' client base of 42,831 (about 60% made up of women). The bank claims a 'more than 40 percent' market share of the Bolivian banking sector, despite holding 'less than two percent' of the banking system's assets (BancoSol 2003). The bank lists this solid client base among its core achievements, but most importantly – for the purposes of this project - its operations stand as a testimony to the fact that 'lending in small amounts to microentrepreneurs is feasible and profitable' – a fact further borne out by BancoSol's ranking among the two most liquid, most solvent and most profitable banks in Bolivia (BancoSol, 2003).

Gonzalez-Vega et al (1996:5-6) attribute the success of BancoSol to what they call the 'intangible assets' that the bank inherited from PRODEM. Among these are stock of information capital, good client relationship, human capital, good reputation, and good connection with international nonprofit networks such as ACCION. Most of these, it must be emphasized, are associated with BancoSol's *humanistic* and *developmental* character, cultivated during its years as a nonprofit microlender. To function and succeed as a commercial bank, the bank has no doubt invested in and benefited from good organizational design, technological development and transformation management (Gonzalez-Vega et al, 1996:19).

Gonzalez-Vega et al (1996:8) have also identified factors that could be regarded as disincentives to the developmental aspirations of a microenterprise bank. Among these is the fact that its clients are not necessarily the poorest of the poor, since a major precondition for obtaining a loan is evidence of an ongoing microbusiness, which must have been running for at least a year. Besides, employees reportedly work in what could be a de-motivating environment, since staff salaries are substantially lower than what obtains in other commercial banks. Indeed, it is believed that for BancoSol to continue to operate profitably, it must keep salaries low (Glosser, 1994:249).

Despite such ‘failure factors’, however, BancoSol, not unlike Grameen Bank, is a clear demonstration that a robust combination of different microlending models, rather than a reliance on a business-as-usual ethos can result in a developmental socio-economic environment in which the needs of microenterpreneurs – indeed, the needs of the poor - are firmly addressed through the banking sector.

4.9 Conclusion

Traditional banking is based on a traditional liberal/individualistic model that succeeds on the basis of individuals’ ability to meet credit obligations. The Grameen Bank approach demonstrates that it takes more than the liberal-individualistic model of traditional banking for credit to reach the poor. Therefore, the bank anchors its lending methodology on collectivist norms, which effectively serve as symbolic collateral in a world where physical assets are absent. A key question is: do these norms exist in every society or do they exist only in ‘traditional’ or developing societies?

Scholars like Ghatak and Guinnane (1999:197) would argue that villages in low-income countries (LICs) are close-knit communities and that in developed societies ‘village norms’ have been washed away by the tides of modernity. This thesis does not embrace this argument. Rather, it maintains that every society has its collectivist norm - whether these exist in family groups, village groups, religious organizations, neighbourhood associations, occupational guilds or clubs – and that microcredit practice must be preceded by sound ethnographic and sociological research into the

bases of collectivist norms, which exist in every society. Indeed, there is no society that is exclusively 'traditional' or 'modern' in the binary sense in which these terms are often used.

Grameen Bank harnessed the collectivist norms in rural Bangladesh; in another society, similar norms would be found probably in religious organizations or neighbourhood associations. As shown in this chapter, group or collectivist norms are distinct from peer pressure. While peer pressure might be an ingredient of collectivist norms, it is not a sufficient 'cause' of conformity, and, therefore, cannot be the main reason Grameen Bank clients feel compelled to meet credit obligations. Peer pressure is a product of underlying norms and its effectiveness in inducing conformity is as a result of the existence of such underlying norms. This is what has helped Grameen Bank to largely mitigate information asymmetry problems. Jain's (1996:83) findings from his study of Grameen Bank support this assertion: 'all group and even centre members lived in the same neighbourhood and often shared the same profession. This led to considerable interactions among group and centre members'.

Despite the model's shortcomings, Grameen Bank has achieved what successful commercial banks have not. Whereas commercial banks lend based on collateral and especially to people who are relatively well off, Grameen Bank lends based on 'trust' – and lends to the very poor. Commercial banks are usually concentrated in cities and men constitute the majority of their clients. Grameen Bank, on the other hand, operates in villages and women are its major clients. Because they are profit making, commercial banks lend to people with proven ability to repay and who have clear evidence of entrepreneurship. Grameen Bank lends to poor women who, according to Yunus, have nothing but their integrity and their innate entrepreneurial abilities (Discovery Channel, 2003). While commercial bank borrowers cannot enjoy further loans unless they have repaid earlier ones, Grameen Bank lends money to help clients get out of the encumbrance of earlier loans, and get on with their business pursuits. In one word, Grameen Bank represents a paradigm shift in the allocation of financial resources (Mainsah et al, 2004:25).

CHAPTER FIVE

DATA PRESENTATION AND DISCUSSION

5.1 Introduction

As stated in Chapter One, this thesis focuses on microcredit practice in South Africa, and in particular, factors impeding access to microenterprise loans. Grameen Bank is introduced in this chapter to highlight specific features associated with the widely acclaimed ‘successes’ of the microcredit sector in Bangladesh, and to explore some hidden lessons in such ‘success factors’ for microcredit practice in South Africa. This chapter is concerned with the presentation and analysis of the various primary and secondary data collected for the study.

It has so far been shown in this work that microlenders in South Africa fall into at least three broad categories, namely: private sector (registered and unregistered); nonprofit lenders, and government-backed lenders. The present chapter restricts itself to registered private sector microlenders and the government-backed microlender, known as Khula Enterprise Finance. The analysis emphasizes activities of KhulaStart retail outlets. Unregistered private sector microlenders are outside the scope of the project, as they typically operate informally or underground. Nonprofit MFIs were also not examined separately, since in practice they are the operational channels (or retail outlets) through which Khula Enterprise Finance actualises its microlending mandate.

The chapter also draws on secondary data from the Microfinance Regulatory Council (MFRC). The presentation and analysis – as well as summaries and conclusions – that follow are based on data relating to KhulaStart retail outlets, registered private sector microlenders, and Grameen Bank.

5.2 Data Presentation

5.2.1 Primary data from registered private sector microlenders

Registered private sector microlenders comprise bank and non-bank registered operators. They are registered with the MFRC under the Usury Act exemption notice, and file their monthly returns with the Council. Examples of registered (commercial) bank microlenders are ABSA, Capitec, and African Bank. They have branches all over the country, and use similar and standardized microlending procedures. Thus, a Capitec Bank branch in Johannesburg operates in much the same way as a branch in Port Elizabeth. The Grahamstown branches of the three banks mentioned were visited for this study, and their managers in charge of microloans were interviewed.

Non-bank microloan operators are localized, and are usually many in any one city. However, they too adopt the same lending procedures and modalities used by the bank-affiliated micro-lenders. Seven of these operators in Grahamstown were visited for this study and their managers, in a few cases owners, were interviewed.

The same set of questions were asked to both bank and non-bank microlenders. The interview sought responses to questions pertaining to, among others:

- loan type (end use of loan)
- loan term (short-, medium-, or long-term)
- category of loan grantees (who qualifies for a loan)
- loan size
- monitoring of end use of loan
- ways of promoting microenterprise development
- interest rate charges

The interview revealed that non-bank microlenders typically lend money to people in short-term financial need. Loan period ranges from one to three months, and sometimes four to twelve months. Banks give both short-term and long-term microloans, and long-term loans range from 12 to 24months. Long-term loans are mainly for housing, education and negligibly to small business expansion. Housing

and education loans make up about 80% of long-term loans, while the remaining 20% goes into business expansion. The most important loan criterion is a regular income stream. What this means is that (bank) microlenders typically lend to salary earners and pensioners; this make up about 90% of their microcredit clients. Some banks give a very negligible portion of their loan to self-employed clients but those that are not in any form of employment do not access any loan.

Private sector non-bank lenders sometimes give consideration to borrowers' level of income. The posting of collateral – in the traditional banking sense of this term - is not a lending precondition. However, a borrower will normally be required to present his or her identity document, proof of regular income (sometimes in the form of one to three months' pay slip), and names of personal referees. Loan sizes range between R50 and R10, 000 with interest charges in the region of 11% and 40%. Repayment is monthly and commences at the end of the month, for the length of the contract.

A key feature of microlending under the private sector bank/non-bank category is that the end-use of the loan is not monitored. Generally both the lender and borrower know that it is for short-term consumption-related needs. Some lenders in this category make use of information supplied by credit bureaus and the Information Trust Cooperation (ITC) to assess the borrower's credit worthiness and ability to repay. Any borrower whose name appears in any one of these documents is refused a loan. In most cases, repayment through bank debits is preferred to cash payments because this method is more reliable and ensures that deduction is made at source before the borrower can access the salary or pension account to which the loan is linked. It is also possible that many borrowers know the added legal complication of consistently defaulting on bank debit orders - a psychological self-check which lenders easily capitalize on.

Some lenders employ debt collectors - or 'credit controllers', as they are often called - to relate with clients. Such relations take place mainly by correspondence, although occasionally, personal visits become necessary after loans have been granted. Respondents indicated that the motivation for visits is not entirely that of client-welfare. Ironically, it is also often not for debt collection either. Private sector bank/non-bank microlending has become so competitive that some form of 'customer

relations' has become imperative, if only to guard against 'client-poaching', which, as one respondent indicated to this researcher, is increasingly becoming a feature of the business. On average, bad debt is about 20% of loan disbursements and is contributed mostly by salary earners.

The private sector bank/non-bank microlenders interviewed did not think they were under any pressure to change their lending features, as beneficiaries of their facilities are pre-defined as those who have the ability (typically, through being salary earners) to repay. Mainly for this same reason, gender is not a lending criterion. Non-salary or very low-income earners are perceived as a business risk and do not count even as a 'potential' market. Lenders do not consider themselves to be in the business of promoting microenterprises or skills training, as these involve considerable risks and costs. Those interviewed, however, expressed the view that they could support such objectives if government provided funding or guaranteed loans given for such purposes.

5.2.2 Secondary Data from Microfinance Research Council (MFRC)

The MFRC collects and publishes information regarding activities of all registered microlenders. Published information is based on returns submitted by registered lenders as a requirement of the Usury Act exemption notice. Information covers lenders' total disbursements, number of loans, size of the loan book, loan clients, average loan size, average loan debts, types of disbursement and other disclosures. Table 1 below shows the trend of loan disbursements by the various registered microlender categories between December 2001 and May 2004:

Table 1: Loan disbursements by size (December 2001-May 2004)

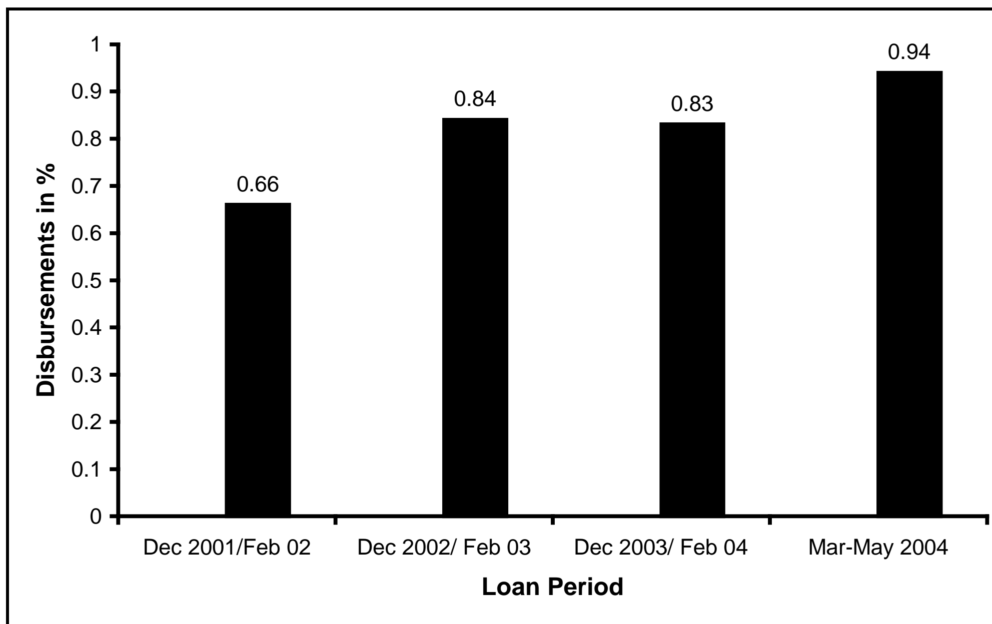
LENDER CATEGORY	LOAN DISBURSEMENTS							
	Dec 2001 – Feb 2002		Dec 2002 – Feb 2003		Dec 2003 – Feb 2004		March – May 2004	
	Loans	Loan Size (Rand)	Loans	Loan Size (Rand)	Loans	Loan Size (Rand)	Loans	Loan Size (Rand)
Banks	621,749	1,020,830,776	723,449	1,036,578,566	913,944	1,636,730,124	939,680	1,659,623,102
P Co's*	57,050	51,333,224	34,582	40,613,744	2,033	7,277,122	6,992	11,259,020
Pvt Co's**	812,623	1,436,859,286	1,058,480	1,593,465,017	963,275	1,939,882,689	960,326	1,809,761,366
CC+	827,960	513,914,841	965,632	569,096,180	1,072,573	678,333,035	1,235,837	783,602,918
Trusts	77,772	42,003,081	82,068	50,395,453	86,274	55,942,936	82,286	53,804,356
Co-op++	24,104	61,569,310	24,226	65,656,324	20949	55,410,450	21,317	57,390,312
Sect 21+++	13,979	20,847,125	13,953	28,375,164	17,548	36,391,908	18,522	41,625,177
Total	**2,435,237**	**3,147,357,643**	**2,902,390**	**3,384,180,448**	**3,076,596**	**4,409,968,265**	**3,264,961**	**4,417,066,252**

Source: **MFRC, 2004c**

Key: *Public Companies; ** Private Companies; +Close corporations; ++Cooperatives ; +++NGOs;

Table 1 illustrates the notion of the South African microcredit industry as a 'fast growing' one. It shows significant increases in loan size and number of loans from the period December 2001 and May 2004. Banks, private companies and close corporations, enjoy the largest industry share in terms of both loan size and number of loan. However, their loans, as noted in the previous section, are not for microenterprise purposes. Section 21 companies, which comprise NGOs and MFIs, focus on microenterprise lending. Strikingly, as shown in the graph below (Figure 1), their share of total industry disbursements – both in terms of actual amounts disbursed and number of loan recipients - is among the smallest.

Figure 1: NGO/MFI loan disbursements as a percentage of total



Source: MFRC, 2004c

Figure 1 above shows microenterprise credit - represented by NGOs disbursements - as a percentage of total disbursements. In each of the yearly totals, that is, the period from December, 2001 to May 2004, NGOs disbursed just less than 1% of microcredit loans. Since their disbursements are mainly for microenterprise purposes, Table 1 and Figure 1 could be interpreted to mean that microenterprise lending is at the bottom of the scale of preference in the South African microlending industry. It also indicates the limited reach of NGOs and MFIs to microentrepreneurs.

Total loan disbursements for the period between March and May 2004 (in Table 1 above) are broken down into different loan types, as shown in Table 2 below:

Table 2: Loan disbursements by type (March-May 2004)

Loan Type	Share of industry disbursements
Housing	11%
Education	13%
SMMEs	4%*
Unclassified	72%+

Source: MFRC, 2004c

*The 4% SMMEs share of industry disbursements is higher than the actual amount of approximately R42 million disbursed by Section 21 companies, as shown in Table 1. The actual disbursement by Section 21 companies to SMMEs is less than 1% of total industry disbursements. The likely reason for this discrepancy is that the 4% shown in this table includes isolated microenterprise loans offered by some banks during the period.

+ Not shown in MFRC Statistics, but deduced mathematically for the purposes of this table.

Table 2 illustrates further the realities of Table 1 and that of Figure 1. The table shows each loan type as a percentage of the total. Housing loans are those taken out mainly for the construction of very low-cost houses and partly for the repairs and maintenance of existing property. Banks extend some of these loans but NGOs often grant a larger part of it as part of the development content of their microlending mandate. Banks and other private lenders grant education loans, while SMME loans are extended mostly by NGOs and, negligibly, by a few banks.

Table 2 above also shows that compared to microenterprise lending of 4%, housing and education loans had a considerably good share, of 11% and 13% respectively. A fair assumption would be that the 'unclassified' 72% of total disbursements was for short-term consumption expenditure. Typically, these are loans extended by lenders other than NGOs. Is this an indication of an aversion to microenterprise lending? The 4% loan disbursements to SMMEs out of the total disbursements suggest this could be the case.

A *Finance24* (2004) report on disbursements in the microloan sector in the quarter ending August 2004 illustrates recent growth trends:

- Growth in total loan disbursements from R4.42 billion in May 2004 to R4.91 billion in August, 2004

- Number of loans increased by 8% from 3.26m in May 2004 to 3.5m in August, 2004
- Banks enjoyed a 14% increase in lending between May and August 2004, with a total lending of R1.9 billion
- Private companies enjoyed 11% increase from R1.81 billion in May 2004 to R2.0 billion in August 2004
- Close Corporations, Trusts and public companies enjoyed a combined increase of 8% in disbursement, to R917 million in August 2004
- Section 21 companies are hailed to have recorded the highest growth of 20%, from R41.6 million in May, to almost R5 million in August 2004.

Although the report indicates that the industry is expanding at a 'satisfactory and controllable rate' in terms of number of borrowers and total amount of loans issued, indicating 'maturity in the industry' (*Finance24,* 2004), the fact is disguised that the growth is mostly associated with short-term consumption credit. For example, banks and other players enjoyed good increases in lending, which when combined, hide any increases recorded by the Section 21 companies (the microenterprise lenders). Although Section 21 companies enjoyed the 'strongest growth', according to the report, their industry share is comparatively insignificant.

5.2.3 Khula Enterprise Finance – KhulaStart retail outlets

As mentioned in Chapter 3, KhulaStart is a microlending scheme which reaches the end-user through retail outlets. These are NGOs and MFIs operating mainly in rural areas and townships. The scheme's reach is hampered by the fact that it is represented in many localities by very few NGOs and MFIs. In the Eastern Cape, for example, with some of the biggest townships in the country (such as Mdantsane in East London), only five retail outlets were in operation up to the middle of 2004. By December of the same year, Eastern Cape retail outlets had reduced to three. For the purposes of this study data were obtained from two of these outlets – Hlumisanani in Zwide (Port Elizabeth) and Libec in Mthatha.

The operational thrust of the KhulaStart scheme occurs at two broad levels. There are those activities that take place before any actual disbursements are made, but are

considered an integral part of the lending process and vital to the success of the microenterprise development objective. These are called ‘pre-lending’ activities. On the other hand, there are some activities that take place from the time of actual loan disbursements and are considered essential to the success of the ‘business’ side of the mandate, as they ensure that the loans will actually be repaid. But even this second, ‘post-lending’ set of activities – such as monitoring of end-use - are rooted (in theory at least) in the imperative of microenterprise development. Pre and post-lending activities are discussed in more depth below.

5.2.3.1 Pre-lending activities – Hlumisanani and Libec

Khula Enterprise Finance offers training to the staff of the KhulaStart retail outlets in order to acquaint them with the microlending model and also to instil in them what one might call a complimentarity of perspective. In other words, the company hopes to instil a strong awareness that it is involved in a developmental activity and not one meant to achieve short-term consumption-related ends. Every year it releases funds amounting to about R300,000 to each retail outlet. In terms of Khula’s policy, the retail outlets are obliged to target only the unemployed, people with no business, or those managing an existing small business. In short, KhulaStart loans are for small business start up and business expansion.

As a matter of policy preference is given to women. About 80% of the Hlumisanani’s and Libec’s clients are women. This is in line with the United Nations microcredit model, which incidentally the world body adopted from Grameen Bank. Gender preference is predicated on the belief that, historically, women constitute the poorest of the poor. 20% of KhulaStart loans are given to men under special circumstances, for example, those with certain disabilities, and those caring for an aged person who is not receiving social grant. But even in this latter case, the rule is that the loans will be used for microenterprise activities that will eventually ameliorate the plight of both the disabled and the care-giver.

Inspired by the Grameen model, the KhulaStart scheme uses a group lending methodology. Women are encouraged to form themselves into groups of between 3 and 10 and the retail outlets lend only to them as members of a group. After being

assessed and approved a newly formed group is put through three weeks of training on basic financial management. Upon completion, each group member receives a loan of between R300 and R3500. Each group appoints a leader whose duty is to, among others, ensure that members meet repayment obligations – often by collecting the repayment instalments herself and handing these to the staff of the retail outlets at their regular meetings. Respondents both at Hlumisanani and Libec indicated that the group-leader-as-debt-collector practice has its weakness. Occasionally the group leader uses up the instalments, thus technically causing the entire group to default.

Usually, only about 30-40% of loan applicants are successful. The staff interviewed at both retail outlets explained that often, unsuccessful applicants are those considered 'illiterate' and 'untrainable'. The interviews, however, revealed that the retail outlets had no clear criteria for assessing who is 'trainable' and who is not.

No collateral is required and there is no uniformity as to the registration fees charged. At Zwide and Libec, registration fee was R150 and R50 respectively. These fees are non-refundable and are allegedly for 'administrative expenses'. Only applicants who accept this condition are considered for loans. If a borrower cannot afford this payment the amount is deducted from the approved loan. Although the KhulaStart scheme tends to favour business in tourism and local craft, borrowers are nevertheless required to indicate the nature of business they wish to go into. The retail outlets interviewed claimed that they take this process further by conducting a feasibility study to ascertain the viability of such a venture, especially in the context of the borrower's residential neighbourhood. As a rule, loans are granted only for businesses deemed 'viable' and to existing businesses.

In the past, borrowers could buy their goods themselves with the start-up loans. This practice has been discontinued due to repayment problems. Retail outlets found that most borrowers were either not investing the whole amounts in the business or were simply squandering the money. Existing practice, therefore, is to purchase the business-ware on behalf of borrowers rather than hand them cash. But according to the retailers interviewed, even this alternative has been subverted as some borrowers simply haul the ware back to the suppliers and exchange it for cash!

Retail outlets allow a three-month moratorium; thereafter repayment is made monthly or quarterly depending on a borrower's preference. This 'dispersed repayment', as the respondents called it, is to reduce cost of collection – which in turn keeps transaction costs low. No additional borrowing is approved except to a borrower who has fully re-paid an earlier loan. Group pressure is used to ensure loan repayment but joint liability is not enforced.

5.2.3.2 Post-lending activities – Hlumisanani and Libec

KhulaStart retail outlets employ field workers to provide 'after sales services' to borrowers to ensure repayment. Both retail outlets employ between 40 and 45 field workers, who oversee about 1,300 microentrepreneurs. They visit borrowers once every three months to monitor progress of clients' business activities in addition to offering business- or loan-related advice. Ironically, according to the staff interviewed, 'after sales' efforts are often rebuffed by borrowers. Borrowers view these efforts as an indication of distrust in their entrepreneurial abilities. Also, these meetings with field workers are often the only occasions where group members meet at all and where group leaders collect loan repayment instalments.

The retail outlets charge between 2% and 2.5% interest on loans. In the last 24 months the size of bad debt of the Port Elizabeth and Mthatha outlet was in the region of R90,000 - or 30% of total loan disbursements. In Port Elizabeth about 40% of borrowers 'succeed' in their business in terms of profitability and business continuity. There are a few isolated cases of remarkable business success. Another 30% of borrowers were said to be 'struggling'.

5.2.3.3 Challenges

According to the respondents, a key challenge the retail outlets face is the issue of HIV and AIDS. In both Port Elizabeth and Mthatha the interviewees claimed, without any concrete supporting documents, that 'about 10% of borrowers' were HIV positive, and that there had been cases where people with outstanding loans fell sick and died. According to the staff interviewed, Khula does not require borrowers to

disclose their HIV status as a precondition for obtaining a loan. HIV and AIDS, they said, was a major explanation for their relatively poor bad debt record.

Getting members to attend the quarterly meeting is also a difficulty. Older women take the meetings 'more seriously' than younger women. According to an interviewee in the Port Elizabeth outlet, clients below 35 years of age 'show no seriousness and feel no obligation' to repay their loans. They are 'very mobile' in terms of relocating from one area to another and often have 'relationship problems' that tend to affect their business and loan repayment obligations. This same problem was observed in Mthatha outlet. However, in terms of Khula's policy, age is not a factor in loan access. Therefore, clients that fall within this age bracket and meet loan conditions continue to enjoy the loan.

There is no enforcement of joint liability. If a member is unable to repay over a long time, she is required to report herself to the police. The police then investigate the borrower to ascertain if indeed she is 'bankrupt'. If the police confirm this to be the case, she will be issued a document indicating her inability to pay. When the borrower presents this document to the retail outlet, she is no longer required to repay the outstanding balance. After three years, the debt is written off.

One instructive finding was that some loan clients blame their business performance – and associated credit behaviour – on their husbands and partners who interfere in the business by squandering sales proceeds. Intervention by KhulaStart retail outlets in such cases sometimes aggravates the plight of the female microenterpreneurs, who are faced with bouts of domestic violence for 'daring to expose to outsiders' their men's financial situation and social behaviour. This finding supports earlier microfinance research that was reviewed in Chapter Four of this work highlighting the problems of lending to women.

An interesting finding - one that underlines a strong need to understand what has been referred to in this work as 'Grameen Bank success features' - is that KhulaStart retail outlets have from time to time had to return 'unutilized funds' to Khula, because 'our coverage area is rural' and 'most of our potential clients are illiterate and untrainable'. Conversely, the retail outlets have experienced bureaucratic delays in obtaining loan

funds from Khula and thus have faced situations where they cannot meet their lending obligations timeously.

5.3 Discussion of Findings

5.3.1 Comparison of the private sector, KhulaStart and Grameen microlending features

In Table 3 below, an attempt is made to compare the features of three microlending 'models' – those of South African private sector microlenders, KhulaStart and Grameen Bank – with particular attention paid to factors that promote or inhibit access to microenterprise loans. Access factors here refer to eligibility criteria, and answer the question, '*who is eligible for loans?*' (See Simanowitz and Walter, 2002:17). The aim of this comparison is to show the implications of the various models for microenterprise credit access, job creation and poverty reduction.

Table 3: A comparison of three microlending 'models'

MICROLENDING FEATURE	PRIVATE SECTOR LENDER	KHULA ENTERPRISE FINANCE	GRAMEEN BANK
Lending to the 'poor' (unemployed, self employed, illiterates)	No. The 'poor' are considered a bad 'credit risk'	Yes – subject to completion of 3 weeks' training. But core 'illiterate' are denied access to loans.	Yes – subject to completion of one-week training. The poor are considered 'good credit risks'.
Collateral as lending criterion	Technically, no. But one to three months' bank statements required as evidence of regular earnings. Referees sometimes required.	No	No
Gender preference	No. Ability to repay is paramount. Not a development lending model	Yes. 80% lending to women, universally considered poorest of the poor.	Yes. Over 90% lending to women, universally considered poorest of the poor.
Group lending	No. Individual lending is the rule.	Yes. Groups of 3-10 favoured.	Yes. Groups of 5 favoured.
Client seeking by staff	No. Clients go to lenders.	No. Clients go to lenders.	Yes. Field workers prospect for clients, who then find others, with whom to form groups.
Repayment	Usually monthly	Monthly or quarterly	Mandatory weekly or

MICROLENDING FEATURE	PRIVATE SECTOR LENDER	KHULA ENTERPRISE FINANCE	GRAMEEN BANK
periodicity	repayments	repayments depending on clients' choice.	bi weekly repayments
Compulsory savings as part of loan condition	No	At Hlumisanani, No At Libec, Yes	Yes. Compulsory savings in the form of personal, special and pension savings.
Flexibility of loan terms	To a large extent, not flexible. Sometimes the non bank lenders make personal arrangements with "regular" borrowers.	To a large extent, not flexible. Flexibility only in the choice of monthly or quarterly repayments	There is flexibility in terms of loan size and loan repayments.
Sustainable interest rate	Yes Between 12 and 40%. Profit is the main motive.	No. Only between 2% and 2.5% because the loans are subsidized by the state.	Yes. Rates are applied on a sliding scale: 20% for microenterprise loan, 8% for housing and 5% for education loans
Lending for productive purposes	To a large extent, No. Loans are mainly granted to meet short term needs. Sometimes small education loans	Yes - for starting and expanding existing small business	Yes - mostly for starting and expanding existing business. Housing and education loans are also given as part of the comprehensive programme.
Multiple loans	No Initial loans are offset before giving additional loans	Only on full repayment of an initial loan.	Yes – on partial repayment of initial loans.
Loan size	Not very small loan size	On the average, loan size is about R1000	Very small loan size - to discourage the not-so-poor.
Registration fee as loan criterion	No.	Yes – R150 "commitment fee" mandatory.	No.

Source: Data collected and adapted from Grameen Bank lending features, MFRC and Khula Enterprise Finance

For many people, especially in the developing world, microenterprises provide income and employment where other alternatives are not readily available (Otero and Rhyne, 1994:1). There is always the possibility that people engaging in, or aspiring to go into, these businesses have working capital or venture capital problems. In South Africa, this is glaringly the case. The extent of access to microenterprise credit could be observed from the above table, which summarizes the characteristics of the major

players in the microlending industry. Below are key deductions from the three models presented in Table 3, especially in terms of microenterprise credit access.

5.3.2 Private sector microlenders

Although private sector microloans do not call for collateral they also do not seem to be attractive to a wide segment of the 'loan-needy' population. This is probably because requirements in terms of bank statements and personal referees anticipate that prospective applicants are already banked. The 'unbanked' and those with no credible referees, who could obtain loans for microbusiness ventures, are effectively shut out. These seeming *subtle* requirements could be equated with collateral requirement in the formal credit market, and serves the purpose of screening out people already preclassified as bad credit risks.

Unlike Grameen Bank, South African private sector lenders service individuals *qua* individuals, charge 'sustainable' interest rates since they are in business, and provide credit mostly to meet short-term needs rather than for productive purposes. They have no gender preference since they are not development microlenders. Because they give short-term consumption credit they do not bother about long-term implications of such credit, that is, savings is not required as condition for the loan. However, no registration fee is required and the loans are usually relatively small.

Ledgerwood (1999:47) argues that microlending practices may be a question of the choice of target. According to him, microlenders could be targeting economic, sociopolitical or psychological impact. Economic impact, for example, could mean enterprise promotion, gains in income, household aggregate wealth accumulation, income or economic resource protection – and microlenders could have any combination of these 'targets' in mind when designing their loan models. The data presented so far would seem to suggest that registered private sector lenders adopt household wealth accumulation, income and economic resource protection as their microlending target. Although this 'economic impact' reduces economic insecurity and protects clients against vulnerabilities caused by economic shocks (Ledgerwood, 1999:48), one could argue that it is harmful to ignore enterprise promotion – a major prerequisite for job creation and poverty reduction. Household wealth accumulation, income and economic resource protection are based on conventional ideas of banking, which see credit as an individual affair. The South African situation is a glaring

example of how aggressive socio-political engineering (such as took place under apartheid) could pre-structure poverty and unemployment in a society. Invariably also, the South African situation demonstrates that individualist notions of credit cannot make a dent on the malaise of poverty and unemployment unless the microcredit industry prioritizes and targets enterprise promotion *alongside* other 'impacts'.

5.3.3 KhulaStart

The KhulaStart scheme targets the poor. Its 'economic impact' - to again use Ledgerwood's (1999:48) phrase - is that of enterprise promotion. Like Grameen Bank, Khula gives preference to women, lends without collateral, lends to people as members of small borrower groups - although the Mthatha retail outlet occasionally gives individual loans - and gives loans only for business start-ups and expansion. It theoretically encourages microenterprise credit access. Subsidized interest rates encourage access and reduce repayment burdens on the borrowers, while intensive training on rudimentary financial management increases borrowers' management skills and reduces the possibility of loan failure while also helping to broaden access to loans. Whereas Grameen Bank gives multiple loans to support further business expansion, KhulaStart loans are given in sequence and if initial loans are not paid up no new loans are given.

In practice, unlike Grameen Bank, KhulaStart retail outlets do not look for clients. Clients often stumble upon information regarding the scheme, usually from existing beneficiaries, and through scanty publicity. In a way, those who need the scheme most do not have much knowledge of its existence (Mashego, 2003:29). The retail outlets require registration fees, which is a setback to microcredit access. As a policy, Khula has no savings programme for the clients, although on its own, Libec recently introduced compulsory savings as a way of stabilizing its clients' financial needs. These features and shortcomings hinder microcredit awareness and access.

Especially among the deprived segments of the population, which constitute the target market of KhulaStart, information management is a delicate task because of the meanings people attach to particular concepts. Registration fee, for example, can be

construed as 'extortion' and people can avoid KhulaStart loans simply on account of such perception.

Although the scheme has made some inroads into the poor segments of the South African population and has helped a number of underprivileged people to set up small businesses, its coverage is still very small, considering the credit needs of the vast majority of the poor. The low coverage is evident in the very small number of retail outlets that service the microenterprise sector; for example, as indicated earlier, by December 2004, only three retail outlets serviced the entire Eastern Cape Province, while Limpopo Province has none. Also there is no uniformity in the microcredit outlets' (MCOs') lending practices, and this makes it difficult for Khula to properly coordinate and monitor their activities. For example, Libec (in Mthatha) sometimes grants individual loans while Hlumisanani (Port Elisabeth) does not. There are also differences in administration fees between outlets. It was observed that MCOs' administration of loan funds does not always comply with Khula's microcredit outlines. The laxity in monitoring and control probably explains the media image of the KhulaStart MCOs as inept, fraud-ridden and loss-making outfits.

KhulaStart credit does not involve a savings package and beneficiaries are not compelled to open a savings account with formal banks as a precondition for accessing the scheme. This may hamper business continuity and expansion because where clients lack access to funds to meet emergency consumption needs, they can easily squander microenterprise loans – and repayment suffers when this happens. Besides, in terms of KhulaStart guidelines, a client who has not fully repaid initial loans cannot access further loans, for whatever good purpose.

5.3.4 Grameen Bank

As a policy, Grameen Bank focuses on microenterprise lending. The economic impact of such lending is evident in the growth of the microenterprise sector in rural Bangladesh and in improvements in borrowers' incomes. The bank gives preference to women, lends to groups, and does not require collateral. No registration fees are charged and field workers maintain close contact with clients. These features bolster broad-based access to microenterprise loans. Small loan sizes ensure that lending

remains focused on the poor – and on the borrower's business pursuits – rather than on the 'not-so-poor'. To ensure that borrowers do not divert microenterprise loans to other uses, the bank maintains a compulsory savings scheme through which borrowers meet emergency and short-term contingency needs. The reason is that savings reduce pressure on microenterprise credit and ensure long-term survival and growth of microenterprises (Rhyne and Otero, 1994:13).

Multiple loans support expansion of existing businesses. The bank does not require full settlement of earlier loans before granting additional loans. When an initial loan has been repaid up to a point without default, an additional loan may be granted to expand the business. This helps the business to be grounded.

A major weakness of the Grameen Bank scheme, as stated in previous chapter, is that borrowers are required to commence repayment one week after obtaining a loan, and thereafter, to repay weekly – a policy that could discourage prospective borrowers who might fear that their intended business ventures would not produce enough returns within such short intervals. Also, other than the one-week orientation given to new bank clients aimed at acquainting them with the banks' lending rules and operational norms, Grameen Bank does not offer any form of business training to borrowers.

By contrast, KhulaStart beneficiaries are required to repay their loans monthly after an initial three-month moratorium, in addition to benefiting from a three-week basic financial management training – a package commonly seen as vital to the long-term survival of small businesses.

5.4 Conclusion

Information asymmetries in the microcredit market influence to a large extent the design of microlending schemes and the delineation of target markets. For example, private sector lenders traditionally adopt loan eligibility criteria that favour clients with regular income streams. This tends to exclude the self-employed, the unemployed and the illiterate. This approach at the very best ensures repayment, but it stunts microenterprise development. By focusing on existing household 'wealth'

and 'resource stability', private sector microlending practice ignores that sphere of credit that has long-term impacts on borrowers and society as a whole.

By contrast, both KhulaStart scheme and Grameen Bank adopt enterprise promotion as a core microlending strategy, and utilise innovative approaches to mitigate the problems of information asymmetry. Such approaches include group lending (by which credit behaviour is checked through group dynamics), lending to women (traditionally regarded as low credit risks), and credit rationing (which entails small loan sizes). Together, these features allow credit access and ensure repayment.

However, unlike Grameen Bank, KhulaStart retail outlets do not prospect for clients to increase loan access, do not encourage savings, but impose registration fees to elicit borrower commitment. Although these approaches may help to reduce adverse selection and moral hazard problems, they limit microenterprise credit access. Grameen Bank demonstrates through its lending features that despite informational problems in the microcredit market, microenterprise loans can be made widely available to the poor and good repayment rates ensured. Above all, the bank demonstrates that the poor are 'good credit risks'.

CHAPTER SIX

CONCLUSIONS AND RECOMMENDATIONS

6.1 Summary and Conclusion

There exists in the formal credit market ways of dealing with information asymmetries. Commercial banks have flourished precisely because lending is collateral-based, and there are standardized measures of screening out bad credit risks, as well as established protocols for monitoring borrower behaviour. Above all lending is done on an *individualized* basis. But all these define a lending paradigm; in this case a liberal-individualistic paradigm that makes loans inaccessible to the poor, and one that cannot be successfully applied to address the crucial issues of microenterprise growth, employment creation and poverty reduction in South Africa. Yet, South Africa needs a strong intervention in the microenterprise sector if only to begin to make a dent on the legacies of apartheid and help tackle the problem of structural unemployment that has literally disfigured the society. Existing lending paradigm, which drives South Africa's sophisticated banking industry, cannot address this problem. Indeed, it primarily explains why the private banks generally avoid the historically unbanked and why their capacity to deal with microcredit – a type of specialized lending - has remained largely undeveloped.

Even in the South African microcredit sector, existing lending practices do not adequately bolster microenterprise credit access. As the data in chapter five of this work show, over 95% of the loans disbursed by this sector are consumption credit extended to salary earners and pensioners. In a nutshell, microcredit in South Africa is little more than an institutionalized salary advance scheme, servicing mainly people in the so-called 'first economy'. A striking insight gained in the course of researching for this work is that the South African microcredit sector wears the paradigmatic prisms of the conventional lending sector, which sees the poor as *bad credit risks,* to be avoided outright or courted with extreme caution. Contrast this with the prism offered by Grameen Bank or BancoSol, which sees the poor as *good credit risks.* Indeed, for Grameen Bank, the 'not-so-poor' are the bad credit risks! Because of using a 'wrong' prism to view the reality of 'the poor', and presuming people a 'credit

risk' until proved otherwise, the South African microcredit sector has failed to develop lending mechanisms that can bring the poor into the mainstream of economic activities and thereby stimulate new levels of economic growth in the country.

Microfinance, as the Grameen Bank example has demonstrated, cannot succeed on the strictly liberal-individualistic model used by conventional banks, and conventional banks cannot meaningfully contribute to microenterprise development and the eradication of pre-structured poverty (such as is uniquely the problem in South Africa) using that paradigm. Specific features like group lending, lending to women, lending without collateral, lending based on 'trust', moderate interest rate charges, and other supporting features eliminate to a large extent, the problems of adverse selection and moral hazard, and ensure that credit goes to who credit is due. Grameen Bank's records demonstrate that pro-poor lending is not *inherently* riskier than formal sector lending.

It must be emphasized that Grameen Bank model is based on a specific ethnographic understanding of the poor in Bangladesh, and it is an understanding that society has certain norms (such as the norms of collectivism) that can be harnessed for microenterprise credit operations. More importantly, the Grameen model sees the norms of collectivism as the *defining social structure* of the world of the poor. The question of whether such norms can be found in South African townships or only exists in rural Bangladesh does not arise. As chapter four of this work has shown, no society is exclusively 'traditional' or 'modern'; collectivist norms exist in every society.

The South African microcredit sector flounders because of its inability to mitigate the problem of information asymmetries. But mitigating information asymmetries between lender and borrower in the microfinance sector - and hence unleashing the power of the unbanked millions - rests on understanding, identifying and harnessing the collectivist norms referred in this work. As things stand in the sector (and this is confirmed by the data in chapter five and the impression given to this researcher in the field) microcredit providers in South Africa consider their client base saturated. That is to say, credit providers tacitly believe that the people who have not yet been reached are the 'bad credit risks'!

Khula Enterprise Finance and other nonprofit microfinance intermediaries provide an example in South Africa of the emancipatory potentials of microenterprise lending, although so far they have made only modest impact. On the basis of the data in chapter five, some reasons can be deduced as to why their impact is limited – indeed, specific factors that limit the lenders' effectiveness are identifiable. One, the development lenders are few in relation to the enormity of microenterprise credit needs. Two, although the KhulaStart scheme is based on the United Nations microcredit model (which is a Grameen Bank replication), some of the key features of that model (like compulsory savings for borrowers) are not in full operation. Three, by charging registration fees – a strategy not used by Grameen Bank – loans may be avoided especially by the very poor. Four, and most importantly, the methods of identifying eligible borrowers appear insensitive to the reality that most historically unbanked South Africans will be selected out of a scheme that was meant to empower them. This could mean that even the methods adopted by the development lenders are diluted or unduly influenced by the conventional paradigm that pre-classifies people as 'good' or 'bad' credit risks. Indeed, as this researcher found, microcredit retail outlets have on occasion had to return unutilized loan funds to Khula on the premise that there are no 'qualified' or 'eligible' borrowers.

Access to credit in the formal financial sector leads to stabilization in income, wealth creation and capital formation, and capital formation increases productive capacities of individuals and firms. These ultimately lead to economic growth. To those that utilize informal credit markets, access to credit should to some extent serve the same purposes as those of the formal financial sector. It should not simply be about 'income stabilization' (which is the argument of the South African promoters of *consumption* microcredit). It should principally be about helping the poor and the economically disadvantaged to increase their productive capacities; that is, ultimately making them creators of wealth (which is what Grameen Bank does).

If the United Nations' Millennium Development Goal of halving extreme poverty by 2015 is to be realised, and if this goal is to be met locally in South Africa, job creation in the informal economy should be stimulated through access to financial services, especially credit. If credit is to stimulate activities in the informal sector, a good understanding of the world of the poor must be gained. In other words, there must be

a sound understanding of the economic potentials of those conventionally pre-classified as 'bad credit risks' – that is people traditionally considered as presenting the greatest risks of adverse selection and moral hazard. Appropriate methods of promoting microenterprise credit access in this segment of the population must then be adopted. Although the present policies of the South African government are, in theory, geared towards job creation especially among the poor majority, the challenges faced by the microlending sector call for urgent policy intervention.

6.3 Recommendations

The Grameen Bank microcredit model represents a benchmark for microenterprise credit and enjoys numerous replications around the world. This thesis emphasizes microenterprise credit; therefore, the following recommendations are made with reference to Grameen Bank microcredit model, and cover two broad policy areas: action by banks and KhulaStart credit delivery paradigm/method.

If microcredit is to be expanded to reach the vast majority of South Africans that need it, commercial banks must be involved. According to Harper (2004:7), often, banks shun getting involved in microcredit not necessarily because of perceived risks and doubts about profitability, but because they lack the requisite knowledge and skills to effectively function in this somewhat specialized sector. They also face organizational constraints and have negative attitudes towards such lending. Although effort by ABSA, Standard Bank and Nedcor to serve the low income market in South Africa have already met with failure (Schoombie, 2000:751), the experience of BancoSol in Bolivia illustrates that commercial microfinance banking can be a profitable venture. BancoSol has creatively blended development-oriented banking with commercial banking ethos to create one of the world's best examples of a successful commercial microfinance bank.

A locally relevant innovation for South Africa could be to take advantage of the country's sophisticated financial infrastructure and blend Grameen Bank ethos and strategies with those of BancoSol to create an initiative that unleashes the economic potential of the country's poor millions. *Mzansi* account does not exactly fall within the rubric of this recommendation, as it is merely a parody of conventional

individualized banking that, if not properly monitored, could expose more ordinary people to exploitation[1]. The starting point would be for banks to reappraise their conventional paradigm of who constitutes a 'credit risk', and what economic potentials abound in the segment of the population traditionally pre-classified as a 'bad credit risk'.

Microenterprise lending is specialized and is best approached with specialized methodologies, such as those used by Grameen Bank and BancoSol. The group lending methodology, for example, significantly reduces transaction costs - a major deterrent to banks in this business - by eliminating to a large extent the cost of screening loan applicants, monitoring, and enforcement of 'restrictive covenants'. It also substitutes for collateral especially if joint liability is enforced. Banks may find this a useful strategy for bridging information asymmetries and increasing microenterprise access. But, as emphasized earlier, this is not simply an issue of methods: the devil is in the paradigm.

Government should give incentives to banks as a way of encouraging microenterprise credit, and do this with a clear understanding that the peculiar South African situation demands the active involvement of the private banking sector which is already very highly developed. One such incentive is to guarantee microenterprise loans. Indeed, because pro-poor microfinance could be quite expensive in a country like South Africa with a huge pre-structured problem of poverty (Baumann 2001:17), government must see its role in this sector as paramount. Although fund guarantees throw up many difficulties, among which is the ratio in which the risk of default could be shared between guarantor and bank (Schoombie, 2000:762), guaranteeing loanable funds does encourage banks to undertake microenterprise lending.

[1] *Mzansi* account holders are not entitled to any form of credit and do not enjoy all the services extended to regular savings or current account holders. For this reason, they pay only a fraction of regular bank charges – an issue the banks make a huge premium out of. However, it is generally believed that South African bank charges are probably the highest in the world (Businessowner, 2004); therefore, *Mzansi* account holders - who are mainly from the historically disadvantaged segment of the population - could actually be paying more than what would be considered 'normal' bank charges in other countries. The possibility that the poor might be heading for exploitation is confirmed by the fact that since the launching of the scheme, most of the banks have made it clear that they admit Mzansi clients in the strong hope that they will eventually 'graduate' into the 'normal' product categories and pay the full service charges.

Some observers maintain that effort to encourage banks into microenterprise lending will yield less result because of the image they want to maintain in the face of global competition and the need to boost confidence in foreign investors. But it can also be argued that global competitiveness does substitute for the need to stimulate locally sustainable economic development. Indeed, global competitiveness and global relevance are not necessarily antithetical. Banks should give priority to the needs of the local economy and support its growth, and government should encourage efforts taken by banks in this direction. Ultimately, due to South Africa's unique situation, pro-poor microlending is better done through government-backed MFI's and/or banks with government-subsidized funds. Khula Enterprise Finance does guarantee bank credits to small and medium enterprise operators; it does not guarantee loans for the microenterprise sector.

Since the KhulaStart scheme is based on the United Nations microcredit model, it should, alongside its microenterprise emphasis, encourage savings and possibly make savings a part of loan conditionalities. The secondary emphasis on savings is important for consumption smoothening and checks the possibility of borrowers diverting microenterprise loans to consumption-related purposes. This recommendation is particularly important because microcredit clients (both present and prospective) are the most unlikely to accumulate savings elsewhere.

KhulaStart targets the very poor; therefore, it is unnecessary to test borrower commitment by imposing registration fees. Ordinarily, the very poor are very fearful and intimidated to ask for loans. An administrative expense, no matter how small, could further discourage their participation in microcredit schemes.

Grameen Bank begins with the belief that everyone, including the poor (who also are often illiterate) *do have* skills that can be utilized. Within this paradigm, the poor are credit worthy until proved otherwise. KhulaStart retail outlets have had to return funds back to Khula on the grounds that potential borrowers are illiterate and therefore ineligible for loans. Khula, like conventional banks, must fundamentally redefine the concept of 'credit risks' if it hopes to stimulate economic development in the historically excluded and underprivileged segment of the population. Everyone has a potential to create wealth, and microenterprise development is essentially about

unlocking this potential in the target population rather than approaching people with a notion that they are either 'good' or 'bad credit risks'.

In the 1999 annual report, Khula management lamented that the organization would have made a better impact on the South African society if its retail outlets 'shared their vision and conviction'. This was an indictment of the differential practices among KhulaStart retail outlets, and underlines the imperative of concerted and regular training through which Khula's vision could be imparted to the MCOs.

6.4 Limitations of the research

The research method adopted in this study required collection of primary data through interviews with private sector microlenders and KhulaStart retail outlets – Libec in Umtata and Hlumisanani in Port Elizabeth. Because the researcher had no funding, interviews were limited to these few outlets against original intention of interviewing as many outlets as possible in the Eastern Cape. The researcher interviewed Hlumisanani staff in person, while respondents at Libec were interviewed telephonically.

Effort was also made to telephonically interview responsible Khula Enterprise Finance staff in Johannesburg, but this was not successful. No one at the other end of Khula's toll-free number seemed able to coordinate a telephone interview. On one occasion when a call successfully went through, a junior manager requested the researcher to send the questionnaire by mail, which the researcher did. However, till the completion of this thesis, no response was received, and repeated calls to request the return of the questionnaire yielded no results. The researcher thus had to rely on data gathered from the retail outlets in Port Elizabeth and Mthatha and relevant secondary data obtained from web resources. Conclusions drawn are therefore based on information available to the researcher.

6.5 Suggestions for further research

Several studies have been done on the microcredit industry in South Africa, touching on different areas. The South African NGOs and MFIs lend only to microenterprises

and through their activities, support the microbusiness sector. Impact studies should be conducted to ascertain the extent to which businesses, which these organizations support have progressed from being survivalist to those that can make meaningful economic impact on the lives of those who utilize microenterprise loans. Microloans should help people to enter the world of microenterprises rather than create mere survival businesses. Such loans should help to make microbusinesses self-sustaining.

AIDS has reached a pandemic stage in South Africa and seems most prevalent in the target market of microcredit products – that is, low-income earners and the poor. As yet, there is no empirical research into the associations between HIV/AIDS and bad debt in the microenterprise credit sector; current estimates regarding such associations are merely anecdotal. Such studies are necessary because in the course of this research, respondents commonly mentioned HIV/AIDS as a major cause of loan default and bad debt.

Finally, microenterprise credit targets mostly women. This researcher encountered allegations in the field as to men's interference in loan performance. Appropriate research should be done in South Africa to ascertain partner resistance and domestic abuse as a factor in loan default and bad debt.

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APPENDIX A

INTERVIEW SCHEDULE – REGISTERED PRIVATE SECTOR MICROLENDERS

Section 1:

1. What type of loan do you typically grant?

   - loan to meet up short term financial needs
   - loan to start small or expand an existing one?
   - Housing loan
   - Educational loan
   - Other ………………………………………….(please specify)

2. Of the total number of loan applicants during the last 24 months, what percentage were successful
   - 1-10%
   - 11-20%
   - 21-20%
   - 31-30%
   - 41-50%
   - 51-60%
   - 61-70%
   - Above 70%

3. Of the total number of your loan grantees during the last 24 months, please indicate percentage according to the type of loan (Tick as appropriate):

Short term Needs	Business startup/Expansion	Housing	Education	Other (Please specify)
1-10%	1-10%	1-10%	1-10%	1-10%
11-20%	11-20%	11-20%	11-20%	11-20%
21-30%	21-30%	21-30%	21-30%	21-20%
31-40%	31-40%	31-40%	31-40%	31-40%
41-50%	41-50%	41-50%	41-50%	41-50%
Above 50%	Above 50%	Above 50%	Above 50%	Above 50%

4. To which of the following categories do your loan grantees fall?
   Salary earners…..Why?………………………………………………..
   Self-employed…. Why?……………………………………………….
   People who want to start new business Why?…………………………
   People who want to expand existing business Why……………………
   Unemployed…Why? …………………………………………………..
   Students…. (Why?) ……………………………………………………

Other (Please specify) Why?…………………………………………..

5. Of your loan grantees during the last 24 months, what are their educational backgrounds:
   - No formal Education
   - Primary Education
   - Secondary Education
   - Post Matric Education
   - Tertiary Education (Technikon/University)
   - Other (Please specify)

6. Of your loan grantees during the last 24 months, what are their levels of income?
   - Up to R6,000 per annum (Specify percentage………………)
   - R6001 -12000 per annum (Specify percentage………………)
   - R12001 -18000 per annum (Specify percentage………………)
   - R18001 - 24000 per annum (Specify percentage………………)
   - R24001 - 30000 per annum (Specify percentage………………)
   - R30001 -36000 per annum (Specify percentage………………)
   - R36001 - 42000 per annum (Specify percentage………………)
   - R42001 – 48000 per annum (Specify percentage…………….)
   - R48,001 – 54000 per annum (Specify percentage…………..)
   - R54001 – 60000 per annum (Specify percentage…………….)
   - Above R60000 per annum (Specify percentage………………)

7. What are the most important criteria you take into account before granting a loan?

8. Are applicants expected to have collateral in order to be granted a loan?
   - Yes…………
   - No …………

9. If yes to No. 8 above, what type of collateral?
   - Land/Landed Property
   - Secure employment?
   - Surety
   - Valuable personal belongings
   - Other (Please specify)

10. If no collateral is required, why not?

Section 2

1. What is the average loan size that you have given out in the last 24 months?
2. Do you monitor the end use of the loans you grant?
   - If yes why?
   - If no, why not?
   -
3. From your experience what do you think your clients use the loans for?

4. How do you ensure loan repayment?
5. Do you visit your client before and after a loan has been granted?
   - If yes why?
   - If not why not?
6. Do you have specific staff that monitor your clients?

7. In the last 24 months, have you had any bad debt?
8. If yes, what is the size of your bad debt ………
9. Which categories of your clients contributed significantly to your bad debt?
10. What is the gender distribution of your clients in the last 24 months?
    Male___%, Female___%
11. In the last 24 months have you lent to people as a group? If yes for what purpose was the loan?
12. Have you at any time specifically targeted low income and unemployed people as loan beneficiaries?
13. What steps have you taken to ensure that your loan reaches low income and unemployed people?

APPENDIX B

INTERVIEW SCHEDULE – KHULASTART RETAIL OUTLETS

1.What criteria must be met before a loan is granted?

2.What sort of collateral do you require from applicants?

Land/Landed Property
Secure employment?
Surety
Valuable personal belongings
Other (Please specify)

3.What is the average loan size that you have given out in the last 24 months?

4.Of the number of applicants, what percentage actually got loans during the last 24 months?

1-10%
11-20%
21-20%
31-30%
41-50%
51-60%
61-70%
Above 70%

5. Are there specific types of business you favour with regards to the granting of loans?

6. If so why?

7. Do you monitor the end use of the loans you give?
If yes why? If no, why not?

8. From your experience what do you think your clients use the loans for?

9. What steps do you take to ensure loan repayment?

10. Do you have specific staff who monitor compliance to loan terms and who also assist in tracking loan grantees to ensure successful loan repayment?

13.What is the size of your bad debt?

14.What is the gender distribution of your clients in the last 24 months? Male___%, Female___%

15.How many microentrepreneurs have you lent to in the last 24 months?

16.Do you monitor their progress? If yes how successful are they?

17.Have you lent to people in a group before?

18 If yes for what purpose was it?

19.In your own opinion what could be done to enable the unemployed to benefit from your microloan?

20.What steps have you taken to ensure that your loan reaches low income and unemployed people?