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South Africa's National Credit Act: A Possible Model for the Proper Role of Interest Rate Ceilings for Microfinance

Megan Whittaker[*]

I. INTRODUCTION

The concept of microcredit, in which poor people are given access to small loans as an alternative to charity, began as an economic and social experiment in the developing world.[1] Microlending was pioneered by Bangladeshi Professor Muhammad Yunus in 1976, when he launched an action research project in his native country to "examine the possibility of designing a credit delivery system to provide banking services targeted at the rural poor."[2]

As of December 2007, the product that resulted from Yunus' research project, the Grameen Bank, has 7.41 million borrowers, ninety-seven percent of whom are women.[3] The Bank has 2259 branches serving 72,833 villages, covering more than ninety-six percent of the total villages in Bangladesh.[4]

The success of the Grameen Bank has been duplicated in various other countries by various other microfinance institutions ("MFIs"). Indeed, loans to the poor have existed for thousands of years, albeit in less formalized models.[5] The movement has advanced from the collective insights of numerous "extraordinary individuals," and today there are thousands of financial institutions around the world providing the very poor

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[*] J.D. Candidate, 2008, Northwestern University School of Law. Thank you to my family for their love and support, and to Professor Stephen Sawyer for his insight and assistance with this comment.

[1] Jay Lee, Note, *Equity and Innovation: Using Traditional Islamic Banking to Reinvigorate Microlending in Urban America*, 16 IND. INT'L & COMP. L. REV. 523, 523 (2006).

[2] A Short History of Grameen Bank, http://www.grameen-info.org/bank/hist.html (last visited May 1, 2008).

[3] Grameen Bank, http://www.grameen-info.org/bank/index.html (last visited May 1, 2008).

[4] *Id.*

[5] *Macro Credit,* ECONOMIST, Oct. 21, 2006, at 78, *available at* http://www.economist.com/people/displaystory.cfm?story_id=E1_RDQJRNJ.

with access to financial services.[6] Since the idea's inception in the 1970s, the Grameen Bank and other microfinance institutions have "reversed conventional banking practice by removing the need for collateral and created a banking system based on mutual trust, accountability, participation and creativity."[7]

Indeed, microfinance has evolved into a highly-regarded anti-poverty mechanism. The UN itself has placed significant faith in microfinance by implementing it in its strategy to "halv[e] extreme poverty and hunger by 2015." It made 2005 the International Year of Microcredit.[8] Former United Nations Secretary General Kofi Annan has stated that access to credit "helps alleviate poverty by generating income, creating jobs, allowing children to go to school, enabling families to obtain health care and empowering people to make the choices that best serve their needs."[9] Most recently, Mohammed Yunus was honored with the Nobel Peace Prize in October 2006.[10]

The emotional appeal of microcredit is undeniable; its success could make it "one of the great humanitarian movements of history, allowing people to free themselves from the bondage of poverty."[11] It provides investors of all financial backgrounds with a means of helping alleviate poverty by expressing faith in the work ethic and entrepreneurial capabilities of the world's poorest people.

The benefits of microcredit, however, are not merely sentimental. Historically, microlending has led to high return rates across a variety of cultures and contexts.[12] Due to the extensive effort and gradual return involved in a single microloan, personal investment in a microfinance institution is not a way to accumulate rapid sums of wealth.[13] With an average return of four percent, however, it "outperforms money market accounts and is safer than the market."[14]

As a result, the concept of microloans has been met with both heavy caution and enthusiastic optimism. The possibilities behind microfinance, both social and economic, have attracted significant study of the forces behind it in an attempt to harness the optimal benefits from such a

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[6] *Id.*

[7] Grameen Bank, *supra* note 3.

[8] *Id.*

[9] Lee, *supra* note 1, at 524.

[10] Celia W. Dugger, *Peace Prize to Pioneer of Loans For Those Too Poor to Borrow*, N.Y. TIMES, Oct. 14, 2006, at A1.

[11] Lee, *supra* note 1, at 533.

[12] *See generally* Tom Easton, *A Survey on Microfinance: Micro No More*, ECONOMIST, Nov. 5, 2005, *available at* http://www.economist.com/surveys/displaystory.cfm?story_id=E1_VDSJPNQ.

[13] Lee, *supra* note 1, at 534.

[14] *Id.*

potentially powerful anti-poverty mechanism.

This comment will discuss the current debate regarding the proper role of interest rate ceilings in microfinance and how the South African National Credit Act should serve as a model for future studies of microcredit systems in developing countries. Part II will discuss the controversy over interest rate ceilings in microfinance, setting concerns regarding the effect of ceilings on the viability of microfinance institutions against the need to protect marginalized consumers from predatory lending. Part III will analyze various alternatives to usury laws that microfinance experts have proposed, with an emphasis on supervisory and regulatory systems as the most promising option. Part IV will discuss South Africa's National Credit Act of 2005, a sophisticated supervisory and regulatory system which the South African government enacted as a response to decades of ineffective policies regarding usury laws. The comment concludes by explaining how the new South African model attempts to resolve many of the issues expressed in Parts II and III, and if successful, may provide a critical example of how interest rate ceilings and microfinance can co-exist in a symbiotic relationship.

II. THE CONTROVERSY OVER INTEREST RATE CEILINGS IN MICROFINANCE

As with any credit system, and especially a developmental one, there remains controversy over the proper interest rates to be applied to such loans. Superficially, one would expect that with a target population of impoverished clients, the lower the interest rate, the better. There is, however, considerable debate in the microfinance world about the role of interest rate ceilings in microlending.

The Consultative Group for Assisting the Poor ("CGAP"), a consortium of thirty-three public and private development agencies, believes that usury rates are a hindrance to the survival of MFIs, and often to the developing economy altogether.[15] For exampie, when the purpose of microfinance is to give credit access to those who would not normally be able to obtain it, the goal would be to extend that access to as many consumers as possible. The costs of microcredit are higher than in regular consumer banking, however, and therefore MFIs generally have to charge higher rates than consumer banks in order to cover those costs and retain enough profit to sustain themselves.[16] This is due not to poor return rates, but instead to the inherent nature of microfinance; the transactional costs

[15] CONSULTATIVE GROUP TO ASSIST THE POOR, OCCASIONAL PAPER NO. 9: INTEREST RATE CEILINGS AND MICROFINANCE: THE STORY SO FAR (Sept. 2004), *available at* http://www.cgap.org/portal/site/CGAP/menuitem.1b5d171ad6c9e30167808010591010a0/ [hereinafter OCCASIONAL PAPER NO. 9].

[16] *Id.* at 2.

involved in making many small loans will always be larger than those required to make one big loan.[17]

A. Transactional Costs

Typically, there are three types of lending costs that need to be covered by interest rates: costs of funds for on-lending, the cost of risk (loan loss), and administrative costs.[18] These costs are compounded by the personal contact with consumers, often in the form of lending agents visiting clients in remote villages, which forms an integral part of the microcredit process.[19] Nevertheless, although the transactional costs are usually proportionally higher for microcredit than for mainstream commercial bank lending, microfinance institutions often are more productive than commercial banks in that microfinance boasts a much higher borrower-per-loan officer ratio.[20]

Unfortunately, the government entities that create interest rate ceilings and usury laws are often composed of politicians, not financial experts, and often do not consider adequately those practical (and often unavoidable) differences in their calculations.[21] According to the CGAP, the reference point is instead "nearly always the lower-cost commercial banking sector, which makes larger loans than the microfinance sector. This decision-making process means that in many cases governments find it politically difficult to set interest rate ceilings high enough for microfinance to flourish."[22]

Moreover, enforcement of these laws is usually not sufficiently addressed. Many usury laws are enacted without a clear means of implementation.[23] Other times, the responsibility is placed in the hands of an agency without either adequate expertise or the enforcement capacity required to regulate the large numbers of non-bank institutions and even individuals that should fall under its jurisdiction.[24]

As a result, usury laws that cap interest rates often reduce the profitability of loans and undermine one of the main goals of microlending by "making it more of a charity than a commercial enterprise."[25] If a microfinance institution cannot cover the costs of its current operations, it will either reduce access to few loan recipients or go out of business

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[17] *Id.* at 3.

[18] *Id.*

[19] *Id.*

[20] OCCASIONAL PAPER NO. 9, *supra* note 15, at 3.

[21] *Id.* at 9.

[22] *Id.* at 5.

[23] *Id.* at 9.

[24] *Id.*

[25] Tom Easton, *A Survey on Microfinance: Bankable Banks*, ECONOMIST, Nov. 5, 2005, at 8.

altogether.[26] Interest rate ceilings may discourage NGOs from transforming into licensed financial intermediaries, or discourage already licensed firms from entering into the microfinance market.[27]

B. Regulation Evasion and Its Effect on Consumers

Alternatively, usury laws may encourage existing participants in the microfinance sector to evade regulation.[28] For example, some MFIs avoid raising interest rates by adding confusing fees that reduce the poor's ability to choose between competitive institutions and programs.[29] Moreover, some MFIs that are unable to cover costs with the maximum interest rate are forced to accept government subsidies, which render the institutions vulnerable to political agendas, instability, and corruption.[30]

C. Cultural Barriers to Usury Laws

Finally, some societies, notably many Islamic countries, prohibit usury laws altogether as a matter of culture. Although Islamic banking is beyond the scope of this comment, most devout Muslims accept the interpretation of the Koran that forbids a fixed rate of interest on loans or deposits.[31] Instead, the basic principle is that of "shared risk"—Muslims generally believe that it is immoral for the risks and benefits of a loan or an investment not to be shared equitably by all participants.[32] Although the concept of "shared risk" is similar to many microfinance programs, the discrete issue of usury laws as a supplement to group loans is closed within many Islamic economies.[33]

D. Benefits to Usury Laws

The debate regarding usury laws, however, is not completely one-sided. The fears of predatory lending are not without merit. There is no shortage of egregious interest rates that leave poor consumers in enormous debt, even to the point of de facto servitude.[34] In India, some MFIs have behaved more like loansharks than ethical enterprisers, charging interest rates on the full amount of a loan instead of the declining balance, and

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[26] OCCASIONAL PAPER NO. 9, *supra* note 15, at 5.

[27] *Id.*

[28] Easton, *supra* note 12, at 9.

[29] OCCASIONAL PAPER NO. 9, *supra* note 15, at 6–7.

[30] *See, e.g.*, *id.* at 4–5.

[31] Lee, *supra* note 1, at 550.

[32] *Id.*

[33] *Id.*

[34] *Microsharks*, ECONOMIST, Aug. 17, 2006, *available at* http://www.economist.com/finance/displaystory.cfm?story_id=7803631.

bullying and humiliating consumers.[35] Even the CGAP has admitted that "[a]t the same time, predatory lending and consumer abuses are legitimate policy concerns."[36]

Furthermore, the arguments for simply repealing usury laws seem to rest on several assumptions. Countries with liberalized interest rates rely on the combination of interest rate disclosure and lender competition to promote fair rates over time.[37] Developing countries are the main target of microfinance institutions, so to assume that their economies will be able to support limitless interest rates effectively is a practically dangerous exercise. Many states will not have the luxury of transparent consumer protection laws and efficient market economies. Nor may they have enforcement capabilities to place any weight behind mechanisms created with the ambition to replace a need for usury laws. Nevertheless, critics of interest rate ceilings have proposed alternatives to usury laws, the practical implications of which will be discussed below.

III. ALTERNATIVES TO USURY LAWS

The main alternatives that critics of usury laws suggest are competition, consumer protection laws, and supervisory and regulatory mechanisms. Despite their theoretical appeal, competition and consumer protection laws are ineffective by themselves due to their inherent reliance on other measures of economic and institutional health that cannot be assumed in a developing country. Supervisory and regulatory mechanisms, on the other hand, build up those strengths rather than take them for granted, and thus enjoy the greatest potential for success as an alternative to traditional usury laws.

A. Competition

Organizations such as the CGAP have stated that "[t]he most powerful mechanism for lowering interest rates in microfinance is competition."[38] In support of this position, they claim that "[i]n many competitive markets, efficiency has improved and microcredit interest rates have declined."[39]

The argument that competition is a cure-all is misleading, however, since competition itself relies on numerous other factors in order to work efficiently. In its Occasional Paper No. 9, the CGAP also states that "[f]irst and foremost, a stable macroeconomic situation is a critical precondition for competitive microfinance. Also important is an appropriate legal and

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[35] *Id.*

[36] OCCASIONAL PAPER NO. 9, *supra* note 15, at 10.

[37] *See generally id.*

[38] *Id.* at 11.

[39] *Id.*

regulatory framework that provides a level playing field, allowing for market entry and a reasonable operating environment for diverse types of financial institutions."[40] And it does not stop there, since "[i]nvestments in basic telecommunications, roads, and education are also critical for future efficiency improvements in microfinance."[41]

There is no doubt that all these variables are important. Nevertheless, since microfinance sectors have erupted mostly in developing countries, many societies that currently have microfinance sectors may not have the resources at this point to have all of these pre-conditions in place.

Without these pre-conditions, competition itself can eventually hurt the poor, "as competition exacerbates asymmetric information problems over borrower indebtedness."[42] As a result, many borrowers may find themselves with multiple loans from different MFIs.[43] In India, for example, a high suicide rate among borrowers was attributed to "[a]ggressive competition and a failure to share information" which "meant some people were in hock to numerous lenders."[44] Therefore, competition by itself is not an adequate alternative to usury laws.

B. Consumer Protection Laws

The CGAP has also claimed that enhanced consumer protection laws, such as truth-in-lending laws, can be "a more constructive alternative" to usury laws.[45] Consumer protection laws can give borrowers the assurance that the information they are receiving regarding loan rates and other applicable fees are both comparable and accurate, and thus allow the borrower to make an informed decision before entering into a credit agreement.[46] The CGAP has noted that "[a]n important goal of consumer protection is to protect consumers from exorbitant fees and interest rates."[47]

However, it would seem that consumer protection laws would face the same enforcement challenges as usury laws, as both would require a competent and authoritative mechanism to implement remedies for violations. Furthermore, although one of the criticisms of having

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[40] *Id.* at 12.

[41] *Id.*

[42] CRAIG MCINTOSH & BRUCE WYDDICK, COMPETITION AND MICROFINANCE (Oct. 2004), *available at* http://www.princeton.edu/~rpds/downloads/seminar_papers/wydick_competition_microfinance.pdf.

[43] *Id.*

[44] *Microsharks, supra* note 34.

[45] CONSULATIVE GROUP FOR ASSISTING THE POOR, FOCUS NOTE 27: PROTECTING MICROFINANCE BORROWERS 1 (May 2005), *available at* http://www.microfinancegateway.org/content/article/detail/26287 [hereinafter FOCUS NOTE 27].

[46] *Id.*

[47] *Id.* at 4.

politicians decide which rates are "usurious" is their lack of technical expertise, consumer protection laws that require courts to enforce these laws would be reserving such decisions for judges, who are presumably no more qualified than politicians to make decisions based on economic (as opposed to legal) principles.

C. Supervisory and Regulatory Systems

The most promising alternatives to traditional usury laws may involve supervisory and regulatory systems. After conducting research in Bolivia, Colombia, and Mexico, Accion International, one of the major microfinance organizations, stated that "we consider a supervisory and regulatory system to be successful for microfinance if it allows microfinance to evolve and become integrated into the mainstream financial sector while appropriately protecting both deposit taking MFIs and consumers against risk."[48]

For example, in Bolivia, competition "engendered by the entry of new players and the growth of the microfinance industry" pushed interest rates from roughly eighty percent in the early 1990s down to levels of between twenty-two and thirty percent "without regulatory pressure from the banking authorities and without unsustainable subsidization of interest rates by the public sector."[49] However, this drop in interest rates occurred only within a larger supervisory and regulatory system.[50]

Accion claimed that several factors can contribute to good microfinance regulation and supervision. First, "a successful system will be tailored to the needs of the microfinance industry in each specific country."[51] Instead of a "one-size fits-all" approach when developing or restructuring their systems, governments should consider the unique microfinance environment that currently exists within their own country, while keeping in mind the specific performance norms applicable to microfinance.[52]

For example, in its analysis, Accion emphasized that Bolivia had created "a system of specialized microfinance regulation and supervision," whereas Mexico had initiated "a delegated system in which federations comprised of representatives from MFIs engage in self-regulation."[53] However, any system that is implemented within a country's economy

[48] JACQUES TRIGO LOUBIÈRE ET AL., SUPERVISING AND REGULATING MICROFINANCE IN THE CONTEXT OF FINANCIAL SECTOR LIBERALIZATION: LESSONS FROM BOLIVIA, COLOMBIA AND MEXICO 10 (Aug. 2004), *available at* http://publications.accion.org/publications/Supervisin_184.asp.

[49] *Id.* at 8.

[50] *Id.*

[51] *Id.* at 10.

[52] *Id.*

[53] *Id.*

needs to be adapted to characteristics of microfinance and "aligned with the local realities of the microfinance industry" in order to foster MFI growth.[54]

Second, "governments should engage in a consultative process to arrive at a well-designed system that provides the basis for growth and development of a healthy industry."[55] According to Accion, officials should solicit the advice of all local stakeholders (e.g., microfinance institutions, other government officials and associations) as well as international experts when designing their systems.[56]

Furthermore, the country must have a "suitable" political and microfinance climate.[57] This means that "a critical mass" of existing microfinance providers should already be operating, and that supervisors assigned to the sector should have a deep understanding of the credit technologies specific to microfinance.[58] Finally, there should be "stable, high-level political support for the microfinance industry."[59] As will be discussed below, South Africa has created by new legislation a supervisory and regulatory system that meets most, if not all, of Accion's requirements for success.

IV. IMPLICATIONS OF THE NEW NATIONAL CREDIT ACT IN SOUTH AFRICA

Microfinance institutions have entered the economies of developing countries all over the world. Reports have been done on the success rates of both the institutions and the role of interest rate ceilings on the viability of those institutions.[60] Each context, however, represents a society at a different level of development, with a different government and a different set of cultural values. Finding a cookie-cutter model for microfinance, therefore, is most likely a futile exercise. However, some models may be analyzed to determine which mechanisms pose the greatest chance for success in a similar context.

The current South African model, with its parameters arising from extensive experience in the microfinance sector, provides a promising example of the integration of microfinance sector into a developing society.

A. History of the National Credit Act

South Africa's first attempt at usury legislation was the Usury Act of

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[54] LOUBIÈRE ET AL., *supra* note 48, at 10.
[55] *Id.* at 10–11.
[56] *Id.* at 11.
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] *See, e.g.*, LOUBIÈRE ET AL., *supra* note 48, at 10.

1968. This legislation was implemented in the era of apartheid, and therefore faced significant issues regarding the financial exclusion of its non-white citizens, most notably the country's black majority population.[61]

In 1992, the Ministry of Trade instituted a Usury Act Exemption, which allowed lenders to charge unregulated interest on small loans.[62] The stated policy goal of this legislation was to spur growth in lending to micro, small, and medium-sized enterprises.[63] As a result, the microloan sector soon exploded, but the effects were not felt by the intended recipients. Instead of improving credit access to poor, rural South Africans, the microlending sector targeted urban, employed individuals for loans.[64] The policy created a disaster by "dividing the market and thereby excluding lower income people from the banking sector and formal credit options."[65] Interest controls were removed without proper regulatory oversight and credit protections.[66] By the mid-1990s, the Minister of Trade and Industry, Alec Erwin, observed that poor and low-income South Africans were being charged unreasonably high interest rates, and Mr. Erwin threatened to revoke the 1992 Exemption altogether.[67]

After five years of dialogue between the industry and the government, the Ministry formed the Microfinance Regulatory Commission ("MFRC") in 1999.[68] The MFRC changed the process of receiving exemptions, largely in response to widespread concern about high interest rates and abusive practices in the "cowboy" microlending market.[69] Instead of generally removing interest ceilings for MFIs, the MFRC used usury laws as incentive for ethical conduct and transparency on the part of MFIs.[70] Microlenders that did not register with an approved regulatory authority would not qualify for the exemption, and would be forced to restrict themselves to the usury rates.[71] Any company found to have violated the regulators' codes of ethics could be expelled from the registry and thereby disqualified from the exemption.[72]

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[61] *See generally* PATRICK MEAGER, MICROFINANCE REGULATION IN SOUTH AFRICA (Apr. 2005), *available at* http://www.microfinancegateway.com/content/article/detail/25525 [hereinafter MICROFINANCE REGULATION IN SOUTH AFRICA].

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] *Id.*

[67] *See generally* MEAGER, *supra* note 61.

[68] *Id.*

[69] *Id.*

[70] Amanda Vermeulen, *State Acts to Stamp Out Microlending Abuse*, BUS. TIMES (S. Afr.), May 16, 1999, at 1.

[71] *Id.*

[72] *Id.*

The problems did not end, however. MFRC research identified several problems with existing credit legislation: 1) it provided ineffective consumer protection, particularly for low-income groups; 2) access to credit was constricted, especially for small and micro businesses; 3) credit costs were high; and 4) some credit providers engaged in reckless behavior.[73] Further research also discovered undesirable practices by micro-credit intermediaries, debt collectors and debt administrators.[74]

B. National Credit Act of 2005

In 2005, the South African government passed the National Credit Act ("the Act"), which officially repealed both the Usury Law of 1968 and the Usury Law Exemption of 1992.[75] Although the Act was passed in March 2005, it did not go into force until June 2007. Gabriel Davel, head of the MFRC, said the Act is "consistent in its application, transparent, and shifts rights to the consumer".[76]

The result of numerous studies on microfinance in the specific South African context, the Act clearly meets Accion's first recommendation that a government should consider the unique microfinance environment that currently exists within their own country. Shawn Barnett, a director at a commercial law firm Deneys Reitz, said "[t]he act has its origins in the long-held belief by various market participants that [South Africa's] existing credit legislation is ineffective in dealing with the needs of a complex consumer market."[77]

For example, South Africa's history "clearly demonstrates the need for public transparency on pricing."[78] According to a 2003 study,

> [t]he average charge for mortgages and pension backed loans [is] between 15-19% per annum compared to the average cost of small short-term micro-loans, which cost consumers around 222–360% per annum. In general, low-income consumers pay the highest rates for credit with the shortest maturity, unless they have access to security such as property, pensions or insurance policies . . . .[79]

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[73] Ciaran Ryan, *Consumers in the Credit Driver's Seat,* SUNDAY TIMES (S. Afr.), July 24, 2005, at 14.

[74] *Id.*

[75] *Id.*

[76] *Id.*

[77] Sanchia Temkin, *New Law to Help Consumers Avoid the Debt Trap,* BUS. DAY (S. Afr.), May 2, 2006.

[78] David Cracknell & Hermann Messan, *The Art and Science of Pricing Financial Services,* MICROSAVE, Oct. 2006, at 12, *available at* http://www.microsave.org/get_filef.asp?download_id=2722.

[79] *Id.* (citing PENNY HAWKINS, THE COST, VOLUME AND ALLOCATION OF CONSUMER

In response, the National Credit Act and supporting legislation have implemented "truth in lending laws" that require pricing transparency, to be achieved, in part, by way of such means as the publication of effective rates.[80] Such transparency will be monitored and regulated by the National Credit Regulator.[81] The Act, which went into effect on June 1, 2007, also addresses most of the other concerns expressed in the previous sections, to be discussed below.

1. Aims of the Act and the NCR

The Act enjoys stable, high-level political support, having been signed by President Mbeke in March of 2005. According to Trade and Industry Minister Mandisi Mpahlwa, the purpose of the National Credit Act is "to promote a credit market that is fair, transparent, accessible and responsible. It also aims to promote a market that is competitive and sustainable. . . . It specifically prohibits practices such as reckless lending and automatic increases in credit limits, and regulates interest and fees."[82]

The Act creates the National Credit Regulator, a body whose purpose is to promote development of an accessible credit market.[83] The NCR is required to "promote and support the development, where the need exists, of a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry to serve the needs of" historically disadvantaged persons,[84] low income persons and communities,[85] and remote, isolated or low density populations and communities, "in a manner consistent with the purposes of this Act."[86] Thus, the Act aims to shift the protected class back from the urban employed to the truly marginalized populations.

In sum, the promoters of the Act display an awareness of the benefits and possible failures both of supervisory and regulatory mechanisms and of interest rate ceilings therein. The Act addresses the concerns discussed in Parts I and II, and seeks an efficient integration of regulation, protection, and free market capitalism.

2. Different Maximum Rates of Interest

The Act requires that the Department of Trade and Industry create

CREDIT IN SOUTH AFRICA, FEASIBILITY(PTY) LTD (2003)).

[80] *Id.*; *see generally* National Credit Act 34 of 2005 (S. Afr.), *available at* http://www.cba.co.za/IMAGES/NATIONAL_CREDIT_ACT.pdf [hereinafter "National Credit Act"].

[81] National Credit Act, *supra* note 80, at s. 13.

[82] Themba Gadebe, *Ban*, ALLAFRICA, June 1, 2006 [hereinafter *Ban*].

[83] *See generally* National Credit Act, *supra* note 80.

[84] *Id.* at s. 13(a)(i).

[85] *Id.* at s. 13(a)(ii).

[86] *Id.* at s. 13(a)(iii).

maximum rates of interest.[87] In determining these caps, however, the Ministry of Trade and Finance, in consultation with the National Credit Regulators (described below), is required to set a different maximum rate of interest, as well as maximum fees, for each subsector of the credit market.[88]

This requirement could address what seems to be one of the main concerns of usury laws in microfinance, namely, the MFIs' inability to compete with larger banks because of their higher operational costs, since theoretically the Minister could create higher ceilings for registered MFIs than for commercial banks. By doing so, the playing field could be leveled enough to allow the MFIs to remain in business while still ensuring a non-usurious rate of interest for the consumers.

Under the Act, the prescribed limits must take into account the "need to make credit available" to historically disadvantaged persons, low-income persons and communities, and remote, isolated or low density populations and communities.[89] The Act further requires the consideration of other factors such as the conditions prevailing in the credit market, including the cost of credit and the optimal functioning of the consumer credit market, as well as the social impact on low income consumers.[90]

3. Rates Will Be Set by Credit Experts

Under the National Credit Act, the interest rate ceilings will not be created arbitrarily by politicians or judges. Instead, the Act adheres to Accion's suggestions that a government engage in a consultative process with a variety of financial experts and industry participants. In determining the appropriate caps for each subsector, the Minister must consult with the National Credit Regulators ("NCR") before setting these limits.[91] The NCR is composed of economic experts, and is headed by qualified Chartered Accountant Gabriel Davel as Chief Executive Officer.[92]

Furthermore, the Act requires the NCR itself to monitor and research any matter relating to the credit industry including "credit availability, price and market conditions, conduct and trends,"[93] as well as competition within the consumer credit industry[94] and access to consumer credit by small businesses or disadvantaged persons.[95]

In an attempt to increase feelings of public ownership over the Act, the

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[87] *Id.* at s. 105.
[88] *Id.* at s. 105(3)(a).
[89] National Credit Act, *supra* note 80, at s. 13(a).
[90] *Id.* at s. 105(2).
[91] *Id.* at s. 105(1).
[92] *Ban, supra* note 82.
[93] National Credit Act, *supra* note 80, at s. 13(c)(i).
[94] *Id.* at s. 13(c)(ii).
[95] *Id.* at s. 13(c)(iii).

South African government has reached beyond the major financial experts for consultation in creating the specific regulations within the Act. The government published a draft of the regulations in the National Credit Act in September 2006.[96] The regulations were then open for public comment until the deadline of October 27, 2006.[97] Groups such as the African National Congress ("ANC") Youth League were encouraged to present the National Credit Regulator with a list of concerns regarding various provisions and policies within the Act, such as the possibility for an "amnesty" for people currently blacklisted by credit bureaus.[98]

Accommodating opinions of the public, as well as experts in the microfinance sector, is a promising sign that the South African National Credit Act will be able to make well-informed decisions based on a real view of the situation on the ground, as opposed to mere academic or political speculations.

4. Consumer Protection Laws

The Act further seeks to improve consumer protection within the credit market, through both enforcement and consumer education. Gabriel Davel, the new head of the National Credit Regulator, has said:

> I believe that the regulator has a big role to play in bringing transparency and honesty to the South African credit market . . . . Loan agreements are frequently complex and difficult to understand, with many of the fees and obligations hidden in the fine print. The vulnerability of people who have become so used to being rejected by credit provider [sic] is frequently exploited.[99]

The Act creates a set of protections, including a standard of overindebtedness and a prohibition on reckless lending.[100] The Act also provides consumer protection laws that protect against usurious rates upon default, which might be used to evade interest rate restrictions, to the detriment of the consumer. For example, Section 103 of the Act states that "the interest rate applicable to an amount in default or an overdue payment under a credit agreement may not exceed the highest interest rate."[101]

In addition to these provisions, the Act authorizes the regulator to receive and investigate complaints, as well as to educate consumers of their rights under the law.[102] Since at the time of this comment, the Act only

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[96] Rob Rose, *ANC Youth to Make Demands on Credit Rules*, BUS. DAY (S. Afr.), Oct. 25, 2006 at 15.

[97] *Id.*

[98] *Id.*

[99] *Ban*, *supra* note 82.

[100] MICROFINANCE REGULATION IN SOUTH AFRICA, *supra* note 61.

[101] National Credit Act, *supra* note 80, at s. 103(1).

[102] *Ban*, *supra* note 82.

recently has gone into effect, the actual effectiveness of these provisions remains to be determined.

5. Enforcement

The National Credit Regulator is required to enforce the provisions of the Act through several mechanisms, including promoting informal resolution of disputes between consumers and credit providers, receiving complaints concerning alleged contraventions of the Act, monitoring the consumer credit market and industry to ensure that prohibited conduct is prevented or detected and prosecuted, and investigating and evaluating alleged contraventions of the Act.[103]

Part B of the Act provides for a National Consumer Tribunal that can adjudicate claims and provide enforcement through the issuance of fines.[104] Upon receiving complaints, the National Credit Regulator may refer matters to the Tribunal.[105] According to the NCR, "[i]n addition to its powers to adjudicate disputes directly, the Tribunal will have the authority to make a consent order reflecting any resolution arrived at through an alternative forum and/or issue a compliance notice."[106] Furthermore, credit providers and consumers who wish to appeal against decisions of the National Credit Regulator may appeal to the Tribunal.[107]

The Tribunal has received some criticism regarding its constitutional implications, in the belief that it would act as an informal court, neither civil nor criminal.[108] A senior magistrate from Pretoria, Franz von Reiche, told parliamentary hearings in August 2005 that the bill required that the Tribunal dealt with consumer matters in an "inquisitorial manner," while South Africa's legal norm was that of an adversarial system.[109]

He further stated that the Tribunal, which he called a "draconian kangaroo court," would impose criminal sanctions based on the balance of probabilities, the test used in civil matters, and not on the principle of reasonable doubt, as required in criminal matters.[110] These criticisms were expected to be addressed by the Department of Trade and Industry, but it may be premature to tell how such concerns are playing out such within the Tribunal's actual jurisdiction.

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[103] National Credit Act, *supra* note 80, at s. 15.

[104] *See generally* National Credit Act, *supra* note 80.

[105] *Id.* at s. 15.

[106] Tribunal, http://www.ncr.org.za/Tribunal.html (last visited May 1, 2008).

[107] *Id.*

[108] Wyndham Hartley, *Magistrate Warns Against Debt Pitfalls in New National Credit Bill*, BUS. DAY (S. Afr.), Aug. 10, 2005.

[109] *Id.*

[110] *Id.*

6. *Effect on Commercial Lending Institutions*

The Act "aims to regulate all types of consumer credit, and the whole range of formal-sector credit providers, from retailers to microlenders to banks."[111] It seems that other lending institutions, including large commercial lenders, should not face major problems as a result, with the proper preparation. First, although the Act repeals previous legislation, it provides for a phasing-in period in which the old acts would remain in force until the necessary infrastructure is in place to administer the new one.[112]

Second, participants in the South African consumer credit market are now required to review their credit practices and documentation to ensure compliance with the Act.[113] The Act sets out new parameters with regard to assessing whether the granting of credit to a consumer is being made recklessly.[114] Retailers are required to undertake extensive checks on the state of a consumer's finances before offering credit. When processing credit applications, retailers' staffs have to complete an exhaustive "financial means" test, which includes establishing the frequency of an applicant's income and his or her existing financial obligations.[115] Furthermore, these new obligations require retail credit controller training and electronic cross-referencing with records kept by the National Credit Bureau.[116]

In anticipation of the Act's enforcement in 2007, many commercial lenders were already preparing for their future duties. FirstRand, a large commercial bank, admitted that the National Credit Act will pose further challenges, as it will affect fees and pricing.[117] However, as of September 2006, the group had already taken steps to address many of these challenges.[118] For example, it planned to securitize more of its assets, which would take those assets off its balance sheet and potentially improve its return on those assets.[119] According to Microsave, a microfinance research group based in Nairobi, "while in the short term the costs of compliance may in fact drive up prices as banks seek to maintain margins, in the medium term the impact of improved transparency *should* continue to exert a downward pressure on pricing."[120]

Moreover, while the National Credit Act puts a ceiling on the interest

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[111] *South Africa; Making Debt Good*, AFR. NEWS, June 17, 2005.

[112] *New Law to Help Consumers Avoid the Debt Trap*, *supra* note 77.

[113] *Id.*

[114] *Id.*

[115] *Id.*

[116] *Id.*

[117] Viwe Tlaleane, *Banks' Challenges*, BUS. DAY (S. Afr.), Sept. 20, 2006, at 16.

[118] *Id.*

[119] *Id.*

[120] Cracknell & Messan, *supra* note 78, at 12.

banks can charge, it also levels the playing field in the lower end of the market, where loans under R10,000 were previously not subject to the Usury Act requirements.[121] As stated before, this meant microlenders could charge what they liked.[122] FirstRand's CEO, Sizwe Nxasana, has stated that under the National Credit Act, FirstRand will get a better foothold in this market.[123] Therefore, even large commercial institutions will be able to thrive under the National Credit Act as long as they anticipate changes resulting from the Act's new regulations and requirements and make the necessary adjustments ahead of time.

7. The South African Model as an Experiment for All of Africa

The success of the National Credit Act would have an effect not just within South Africa's borders, but throughout the African continent as well. Microfinance projects are occurring in many of Africa's countries, who see the National Credit Act as an experiment worth scrutinizing. Cape Town hosted an African Microfinance conference in August 2005 to discuss ways of integrating microfinance into formal financial markets.[124] Rashid Ahmed of the MFRC stated that "[f]or Africa to move forward with economic development and poverty alleviation, it's essential that it has to progress quickly with the integration and transformation of its microfinance industry."[125]

Fortunately, since the mid-1990s, there has been significant change from the parallel banking system—one for the poor and the other for the better off—and operations in some countries, such as Kenya and Tanzania, are undergoing institutional changes and entering the formal financial sector.[126] For example, the Central Bank of Kenya has encouraged greater transparency in all its forty-two branches by using the two national newspapers, the *Union* and the *Standard*, to publish fees and charges on common accounts, such as current accounts, business loans, and personal loans.[127]

Nevertheless, according to Ahmed, microfinance in most African countries is "still regarded as separate to the formal financial sector and handled as such. Until an energetic and determined effort is made to integrate microfinance into the formal banking systems, we'll always be

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[121] Tlaleane, *supra* note 117.

[122] *Id.*

[123] *Id.*

[124] *South Africa; Microfinance Specialists to Debate Financial Market Integration*, AFRICA NEWS, Aug. 29, 2005.

[125] *Id.*

[126] *Id.*

[127] Cracknell & Messan, *supra* note 78, at 13.

playing catch-up."[128] The rest of Africa will be watching the reaction to the National Credit Act by the various players in the industry, especially the extent to which the government is able to both replace current disparate credit laws with consistent, enforceable credit legislation and regulate debt relief, standard marketing/advertising/disclosure practices, and credit reporting.[129]

8. Recent Results of the Act

The National Credit Act is still in its early stages, but its impact on South Africa seems to be largely positive so far. An August 2007 report by PricewaterhouseCoopers, issued just weeks after the Act went into effect, estimated that revenue growth for South African banks in 2007 would range between ten and thirty percent, while income growth was expected to rise by as much as twenty-five percent per year for the next three years.[130] Microlending itself was expected to record fifty percent growth in 2007, but the banks also recorded success in capital markets, mergers and acquisitions, foreign exchange, property finance and brokerage.[131] According to the report, the regulatory environment fostered by recent developments such as the Act "is now seen as the most important driver of change" and that the "widely held view was that regulations would continue to proliferate across the financial sector."[132]

As predicted, those banks that reacted early on to the Act's new provisions have created an advantage over competitors who were not as quick to implement the appropriate changes. Capitec Bank Holdings, which provides entry-level services to the poor, has followed the shift in banking that recognizes the potential in low-income clients.[133] Capitec has been able to comply with the Act and still be sustainable by using technology to keep its costs to a minimum, and has been able to extend its microlending services to an estimated 336,000 new clients from August 2006 to August 2007.[134] As a result of its extraordinary success, Capitec was ranked third in South Africa's Top 100 companies chart.[135]

African Bank Investments Limited ("Abil"), one of the dominant

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[128] *Id.*

[129] *Id.*

[130] Regis Nyamakanga, *Players Expect to Keep Riding Crest of the Wave,* BUS. DAY (S. Afr.), Aug. 27, 2007, at 18.

[131] *Id.*

[132] *Id.*

[133] Richard Stovin-Bradford, *Capitec Takes Its Banks to the People*, SUNDAY TIMES (S. Afr.), Nov. 11, 2007, at 8.

[134] *Id.*

[135] *Id.*

institutions in South Africa's microlending business, made it a point to adopt many of the Act's provisions early on.[136] As a result, its quarterly results to June 30, 2007 showed it was set to weather introduction of the Act with ease.[137] During the first month of operation under the Act, sales of new loans were twenty-nine percent higher year on year, and Abil was able to respond to a continued strong demand for credit without any deterioration in credit quality.[138]

Clearly it remains to be seen what the long-term results of the Act will be, but early results have been promising. The Act's recent enforcement may mean that some institutions affected by the changes still suffer from a lack of education or understanding of the Act's specific provisions, and thus the success of banks and other commercial lenders could increase further with greater familiarity as time goes on.

V. CONCLUSION

Microfinance's potential is well-documented. The question is how to harness that potential within developing markets and sometimes rudimentary institutions.

The goal of microfinance is to improve the access to credit for the world's poorest communities, emphasizing the business skills of the marginalized as opposed to their need for charity. Yet, to do this requires more than an idealistic notion; it requires a thorough analysis of how to balance that access with the profitability that provides the basis for any successful business model.

Interest rate ceilings have been criticized by those who claim it undermines that profitability within the microfinance sector by placing MFIs at an unreasonable disadvantage to commercial banks with lower operational costs. Critics claim that this situation encourages MFIs and other similar NGOs to evade the caps by charging hidden fees or by refusing to enter the microfinance sector altogether.

Yet, even those critics realize that predatory lending, based on usuriously high interest rates, remains a substantial policy concern within the microfinance world. Without regulations, lenders can charge, in the name of viability, unreasonable rates that lead to overindebtedness and *de facto* servitude for poor consumers. Thus, the very victims of microfinance are the people it was intended to empower.

Some critics of usury laws have claimed that alternatives exist that can reduce interest rates over time without setting official (and often arbitrary)

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[136] Richard Stovin-Bradford, *Hedge Fund Managers Key to ABN Amro Sale*, SUNDAY TIMES (S. Afr.), Aug. 5, 2007, at 4.

[137] *Id.*

[138] *Id.*

caps. For example, they claim that "[i]n many competitive markets, efficiency has improved and microcredit interest rates have declined."[139] Creating a competitive market, however, takes time, stability and a level of internal development that may not be present in a developing country.

As a result, abandoning usury laws altogether during the creation of a microfinance sector is not a practically appropriate solution. Instead, they should be accommodated within a supervisory and regulatory mechanism which can account for market conditions and manually place microfinance institutions back in a position where they can sustain viability in competition with commercial lenders.

Following a nearly forty-year history of legislative attempts to regulate interest rates, South Africa's government passed the National Credit Act of 2005. This Act provides a promising example of a supervisory and regulatory mechanism which, if successful, can be used as a model from which other nations may base their own custom-made model.

The Act provides for a mechanism that is tailored specifically to South Africa's microfinance needs, rather than simply lifting the model of another country. In creating such a mechanism, the creators of the Act, as well as the leaders of the Act's supervisory institution, the NCR, engaged in "a consultative process to arrive at a well-designed system that provides the basis for growth and development of a healthy industry."[140]

The Act further benefits from a "suitable" political and microfinance climate. Microfinance providers have existed for several years, under various legislative regulations. As stated previously, although the Act was passed in March 2005, it only went into force in June 2007, and the time period between both dates was designated as a "phasing-in" period to allow existing businesses from various sectors to transition successfully from the old regulations to the new ones.[141] Moreover, the members of the NCR are all experts in either banking, law, or economics, and the Act enjoys stable, high-level political support from everyone from its Minister of Trade and Industry to President Mbeke.

As discussed before, the Act requires that the Minister and the NCR take into account several important factors in setting the interest rate limits for each subsector, such as the current market conditions, the aims of the Act, and the concerns of market participants across the spectrum.

Drawing from the research and analysis of other organizations discussed earlier in this comment, there are several other factors that the Minister and the NCR should specifically take into account when setting these caps. For example, "as in all commercial structure," market viability

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[139] OCCASIONAL PAPER NO. 9, *supra* note 15.

[140] LOUBIÈRE ET AL., *supra* note 48, at 10.

[141] Tlaleane, *supra* note 117.

requires that the interest rate be calculated with a view to at least cover the costs of the institution, including administrative expenses, costs of funds, and the cost of loan losses.[142] These costs can vary from country to country, or even from institution to institution, so the Ministry needs to focus on the environment in which the microfinance institutions provide their services.[143]

Additionally, the NCR and the Tribunal should be reasonable with the non-compliance penalties that they enforce. While penalties are obviously important for the effectiveness and credibility of the act, the regulating institutions should keep in mind that their role should be less about punishment and more about enabling these institutions to increase their efficiency in the long run.[144]

Finally, the interest rate ceilings are exactly that—ceilings. If the critics of usury laws are correct, the regulations currently set may become irrelevant if MFIs and commercial banks use competition as a means of continually lowering their own interest rates. However, at that point, there should be no argument for the detrimental effects of such ceilings.

In sum, South Africa's new model has the potential to prove that usury laws can be effective if they are regulated in a supportive and reasonable mechanism. If the Act continues to be successful, it could enhance significantly the world's attempts to find that balance between idealistic attempts to end poverty and the forces of business.

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[142] Microfinance Matters—Voices of Microfinance, http://www.uncdf.org/english/microfinance/newsletter/pages/july_2004/voice.php (last visited May 1, 2008).

[143] *Id.*

[144] *Id.*