The Developmental Microfinance Sector in SA: Update 2004

For FinMark Trust

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Acronyms

ANC:	African National Congress
BEE:	black economic empowerment
CGAP:	Consultative Group to Assist the Poorest
CMN:	Community Microfinance Network
COSATU:	Congress of South African Trade Unions
DBSA:	Development Bank of Southern Africa
DMS:	developmental microfinance sector
DNT:	Department of National Treasury
DTI:	Department of Trade and Industry
FSC:	financial services co-operative
GEAR:	Growth, Employment, and Redistribution (policy)
HPF:	Homeless People's Federation
MFO:	Microfinance Organisation
NEDLAC:	National Economic Development and Labour Commission
NGO:	non-governmental organisation
NHFC:	National Housing Finance Corporation
PBO:	Public Benefit Organisation
PPM:	Poor People's Movement
RFI:	Retail Financial Intermediary
SACCOL:	Savings and Credit Cooperative League of South Africa
SACCO:	savings and credit cooperative
SACP:	South African Communist Party
SAHPF:	South African Homeless Peoples' Federation
YMSA:	Youth Microfinance and Savings Movement

1. Introduction

1.1 Background

This paper is an update of *The Pro-Poor Microfinance Sector in South Africa*, originally published by FinMark Trust in 2002. The topic of that study was a specific subset of South African institutions that

- provide microfinance services, specifically to
- augment the livelihood strategies of poor household. They use
- social intermediation methodologies and their goal is
- to alleviate poverty.

To quote from the original paper,

> This multi-part definition is both broader and more specific than 'microfinance'. It is broader because 'microfinance services' encompasses both savings and credit, whereas much South African 'microfinance' discourse focuses on microcredit only. Also, as employed here, the concept 'microfinance services' does not assume a commercial orientation, but includes not-for-profit institutions (i.e. NGOs). This study is also concerned with more than microenterprise credit, but also consumption, housing, and 'lifeline' (i.e. emergency and expense-smoothing) credit. It is narrower because although a number of South African institutions provide microfinance services for the poor, this study is concerned with those that are both not-for-profit and employ social intermediation methodologies (e.g. group savings and credit).

For essential background, particularly on concepts and the institutions involved, please refer to the 2002 paper.

One concept that has changed since 2002 is the notion of 'pro-poor'. For a variety of reasons, it seems more useful (and certainly results in a better acronym), to refer to the 'developmental microfinance sector'. This expresses the idea that the types of microfinance interventions in which we are interested are those motivated by socio-economic development and not profit. Some of these interventions may not specifically target the very poor, but they are nonetheless trying to achieve social-economic development rather than profit.

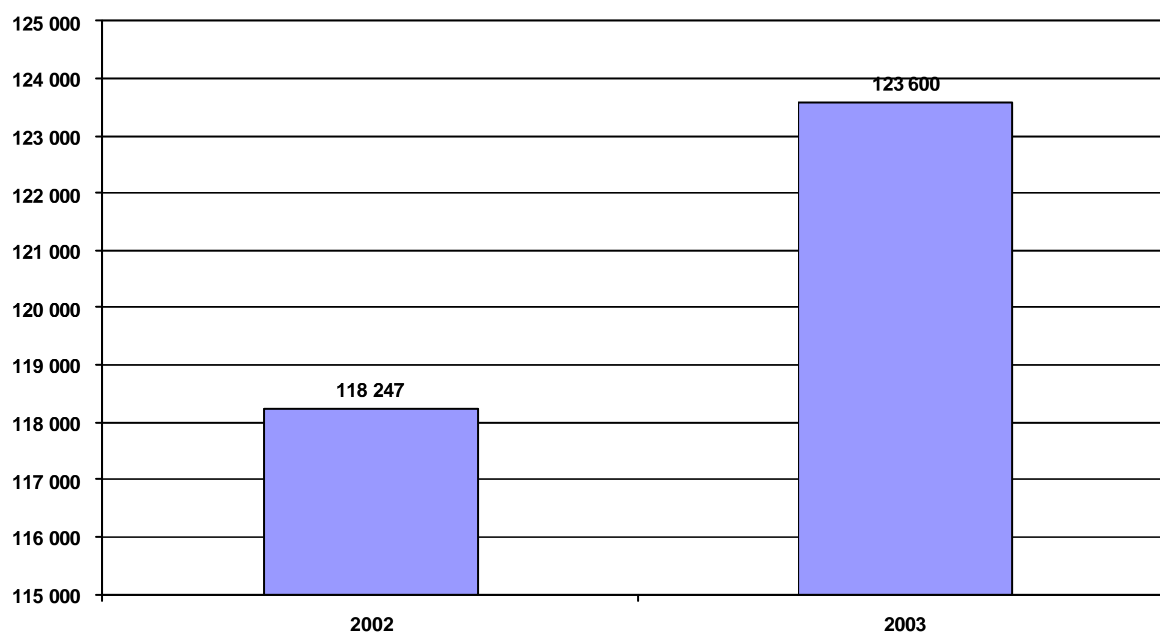
1.2 Scope of this Update

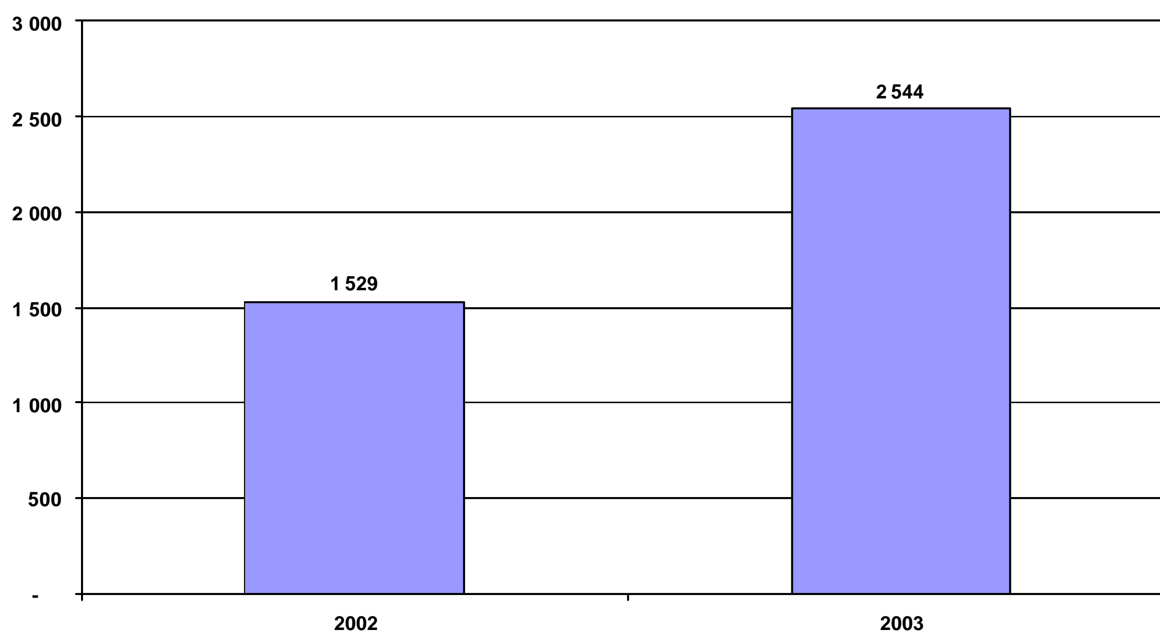
This document reviews developments in the South African developmental microfinance sector during the past eighteen months. It updates statistical information on the DMS and discusses related events, processes, and issues.

2. Key Developments since Mid-2002

2.1 Some statistics

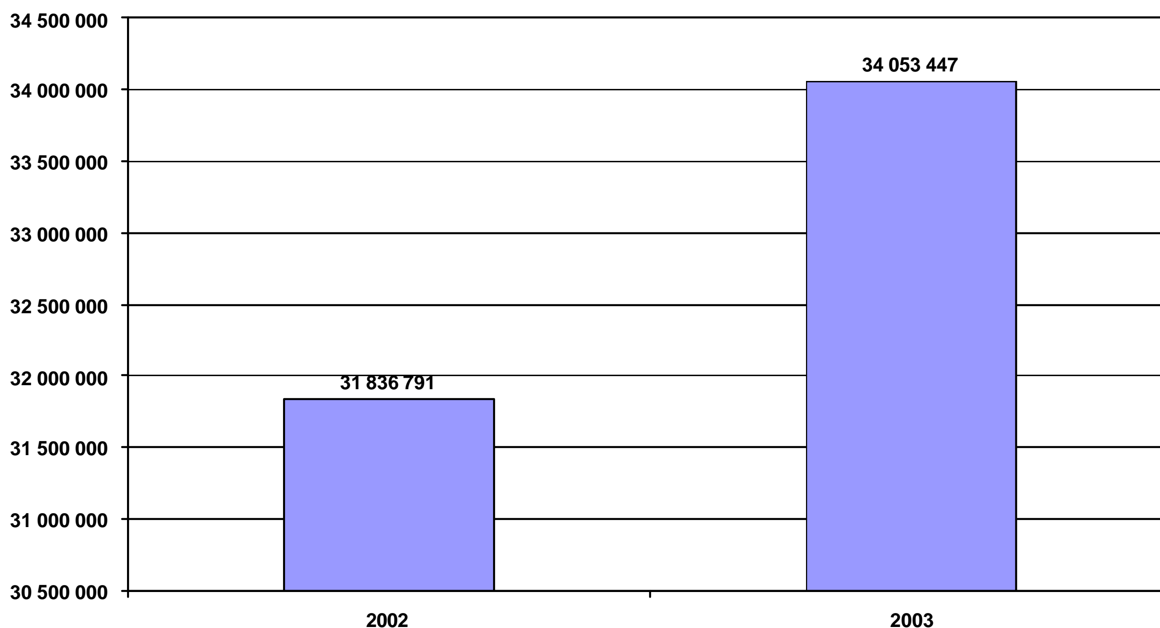
The 2002 paper presented a statistical snapshot of the South African DMS, focusing on numbers of people and groups, savings, and loan balances. The following graphs update the statistics for 2003.[1]



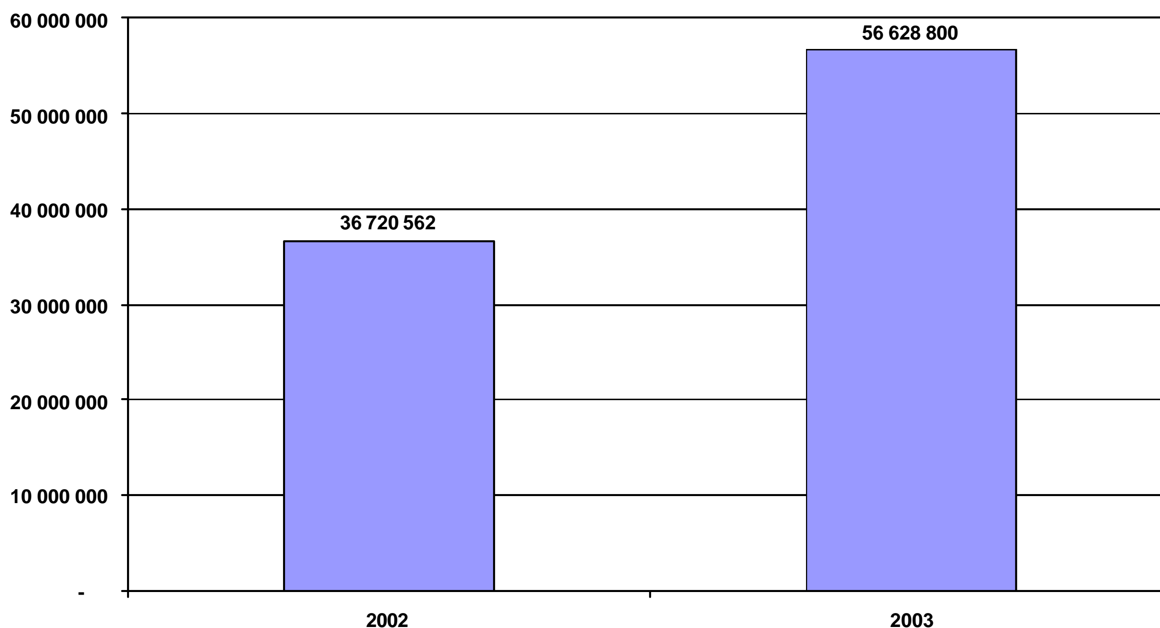


[1] Detailed statistics are available as a separate spreadsheet.

The number of clients/members in the DMS has not grown as much as might have been expected due to membership loss (now reportedly reversed) at the SA Homeless Peoples' Federation, South Africa's largest savings and credit network. It appears, however, that the SAHPF had overestimated its membership for some time; the figures for 2002 may be too high. Interestingly, however, the SAHPF reports many new, albeit smaller, savings and credit groups, which has pushed the overall number of such groups up significantly.



Total savings in the DMS has increased, and would have been higher but for revisions of the SAHPF figures and FINCA South Africa's decision to withdraw from involvement with client savings. Average client/member savings increased marginally from R270 to R275.



There was a significant jump in loan principal outstanding in the DMS, due largely to a large increase in the loan portfolios at the Small Enterprise Foundation and Marang Financial Services. Average loan balances per client increased by nearly 50%, from R310 to R458.

Section 2.3 discusses some of the factors behind the changing figures.

2.2 Issues in the environment

2.2.1 A new vision from government?

The most interesting development affecting the South African developmental microfinance sector is relatively recent. In his 2004 State of the Nation address, President Thabo Mbeki enunciated a 'two economies thesis'. This accepts that the post-apartheid economy is leaving a large part of the population behind. This has serious implications for South African socio-economic policy – and for developmental microfinance.

Since 1996, when it adopted the Growth, Employment, and Redistribution (GEAR) framework, the ANC government has been criticised for its macroeconomic conservatism. Many critics, however, miss the point that GEAR is a logical corollary to the Department of Trade and Industry's economic development strategy, which is based on the assumption that South Africa is essentially a modern economy that has been 'distorted' by apartheid. The DTI's core vision is of a South Africa that will create jobs and domestic demand by restructuring around flexible manufactured export and service industries. Growth in these sectors will kick-start employment-intensive domestic consumer industries. The antecedent of this view is the 'post-Fordist' regions of Europe, North America, and Asia that have created opportunities for thousands of employment-intensive small and medium enterprises (SMEs).

GEAR is designed to make South Africa attractive to foreign investors, whose money will drive the initial stages of this restructuring. GEAR seeks to avoid the macroeconomic mistakes of other developing countries by reducing the fiscal role of the state. Although the short-term costs of restructuring may be high (job losses, etc.), in the long run the South African economy will catch up to the developed north, with high and stable employment.

A second-order corollary of this 'vision' is that government should not waste money on microfinance programmes for 'unproductive' or 'survivalist'[2] households. Limited state resources should go to productive, capital-accumulating SMEs, which will create jobs for the 'survivalists'. Thus, Khula Enterprises, the state's wholesaler for SME microlending, has consistently stressed policies that favour SMEs over 'survivalists'.

This package of assumptions, policies, and consequences is the principal reason why South Africa remains one of the few developing countries without a serious state effort to support the development of a microfinance sector that recognises the needs of 'survivalists'. Until very recently, South African policy-makers have ignored the sorts of policies that have created massive microfinance sectors in countries like Bangladesh, Bolivia, and the like. South African policy-makers aspire to do better than that – to become more like an OECD country.

The problem is that the assumptions behind the DTI's trade and industrial policies, and thus GEAR, seem to be wrong. Although South Africa is integrating rapidly into the global economy, net job creation has been minimal. Because of South Africa's geographical and economic location far from the centres of global mass consumption, the types of firms that have done well out of globalisation tend to be capital-intensive, technological, and to source many inputs from imports rather than

[2] A term rejected by most of the international microfinance community but still employed in South African government circles. Use of this term does here not imply acceptance of it by the author.

domestic SMEs.[3] There simply has been no SME boom – not principally because of lack of credit or other supply-side factors, but because of *lack of demand* for their goods and services in the production chain. One of the major problems is lack of domestic and regional consumer demand: South African and African poverty is thus a major cause of joblessness, which in turn entrenches poverty.

The ANC's 'two economy' thesis marks the first time the post-apartheid government has explicitly accepted the existence of a 'third world' socio-economy inside our own borders – where people live as billions do throughout the underdeveloped South. As the ANC's *Ten Year Review* argues,

> One of the major consequences of this changed structure of the economy is that two economies persist in one country. The first economy is an advanced, sophisticated economy based on skilled labour. The second one is a mainly informal, marginalised, unskilled economy, populated by the unemployed and those unemployable in the formal sector. The benefit of growth has yet to reach the second economy.[4]

In President Mbeki's words,

> (A) defining feature of our country is that we have two economies, one belonging to the developed world, and the other to the underdeveloped world, the first and the second. This second economy includes millions of people who are poor. These are ordinary working people whose problems cannot be solved by reliance on "the market".[5]

The ANC National executive neatly outlines the way that a 'first economy' focus has shaped South African socio-economic policy to date:

> As part of the process of the development of the necessary policies for the fundamental transformation of our society, on which we have focused during our First Decade of Democracy, during the year of the 91st anniversary of our movement, we advanced the proposition that we had inherited a country of two economies. The First is developed and part of the global economy, and the Second is characterised by poverty, underdevelopment and marginalisation. We explained that these two economies do not necessarily respond to the same economic stimuli. It was therefore necessary to elaborate and implement the initiatives appropriate to each of these economies. During the First Decade, we had carried out this work focusing on the First Economy. This is because without a strong First Economy, it would not have been possible for us to find the resources to develop the Second, except by borrowing these resources and thus building an unsustainable national debt. Without reducing our focus on the First Economy, during the Second Decade we must pay special attention to the transformation of the Second Economy.[6]

Disregarding the political spin that the shift from an exclusive focus on the first economy is all according to plan, the ANC statements do outline a fresh perspective on the nature of the economy the majority of South Africans inhabit. This should have serious implications for South African microfinance. Perhaps the 'first economy' vision of the gallant SME entrepreneur is not sufficient for South African microfinance?

2.2.2 The 'second apex'

The two economies thesis immediately comes into play as we turn to the question of state interventions to support the DMS. As noted in the 2002 paper, the South African government has been 'fiddling' – there is no better way to describe it – with the idea of setting up a wholesale funding institution aimed at the DMS for several years. The rationale for this institution is that Khula has had no success in extending credit to microlenders targeting second economy households. Many

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[3] For an elaboration of the argument, see the CMN January-February 2004 Newsletter, http://www.cmfnet.org.za/Documents/Newsletters/CMN%20Newsletter%20Jan-Feb%202004.doc

[4] http://www.anc.org.za/elections/2004/briefings/review.html

[5] http://www.anc.org.za/ancdocs/anctoday/2003/text/at43.txt

[6] Statement by the National Executive Committee of the ANC on the 92nd anniversary of the ANC, 8 January 2004 http://www.anc.org.za/ancdocs/pr/2004/pr0108.html

stakeholders hope that a second 'apex' modelled on the Bangladeshi Palli Karma-Sahayak Foundation (PKSF) (see http://www.pksf-bd.org) will be more successful in this regard.

This is an excellent idea, and the 2002 paper argued for such an institution. Unfortunately, however, issues that have long bedevilled the South African microfinance community continue to get in the way, and we may be no closer to having one. A brief history:

- The 'second apex' idea originated several years ago. The Department of Trade and Industry took it upon itself to consult 'stakeholders' and develop a basic design. For a variety of reasons, the DTI effort made little progress.

- In early 2002, a group of South Africans visited Bangladesh, including First Lady Zanele Mbeki, chairperson of the Women's Development Banking Trust, and Maria Ramos, then Director-General of the National Treasury. The powerful nature of these stakeholders led to a cabinet decision to make the apex a joint project of the DTI and Treasury. The Development Bank of Southern Africa was contracted to drive the consultation and design process during 2002-2003. Several consultative meetings were held and the DBSA group developed a draft design.

- During 2003, stakeholders were given to believe that the launch of the second apex was imminent. However, in the second half of the year, behind-the-scenes manoeuvring led to the process being taken away from DBSA and given back to a team at DTI, including selected stakeholders from the DBSA process, but excluding others. The DTI team's strategy has been to stop consulting those with whom it disagrees, and to base itself on the surviving KhulaStart MFOs. As far as the DTI team is concerned, the consultation process is over.

- There has been a significant shift in the stated goals of the apex under the DTI team. The core mission of the 'second apex' is now defined as to "provide sustainable micro savings mobilization and micro credit through viable MFIs to the economically active poor engaged in viable enterprises and to very poor households wishing to engage in gainful economic activities in the urban and rural areas in South Africa".[7] Note the emphasis on the 'economically active' poor and those 'wishing to engage in gainful economic activities'.

- Many stakeholders, however, are unhappy about this. There is a feeling that the shift from DBSA back to DTI was designed to circumvent a more 'radical' focus on the 'non-entrepreneurial' second-economy poor and on desperately needed capacity-building resources for the DMS. Indeed, it appears that the DTI has essentially reasserted its control to bring the apex process back into line with an 'entrepreneurial' first economy orthodoxy.

As the mission statement from the DTI apex document illustrates, its vision of microfinance remains dominated by a pre-two economies worldview. In this, 'microfinance' means microcredit for 'economically active' households – those whose enterprises have the potential to accumulate capital and employ people. Microcredit is seen as an essential input unavailable from the formal banking sector (although why this would be so if enough viable SMEs are out there has never been explained satisfactorily). The government thus needs to intervene to provide it, albeit indirectly, via wholesale lending to Retail Financial Intermediaries (RFIs). Since Khula has been unable to serve the lower end of the market (defined in the DTI apex document as loans of under R10 000), however, it is necessary to set up a second apex to do so.[8]

[7] South African Microfinance Apex Fund Operating Manual: Final Draft December 2003, p. 8. Emphasis added.

[8] There is still little clarity on why Khula could not do this on its own. The best explanation is that the personalities and institutional culture of the parastatal make it impossible.

Although the DTI Apex leaves the rhetorical door open for the very poor 'wishing to engage in gainful economic activities', its phraseology suggests that 'survivalist' households are not in the picture. 'Survivalists' are not involved in 'gainful' activities in the sense that they are not creating jobs and accumulating capital, but simply meeting basic human needs through non-job economic activity, or 'livelihood strategies'.

Most worrying of all is that those MFOs in South Africa targeting the very poor successfully with loans under R10 000 would be forced to stop dealing with Khula and obtain funds from the new apex. This may work out fine – but given the history and politics behind the DTI apex, it may not.

The problem, as the 2002 paper argued, is that South Africa's 'two economies' produce structural joblessness and poverty, determined by both our apartheid past and the process of South Africa's incorporation into the globalising economy. Many of those stuck in the second economy are there, for all intents and purposes, *permanently*. For a large part of South Africa's population, no amount of training is going to make them suitable for first economy jobs, because the problem is on the demand side.

Pushing microcredit products designed for entrepreneurial first-economy microenterprises at the second economy will not work, however. The demand for microcredit is *derived* from the demand for the outputs of microenterprises. Second economy 'survivalist' microenterprises service a stagnant market flooded with cheap goods produced by first-economy firms. We cannot expect them to be able to make use of the 'first economy' microcredit products favoured by DTI. Nevertheless, second economy households do need microfinance services – along the lines of those provided by developmental MFOs throughout the developing world, which recognise and accept their clients' economic reality.

This leaves state support to the DMS where it started: the majority of second economy households left out of the picture. So it seems likely that, even with the DTI apex (now called a 'business fund'), South Africa will still be without a support structure for truly developmental microfinance suitable to households in the second economy. It remains to be seen, of course, and the DTI team may surprise us, but all things considered there is still a long way to go before the South African government takes the need to support the livelihood strategies of the very poor seriously.

2.2.3 'Third tier' banking

Related to the 'apex' issue is the question of so-called 'third tier' banking services. This is a complex issue driven by a mix of interests from four distinctly different sets of stakeholders: government, the ruling ANC/SACP/COSATU alliance; banks; and the financial services co-operative movement. To understand the issues, it is best to start with the stakeholders:

- **Government** is under pressure, particularly from parliament, to extend a full range of financial services to the 60% of South African households that does not enjoy them. Faced with what it considers intransigence from commercial banks, cabinet has instructed the relevant departments (DTI and Treasury) to explore the possibilities of cooperative banking.

- One reason the government has focused on a cooperative approach is that the **ANC** is under pressure from alliance partners **COSATU** and the **SA Communist Party** on the financial services issue. A cooperative approach is ideologically appealing to COSATU and the SACP, who are otherwise largely ignored by the ANC in matters of socioeconomic policy.

- **Commercial banks** are also under pressure to do more for the poor. Reluctant to bring perceived-to-be 'risky' clients onto their own books, South Africa's banks have encouraged the cooperative banking idea, or at least a resurrection of the 'mutual bank' model provided for in early-90s legislation. This would allow them to reach very poor households indirectly (via

loans, investments, technical support etc, for cooperative institutions), reducing their own risk and transactions costs.

– South Africa's tiny **financial services co-operative movement**, although divided and territorial, is obviously keen to gain the greater acceptance – and resources – that a focus on third-tier banking could bring. The FSC movement's vision and understanding of cooperative financial services, however, may differ significantly from that of government and the banks.

The third-tier banking idea started out as a topic at one of the NEDLAC forums. It has since been taken up by cabinet, DTI and Treasury and a variety of initiatives are underway to explore support mechanisms and legislation. These include a draft Limited Mutual Banks Bill, a draft Cooperatives Bill, and parliamentary investigations into a new, comprehensive Financial Services Act. Also, the DTI apex process discussed above took an unexpected turn in the FSC direction after it was removed from the DBSA. DTI instructed its apex team to include in its ambit financial services co-operatives – despite the gulf between the logics of microcredit and cooperative financial services. All these initiatives are in the secretive pre-public discussion phase, where key decisions are often made.

There may be one fatal flaw in all of these efforts, however. To see why, we need to take a detour through some theoretical issues. The South African financial services landscape comprises two 'segments'.

– The **formal financial services segment**, which operates under the current patchwork of laws, regulations, and exemptions. This segment is 'formal' *because* it adheres to the law. However, it is expensive (a quantitative problem) and its products are often unsuited to the needs of the poor (a qualitative problem). One reason for this is the confused regulatory environment, but another is the socio-economic assumptions about their clients around which South African banks especially are built.

– The **informal financial services segment**, which includes everything from savings clubs and neighbourhood stokvels to burial societies and large savings and credit networks. This segment is defined by lack of adherence to any laws except those of the natural section – if it works for members/clients, people do it and the scheme thrives; if it does not, they don't and the scheme dies. Except for various SARB exemptions, which are largely ignored, there is no effective state regulation.[9]

Finmark Trust's research has shown that the formal/informal relationship in regard to financial services is correlated to income. In South Africa, income is closely correlated to race, and therefore to history and 'culture'. Poor – mainly black – households prefer the informality of the unregulated financial services segment, even if there are opportunity costs and risks, because its 'products' suit them and their socio-economic understanding better than those of the formal segment. In other words, informality – more accurately, an alternative formality – is preferred for its own sake.

To put it another way, in South Africa's informal financial services segment, *product quality*, which in this case is about the socio-economic and cultural specifics? of poor SA households, wins out over *product cost.* In South Africa as in many developing countries, therefore, many households are prepared to forgo interest earnings and even to risk some loss of savings in order to have the convenience and predictability of informal financial services. Households in this sector know that people in some schemes 'eat' money, but to them this is better than paying for transport to a bank and then high bank fees.[10]

[9] The legal basis of the state's tolerance of this segment has been that in common law a voluntary association is entitled to do whatever it wants as long as it operates on an exclusive *membership* basis. The Eurocentric attitude of the SARB has also led them to ignore this segment.

[10] To complicate matters further, some NGOs are supporting networks of savings and credit groups amongst very poor households. These groups are firmly established on the 'informal' side of the financial services segmentation and have neither

Where would a more formal, third-tier banking sector based on cooperative financial services fit into this picture? It would sit uncomfortably between the formal and informal financial services segments.

- On one hand, many stakeholders assume that financial services co-operatives (SACCOs, FSCs, village banks, mutual banks, etc.) are 'accessible' to the poor because they incorporate elements common to the informal segment (cooperation, smaller scale, membership control).
- On the other, South Africa's existing regulated cooperative financial services institutions (as above) are formal (i.e. legal, regulated) and therefore impose a much greater burden on their management and members than truly informal schemes. The fact that SACCOs, etc. are cooperative is not the point: they are regulated by the state and therefore difficult to run compared to informal schemes. This raises the question of whether most households would prefer to use them as opposed to the existing options at either extreme of the formal/informal spectrum.

If many South African households prefer the informal segment not because of the *form* of the institutions in it, but because they are *informal*, a third-tier banking sector based on cooperative financial services may struggle to get off the ground. The problem is that there may be insufficient *demand* for more formalised cooperative financial services in South Africa. The key is to understand the demand for cooperative financial services models relative not only to banks, but also to the informal segment. To be sustainable, third-tier banks would have to be *demanded* by households because they meet their qualitative needs for financial services, because their products are better than those currently available in the formal *and* informal financial services segments. Low-income households exist in a 'market' for financial services in which they have an essentially unrestricted option of going 'upmarket' (e.g. to banks) or downmarket (e.g. to informal schemes). Law or no, people will use informal mechanisms as long as they make sense to them, because enforcement is impossible. The question is thus whether cooperative third-tier banking models offer any real attractions relative to informal mechanisms – or whether they are just as much 'hassle' as banks, without the benefits of banks. If they are attractive, people will use them, but if they are not, they will be able to ignore them and use stokvels, etc.

The implication may be that in order to make third-tier banking work in South Africa, government would need to eliminate the informal financial services sector through vigorous policing, so people would have no informal option! This would be politically and practically impossible and nonsensical, given the important role that informal financial services play in the livelihood strategies of low-income – and indeed many better-off – South African households.

Ultimately, the problem is that developing countries with strong 'formal' financial services co-operative sectors (such as Kenya) tend to provide lots of opportunities for livelihood strategies that require access to low-cost financial services, including both savings and credit – for example, small-scale cash cropping. Because of how they make a living, households in those countries need low-cost savings *and credit* mechanisms that are based on their seasonal income cycles and facilitate their productive activities. Cooperation with others in the same situation therefore makes sense to them (as it does for most farmers).

In SA, by contrast, most low-income households are either monthly wage-earners or informally employed with a high degree of household dependence on the monthly social grant system (which is just like a wage in the sense that it is paid monthly). They need *saving* facilities that cater for this income source and its monthly cycle, and need credit mostly for emergencies and/or life-cycle consumption.[11] Without the credit side of the equation, however, a FSC cannot pay its way.

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the capacity nor inclination to go over to the 'formal' side. Their rationale is that, besides their inherent value, self-help financial services lead to the development of social capital that can be used to address wider issues of poverty, power, and exclusion.

[11] This is not to say that low-income households do not demand credit, but that such households consider that the types of credit demanded (emergency, lifecycle, and consumption) are better served by informal, traditional mechanisms than formal bank accounts or

This indicates the importance of *how people earn their money*, not just what they do with it once they've got it (which has been the focus in SA). 'Formal' (i.e. legal, registered) financial services co-operatives emerge and are demanded in a specific set of socio-economic conditions, which may not obtain in South Africa. The danger is that once again we impose a model that has little relevance to reality in the South African instance.

2.2.4 Controlled interest rates for tax-exempt MFOs?

The ever-active National Treasury, via the SA Revenue Service, proposes to regulate the lending terms and charges of 'public benefit organisations' that provide microenterprise loans. As the draft regulations are written, if a non-profit MFO enjoys a tax exemption as a Public Benefit Organisation (PBO) as defined by Schedule Nine of the Income Tax Act, the proposed regulation has inter alia the effect of:

- Limiting maximum interest and fee etc., charges to clients to 2% below the ruling repo rate (meaning they would have to charge 9% effective APR);
- Setting the maximum the MFO may lend to an individual to R3 500;
- Requiring the MFO to provide training and business support services to clients.

This would be a disaster for any South African MFO that falls into this specific category. Note, however, that the MFO must be (a) tax exempt and (b) lending for microenterprise. If it is not tax exempt, or if it lends for housing or other non-microenterprise purposes, then the proposed regulation does not apply.

Indeed, most South African non-profit MFOs have not registered as PBOs and do not enjoy tax exemption – but since none of them make any profits, this does not appear to matter. Nevertheless, some non-profit MFOs are poised to turn an operating surplus soon, and the question would become relevant. Even more ominous is the possibility that the tax laws could be interpreted to regard donor funds as taxable since they form part of the 'revenue' of non-profit MFOs. Carried-over donor funding would contribute to MFO 'profits' and be subject to tax. This would end donor funding of South African MFOs immediately. Other potential detrimental effects of these regulations include the following:

- An additional layer of interest rate regulation will be introduced into the South African microfinance industry, driven only by 'political' issues, unrelated to market considerations;
- Because the proposed repo-minus-two rate is unsustainable for any PBO microlender, those presently active will be forced to stop lending or to give up their tax exemptions (which may be important to their ability to operate);
- Potential PBO microlenders will not enter the market;
- The scope and depth of South African developmental microfinance will be further restricted, and potential innovation in the non-profit sector, which is badly needed in the South African environment, will be discouraged.

It is not clear why the Treasury proposes to link interest charges to tax exemption, but it seems safe to assume that it is motivated by a belief that PBOs that enjoy tax exemption should not 'exploit' borrowers. Parliamentary hearings on financial services issues and the poor have been marked by remarkable ignorance about the nature of microcredit and interest rates. There is a common assumption that annual effective rates higher than those enjoyed by middle-class households on their mortgages, overdrafts, and the like are somehow 'exploitative'. There is no reason to believe,

FSCs, which are unfamiliar and require significant participation. Also, it is increasingly recognised that many South African households demand credit as an alternative to unavailable savings products.

however, that interest rates charged by South African developmental MFOs are excessive relative to their tiny, undeveloped, and inefficient 'market'.

The proposed regulations, although motivated by legitimate concerns, address the wrong part of the problem. Non-profit MFOs are essentially like any other commercial enterprise except that they do not seek a profit – they use surplus revenue (if any) to expand their operations. *If* properly governed by a board and with appropriate regulatory oversight, non-profit MFOs can be expected to charge the lowest possible interest rates compatible with self-sufficiency, and DNT should not assume that these rates are 'exploitative'.

There *is* legitimate concern, however, that some non-profit MFOs do not make every effort to ensure that their cost of operations are as low as they could be, leading to upward pressure on interest rates. It is easy for an MFO to claim that it needs to charge a certain rate to cover its costs, but many of those costs may be excessive relative to other developmental MFOs. What are the components of their overheads? How much are personnel paid, particularly senior managers, who often set their own salaries? Are they operating within the accepted norms of the non-profit sector or concealing inefficiency and self-interest with excessive interest rates? The issue that the Treasury should be addressing, in other words, is not the pricing of microenterprise microloans by PBOs, but the underlying cost of their operations.

The proposed regulations will essentially eliminate any microlending by PBOs in South Africa. If this is what the Treasury intends, then it would be preferable simply to ban the practice. Nevertheless, the Treasury could provide much more useful input by focusing on the issues identified above.

2.2.5 Renewed interest in housing microfinance alternatives

A more welcome development is a burst of interest in unexplored housing microfinance options from the parastatal sector, particularly the National Housing Finance Corporation. As has Khula in the microenterprise microcredit sector, the NHFC has failed to reach 'second economy' households. And as with Khula, the reason has been the parastatal's unwillingness to break with 'first economy' assumptions.

The NHFC has long been stuck in the middle-class 'mortgage' worldview. Its efforts have been directed towards extending the existing formal model 'downwards' to the second economy poor but, as in Khula's case, it has failed.

In much of the developing world, however, unsecured, short-term, non-mortgage loans are used to finance incremental housing improvement by households and communities. In South Africa, this option has been pushed aside by the focus on 'one-off' housing delivery via the housing subsidy, which has led to a housing finance focus on 'top-up' mortgage financing. The problem is that the mortgage model makes no sense to people living on informal or very low wage incomes. As in the case of non-housing microfinance, the problem is at least partly on the demand side. Providing a 'middle class' product that poor households do not want is not the way to address the housing finance problem. Indeed, overseas housing finance experts attending an NHFC meeting in late 2003 were surprised to learn that South Africa has very few incremental housing microlenders.

In recent months, however, the NHFC has been 'read the riot act' by the Housing Ministry. Newly-installed Minister Bridgette Mbandla has reportedly told the NHFC to use its money or close down. This has resulted in a flurry of investigations into more appropriate alternatives, including Cape Town's Kuyasa Fund (see below). There is renewed interest in the Rural Housing Loan Fund's Incremental Housing Programme, and in the use of commercial microfinance products to fund housing improvements. Some good research has been done over the last eighteen months on this issue, particularly by the Housing Finance Resource Programme, and it may soon bear fruit in the form of new products and institutions.

As in the case of microenterprise microcredit, however, the key problem remains the lack of a suitable state support structure for the emergence of a new developmental housing microfinance sector. The problem can be seen in terms of market failure. South Africa needs new institutions to specialise in unsecured housing microfinance. But the cost and risks of setting them up are not attractive to commercial banks. Offshore donors are reluctant to provide funds to developmental housing microfinance start-ups because of the assistance given the Department of Housing for the housing subsidy programme. Hopefully in the next year or so the NHFC will shift some of its massive resources in this direction.

2.2.6 Better information

There has been a significant increase in the quantity and quality of research information available on the DMS in the last eighteen months. Sponsored mainly by FinMark Trust and the Ford Foundation, several studies have shed light on financial services practices amongst South Africa's poor households. Highlights include the updated FinScope study (www.finscope.co.za), a detailed survey of stokvels by the Unilever Institute at the University of Cape Town, a number of papers by the Community Microfinance Network (www.cmfnet.org.za), an ongoing 'financial diaries' study based at the University of Cape Town, and housing finance research by the Housing Finance Resource Programme (www.hfrp.org.za). A number of unreleased studies have also been commissioned and completed.

2.2.7 The financial services charter and the national savings account

Many readers will be surprised to find the financial services charter last on the list of contextual issues of relevance to the DMS. This is partly because at this stage the Charter is still on paper only. But more importantly, many of the Charter's practical ideas are concentrated on black economic empowerment in the sector rather than the needs of the poor. BEE is important, but of frankly little relevance to the millions of South Africans in the second economy.

More important is the initiative of the 'big four' South African banks to provide a national savings account. This is driven in part by the Charter, which requires financial institutions to make their services accessible to poor households.[12] But there is a good reason to do this with or without the Charter. Organisations like the Consultative Group to Assist the Poorest are beginning to argue that the focus on stand-alone MFOs during the 1990s has obscured the importance of mass banking for the poor. Some countries, such as Brazil and Indonesia, have long provided low-cost financial services to all households via state banks, but South Africa does not have such a tradition – except the moribund Post Bank, which is so antiquated that it requires savers to send their passbooks to Bloemfontein once a year to be reconciled. The national savings account, due to be 'rolled out' later in 2004, will hopefully create a new financial services dynamic in the second economy, leading to greater extension of more sophisticated services.

2.3 Issues within the sector

2.3.1 Comings and goings

Inevitably, there have been some changes in the terrain of the DMS since mid 2002:

– The **Small Enterprise Foundation** has expanded its portfolio to over 20 000 clients with nearly R16 million in active loans. SEF is poised to become the first South African non-profit microlender to achieve operational self-sufficiency in the current quarter.

[12] If they achieve 80% penetration of this market by 2008, they will get four points in terms of the Charter's 'scorecard' system. The more points each bank scores, the more likely it is to benefit from government business in future.

- **Kuyasa Fund**, a Cape Town-based housing microlender, has emerged as a hot topic of investigation and analysis. Kuyasa is one of the few, if not the only housing microlender in the country providing unsecured loans to informally-employed households to augment the housing subsidy. The MFO has been pressed aggressively by the National Housing Finance Corporation to borrow funds from the parastatal, but has so far refused on the grounds that the NHFC's policies do not accommodate Kuyasa's model.

- A group of community activists in the Western and Northern Cape have launched a savings and credit network called the **Poor People's Movement**. The PPM is organising farmworkers, town dwellers, and backyard shack dwellers in Cape Town into a regional network devoted to community empowerment via regular savings and mobilisation.

- The SA Homeless Peoples' Federation has spawned an **SA Youth Federation**, also based on savings and credit, but targeting people under 30. This group has expanded rapidly and is now active in all nine provinces.

- The PPM and Youth Federation have joined hands with the Homeless Peoples' Federation and other savings and credit organisations to form a **Coalition of the Urban Poor** (although many members are rural).

- The **Savings and Credit Cooperative League of South Africa** (SACCOL) has registered its 30-odd SACCOs with the Microfinance Regulatory Council, which has promised to support the financial services co-operative sector in improving its information gathering and management capacities to comply with state regulation of microlending. Several newer FSC support organisations have also emerged over the last year, but it is not yet clear if they will be any more successful than SACCOL.

- Not all the news is good. **FINCA South Africa** has scaled back its microcredit operations after a disappointing initial experience in kwaZulu-Natal. The number of clients has been halved and many loans have been written off. FINCA hopes to return to its previous scale and expand if it is able to develop an appropriate model for urban South African conditions. FINCA, of course, is part of an international network whose experience is mainly in rural village banking – a far cry from urban South African microcredit.

- The **SA Homeless Peoples' Federation** has conducted a survey of its active membership and their savings and credit practices. The result has been to revise downward its estimate of active savers and to reveal problems in the credit side of its self-help savings and credit model. Also, because of ongoing difficulties in securing housing subsides, the SAHPF's Utshani Fund has stopped providing unsecured housing microloans to its members. Loans will now only be extended when provincial authorities have approved housing subsidies.

2.3.2 Increased cooperation in the developmental microfinance sector

There have been several interesting developments in self-organisation in the DMS over the last eighteen months:

- Nearly all of South Africa's non-profit MFOs came together in August 2003 to discuss, amongst other things, a **Microfinance Practitioner's Organisation**. This grouping included most of the erstwhile KhulaStart MFOs. The meeting decided to explore the idea of an association for the sector, but it is not clear if anything has happened since.

- A group of young MFO employees has formed a "**Youth Practitioner's Microcredit and Savings Movement**". The YMSA has three focus areas "(1) advocating and lobbying government on national pro–poor microcredit and savings policies (2) developing institutional frameworks for long term sustainability and human resources development and (3) creating a

conducing (*sic*) environment to develop a high calibre cadre for community economic development through rigorous debates, field visits, guest speaker invitations, print media and the Internet."

– The **Community Microfinance Network** has formed a strategic alliance with the Coalition of the Urban Poor to develop a support programme specifically for 'self-help' savings and credit groups affiliated to it. This 'Asian' microfinance strategy is rapidly becoming a hot favourite of South African NGOs, but there is little local experience – and there are some problems with older groups. The CMN/CUP alliance will try to create an experience-sharing platform for South African savings and credit groups and build links with more mature savings and credit movements in other countries.

2.3.3 Capacity-building and human resources

One problem in the DMS is a 'resource gap' that prevents MFOs from getting off the ground. The experience of successful South African MFOs has been that a great deal of institutional development and learning – and therefore money – is required to get from the desire to reach the very poor and successful practice. A major reason for this is that South Africa lacks the skills and experience to supply MFO start-ups with staff able to 'hit the ground running'. On-the-job learning is the result, during which time efficiency, productivity and performance is not up to global standards.

The Community Microfinance Network undertook a study in 2003 that compared South African microcredit MFOs with a set of global benchmarks fromthe *Microbanking Bulletin*.[13] The results are not encouraging. South African microcredit MFOs are far behind their global and African peers in most measures of efficiency and productivity. Moreover, because of South Africa's huge income disparities, South African microcredit MFOs must recover 'first world' costs, particularly salaries, from revenues based on clients who can only afford loans on a par with 'third world' countries. Compounding this are structural obstacles to microenterprise in South Africa, as well as obstacles to productivity in microcredit delivery. Taken together, this means South African microcredit MFOs have the highest 'salary burden' in the world. To make matters worse, MFO managers face significant obstacles to improving productivity to compensate for the divergence between staff and client living levels. These include an inadequate skills base, the small scale of the market, rapid labour turnover, and limited resources for capacity development.

The need for a second apex is based in part on these considerations. If the South African government wants a DMS to emerge and flourish, it needs to help develop the basic resources required to run it. Simply supplying wholesale funds on a semi-commercial basis is not good enough.

Fortunately, the Universities of the North and Venda are developing courses and training modules for the DMS, aimed at staff and potential MFO workers. One course is to be offered in 2004 in conjunction with the Microenterprise Development Institute at Southern New Hampshire University in the US. These will go some long way to help meet the non-financial 'supply-side' needs of the South African DMS, but the need for funding to tide MFOs over during the 'learning phase' remains acute.

2.3.4 Debates over objectives and models

The 'second apex' process has revealed a split, of sorts, in the DMS. On one side are practitioners mainly interested in reaching the *very* poor – the so-called 'survivalists' – and prepared to make adjustments along the way to achieve this goal. For this group, poverty targeting is essential. On the other side are those mainly interested in encouraging entrepreneurial SMEs even if this means

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[13] *Doing Pro-Poor Microcredit in South Africa: Cost Efficiency and Productivity of South African Pro-Poor MFIs*, available from www.cmfnet.org.za.

working with the less poor. For this group, poverty targeting is not explicit, and client self-selection is preferred.

The importance of this split lies in the impact it has on strategies for support for and future development of the DMS. The DBSA vs. DTI aspect of the 'second apex' process arose in part because the second group of practitioners mentioned above were concerned that an 'overly' pro-poor approach would 'scare off' the DTI and prevent the apex from getting off the ground. The first group remains concerned that without an explicit pro-poor focus, the second apex will end up more or less like Khula – trying to reach those seeking smaller microenterprise loans, but unable to succeed because of lack of attention to the different methodologies required to do so.

It is difficult to know where this will end. But failure to resolve these issues, as a group of developmental microfinance *practitioners,* and failure to present a unified front to the government will probably lead to further delays and debates, slowing the DMS' development even further.

2.3.5 Challenges to the savings and credit model

The savings and credit subgroup of the DMS is also facing challenges. We noted earlier that the SA Homeless Peoples' Federation had suffered declining membership and savings (although this has been reversed). This is due to two factors:

- The HPF combined local-level 'self-help' savings and credit and an NGO-run external loan facility (Utshani Fund). Utshani provided bridging loans for housing construction – to be retired by the housing subsidy – and pilot income-generation projects. Unfortunately, the housing subsidy system never came close to matching the pace of Utshani disbursements. HPF members who had planned to make Utshani loan repayments for a few months until their subsidies arrived began to falter as months stretched into years and interest charges mounted. Critically, neither the HPF leadership nor the NGO made sufficient effort to control this, and the HPF membership quickly realised that there was no cost to 'default'. Utshani repayments dropped precipitously, and in 2000 the Fund stopped extending new loans. This led to an exodus of HPF members who had joined only to access Utshani loans.

- The HPF's local-level savings and credit activities were never regarded as an area where the NGO should intervene – except to 'bail out' schemes where funds were 'eaten'. NGO professionals assumed that savings and credit were natural practices that poor households could manage for themselves. Most communities can indeed manage their own savings pools, but two factors undermined the HPF. First, the Utshani Fund experience 'corrupted' the system and led to a breakdown of savings and credit discipline, particularly with so many members joining only to get Utshani loans. Second, it is clear that once savings and credit activities are scaled up into networks, an element of 'third party' support is critical to provide oversight and maintain confidence in the system. The HPF's NGO partners provided neither of these on any systematic basis.

These two factors (along with others) combined to undermine the savings and credit foundation of the HPF. Members left in droves in 2000-2002 – but began to return in 2003 once new principles and systems were established. It is still unclear, however, whether the relationship between NGO and community savers has been sorted out.

Besides the impact on the HPF, the importance of this experience is that it has led to the formation of other savings and credit networks, which are grappling with the same issues of principles, systems, and relationships around community-level savings and credit activities. To assist these groups, the CMN intends to devote significant resources over the next two years to networking, experience-sharing, and support.

3. Conclusions

3.1 Any changes to the scenario?

The 2002 document developed a high/middle/low road scenario for the developmental microfinance sector. How is the sector doing and where are things going?

All in all, the DMS seems to be on the middle path. As noted above, the sector still lacks appropriate vision and support from government, and this is limiting its growth. There is also internal division. Nevertheless, some MFOs are finally beginning to grow rapidly, and these experiences – hopefully with support from the DTI apex – will spawn imitators. Aside from the problems at the Homeless People's Federation, nothing negative has affected the DMS, and there is steady growth in numbers and financial activity. The 'middle scenario' will most likely be the case in 2010.

3.2 Issues for the near future

Nevertheless, there is cause for concern. The biggest issues are:

1. The underlying health of the microcredit model pursued by NGO microlenders. Although the Small Enterprise Foundation is poised to become 'sustainable' in 2004, no other MFO is close to its levels of cost-recovery. It will be necessary to monitor progress in this respect. As the CMN paper cited above noted, the barriers to successful microcredit for the very poor in South African conditions are considerable.

2. The 'second apex' saga needs to be resolved. The DTI cannot expect to succeed on the basis of selective consultation. It is doubtful whether the apex can successfully combine support for microcredit and cooperative financial services in one institution.

3. The financial services co-operative sector continues to disappoint. Two of the three umbrellas have collapsed, and SACCOL remains small. The intense interest in cooperative financial services from government and political parties is not driven by any real understanding of the issues or challenges, and there is a danger that a combination of unrealistic expectations and inappropriate support strategies may no more harm than good.

4.1 SA Developmental Microfinance Sector

Institution	Location	Type	Individual savings facilitated	Self-managed group savings	Loans from Group Savings	MFO loans for non-microenterprise purposes	MFO microenterprise loans	Poverty Profile	Targeting strategy	Origin
ACAT KZN	KZN	Microcredit and business development services	Yes	Yes	No	No	Yes	Generally poorest in community	Participatory wealth ranking to identify poorest	Christian rural development NGO
Beehive EDC	Mpumalanga	Microenterprise MFO and business services centre	No	Yes	Yes but only for some clients	Housing microloans	Yes	Claims to reach very poor	*Ad hoc*	Business development centre
FINCA KZN	KwaZulu-Natal, Eastern Cape	Microenterprise MFO	Yes	No	No	No	Yes	Claims to reach very poor	*Ad hoc*	FINCA International affiliate
Kuyasa Fund	Cape Town	Hybrid housing microloans / microsavings	Yes	Yes but not centralised	No	Housing microloans	No	Very poor to poor women in urban townships around Cape Town who have not yet received housing subsidies and who are members of independent savings groups	Community self-selection	NGO programme evolved to stand-alone
Marang Financial Services	Gauteng, Mpumalanga, Free State, Eastern Cape, KZN	Microenterprise MFO	No	No	No	No	Yes	Unemployed households in a given area with microenterprises	Geographical targeting	Created to absorb Get Ahead Financial Services and Rural Finance Facility
Poor People's Movement	Western Cape	Savings and credit network	No	Yes	Yes	No	No	Mixed including street dwellers, farmworkers	Community self-selection	Church welfare project
SA Youth Federation	National	Savings and credit network	No	Yes	Yes	No	No	Varied	Community self-selection	Offshoot of SAHPF

Institution	Location	Type	Individual savings facilitated	Self-managed group savings	Loans from Group Savings	MFO loans for non-microenterprise purposes	MFO microenterprise loans	Poverty Profile	Targeting strategy	Origin
SACCOL	National	Support and statutory umbrella for SACCOs	No	Yes	Yes	Only at start-up for SACCO running costs	No	Average member income around R1 200	Geographical	Statutory umbrella for SACCOs
Small Enterprise Foundation	Limpopo rural	Microenterprise MFO	Yes	No	No (but patching used within loan groups)	No	Yes	To programs roughly equal in size. One works with existing poor entrepreneurs. The second targets those below 50% of the poverty line. Most are women in rural villages in ex-homelands who have household-based microenterprises.	Conscious strategy of poverty wealth ranking when new branches formed	Start-up initiative
Homeless Peoples' Federation	National	Savings and credit network	No	Yes	Yes	Housing and land	No	Very poor to poor women (85%) in urban informal settlements and recently-developed townships around major cities and towns	Community self-selection	Homeless people's movement
Women's Development Banking			No	No	No	No	Yes	Unknown	Community self-selection	Start-up initiative

4.2 Statistics for the Developmental Microfinance Sector

Institution	Savings		Principal Outstanding		Clients / members		Branches / groups	
	2002	**2003**	**2002**	**2003**	**2002**	**2003**	**2002**	**2003**
ACAT KZN	150 000	270 000	88 257	298 800	475	1 105	95	221
Beehive EDC	n/a	n/a	652 311	2 300 000	3 623	6 094	3	3
FINCA KZN	4 950 000	n/a	1 100 000	1 000 000	2 500	778	290	133
Homeless People's Federation	2 572 791	2 860 000	2 000 000	1 500 000	68 789	44 165	800	1 270
Kuyasa Fund	1 600 000	3 500 000	1 700 000	5 000 000	5 603	4 620	250	400
Marang Financial Services	2 894 000	4 196 300	8 529 994	14 000 000	14 470	21 000	12	19
Poor People's Movement	0	200 000	n/a	n/a	0	7 000	0	70
SA Youth Federation	0	17 147	n/a	n/a	0	8 290	0	250
SACCOL	17 500 000	20 000 000	14 000 000	16 000 000	7 900	8 000	28	27
Small Enterprise Foundation	2 170 000	3 010 000	8 350 000	15 600 000	13 387	20 048	300	550
Women's Development Banking	n/a	n/a	300 000	930 000	1 500	2 500	1	1
TOTAL	**31 836 791**	**35 453 447**	**36 720 562**	**56 628 800**	**118 247**	**123 600**	**1 529**	**2 544**