

# SOUTH AFRICAN BANKS AND THE UNBANKED: PROGRESS AND PROSPECTS

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## Abstract

This paper investigates what the big four banks in South Africa have achieved regarding opening up access to their lending facilities to the unbanked, distinguishing between lending to low-income salaried individuals and loans to micro-entrepreneurs, and the appropriate strategy for the future. The different strategies, namely linkage banking, downscaling, and dedicated banks are analysed with reference to the international experience and focusing on the period since 1998. It is postulated that the banks' focus in micro-lending will remain on loans for low-income salaried individuals and for this the downscaling strategy will be used. It is not foreseen that the big four banks can or will significantly be involved in micro-entrepreneur lending in future, rather that this be done by creating dedicated banks, and not linkage banking as was suggested by the author in 1998.

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## 1. INTRODUCTION

Commercial banks traditionally do not serve low-income earners, micro-entrepreneurs and the poor (collectively referred to as the unbanked), chiefly because the high costs involved make it unattractive. The big four of South African banking,<sup>1</sup> who between them have a market share in excess of 80 per cent (South African Reserve Bank, 2002:4), are no exception in this regard. It is only since the early 1990s that they have given serious thought to entering this market segment, in no small way influenced by the changes in the local political landscape. The new government and its supporters claimed that the big four had backed the race-based policies of the previous regime, demonstrated by their unwillingness to serve, in general, the black community. These banks have been pressurised into rectifying this situation. The emphasis has been on opening up access to their lending facilities in the belief that they have the funding available to meet the pent-up demand for financing in the black community.

A period of approximately ten years have passed since the big four banks cautiously ventured into this market. What has been achieved? They have definitely not lived up to the expectations of the currently 17 million unbanked (Porteous, 2003:2) or the government. The banks

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<sup>1</sup> Absa, FirstRand, Nedbank and Standard Bank.

themselves know that they have not accomplished enough. That is why access to basic banking services to poorer people is one of the pillars of the proposed Financial Services Charter currently being drawn up by the industry.

Research was previously done on the strategies South African banks had followed in the first five years of their efforts to open up their services, more specifically their lending facilities, to micro-entrepreneurs (Schoombee, 1998 & 1999). Proposals were made, given the international experience, as to which were the more appropriate strategies to pursue. In this paper, consideration will be given to what has transpired in South Africa since that research was completed, taking cognisance of the trends internationally in opening up bank lending services to those who have previously been shunned. The local efforts can be split into lending to low-income salaried individuals, mainly for consumption purposes (section 2) and offering loans to micro-entrepreneurs (section 3), jointly referred to as micro-lending.<sup>2</sup> The appropriate strategy to implement in the current circumstances is identified in section 4.

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<sup>2</sup> Loans (excluding overdraft facilities) up to the amount exempted from the provisions of the Usury Act, R6 000 originally and currently R10 000, are generally regarded as micro-loans.

## 2. LENDING TO LOW-INCOME SALARIED INDIVIDUALS<sup>3</sup>

Banks were up to 1992 not interested in offering small loans. This was due to a ceiling placed on lending rates by the Usury Act of 1968 to protect borrowers from excessive charges. The transaction cost per rand lent was just too high to make such business profitable. On 31 December 1992, the Minister of Trade and Industry exempted certain moneylending transactions not exceeding R6 000 from the provisions of this Act. This decision was the result of representations made by the Law Review Project on behalf of various bodies to make smaller loans a viable business proposition for loan-granting organisations, the ultimate aim being increased access to funding for micro-entrepreneurs.

The exemption opened the door for banks to supply small loans profitably and thus for the first time to consider serving the previously unbanked. One would have expected the big four banks, if they were dedicated to serve the unbanked, to speedily enter that section of the unbanked lending market that holds the least risk for them, i.e. providing loans to the low-income formally employed. This did not happen. Instead, the so-called 'formal' micro-lending industry (those belonging to the Micro Lending Association of South Africa) outside of the banking sector mushroomed in a very short span of time. Research done in 1998 (Du Plessis, 1998) estimated that 3 500 'formal' micro-lenders were already disbursing R10 billion loans annually, with a further R5 billion supplied by micro-lenders not belonging to the Association. To qualify for a

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<sup>3</sup> This discussion excludes lending that would normally be categorised as home loans.

loan from a 'formal' lender, the borrower had in fact to be a bank customer as repayment was effected by bankcard withdrawal or direct deduction from the borrower's payroll. Given these circumstances, it would appear that the big four banks had at the time little commitment to this market. Existing bank customers should surely have been in a position to apply for and receive a bank loan.

The unregulated growth of the micro-lending industry inevitably also resulted in unscrupulous lenders entering the market. Public concern for the exploitation, real and perceived, of low-income earners by charging exorbitant interest rates and the increased over indebtedness of borrowers (e.g. Marsh & Saran, 1999) necessitated the authorities and the industry to investigate the future path of the industry. A new exemption notice was issued in June 1999 which, amongst others, required of lenders who operated under the 1992 exemption to register with the newly created regulator of the industry, the Micro Finance Regulatory Council (MFRC); laid down specific requirements for micro-loan transactions; and increased the loan amount exempted from the Usury Act to R10 000. The MFRC launched the National Loans Register which records details of the micro-loans supplied by registered lenders in November 2000. This Register makes it possible for a registered lender to enquire about a prospective borrower's lending commitments and thus to form an opinion of his/her repayment capacity; since 1 July 2002 it is mandatory for registered lenders to submit information to the Register and to do enquiries before lending. The MFRC also implemented 'truth in lending' disclosure requirements to protect the borrower, a one-page summary of the loan agreement containing the crucial elements of the loan.

The big four banks cautiously entered the micro-lending market from 1996 onwards, predominantly using the downscaling strategy (see below). The fast growth of the industry, indicating its profit potential, lured the banks. But they were also prodded into action by the informal pressure exerted by the government and society. The approach followed by the banks broadly corresponded with strategies that had already met with success internationally. The common denominator of these strategies are that all borrowed from the successful way informal financial intermediaries (those operating outside the ambit of financial regulatory authorities) resolve the obstacles of high risk, high cost and consequently low returns banks encounter when serving the unbanked. The strategies include setting up, from scratch, a bank dedicated to provide basic banking services to the previously unbanked; creating a separate division within an existing bank to serve this market (also referred to as downscaling); and linking banks with informal financial institutions. The only strategy not tried in South Africa is that of credit-granting non-governmental organisations (NGOs) transforming themselves into banks (also known as upgrading) due to, amongst others, NGOs not having reached the scale of activities necessary to make upgrading viable.

Standard Bank created E Bank (now E Plan) in 1993 to provide basic banking services to the low-income urban population. It, however, only entered the micro-lending market in 1999. Rather than going it alone, it followed a cautious approach by entering into a joint venture with African Investment Bank Limited (Abil), currently the market leader, in terms of which Abil's loan products are

sold to Standard Bank's E Plan customers through Standard Bank's branch network. The loan book has since grown to R256 million (Standard Bank Group, 2002:21).

Nedbank ventured into the low-income market via its Peoples Bank division in 1995, the latter later becoming Nedbank's empowerment subsidiary with its own banking licence. It currently has a client base of 2 million, primarily low- and middle-income individuals (Nedcor, 2002:45). The focus was originally not on the lending side, but two alliances Nedbank has entered into has positioned it strategically in the micro-lending market. The alliance with Capital One of the US entered into in 1999, gives Nedbank access to Capital One's expertise in information-based penetration into lower-end lending markets. The alliance's loan book totalled R1 billion in 2002 (Nedcor, 2002:63). Nedbank's alliance with the furniture retailer JD Group has concentrated on distributing unsecured personal term loans via the Group's customer base, which includes 1,2 million active debtor accounts falling in the middle- to lower income markets (Nedcor, 2002:47).

The first branch of Absa's NuBank division, aiming to serve those that were traditionally regarded as unbankable, was opened in February 1996. In contrast to Peoples Bank and E Plan, NuBank immediately provided both unsecured personal micro-loans and micro-entrepreneur loans. In April 2000, Absa acquired a 51 per cent stake (later increased to 61 per cent) in one of the then market leaders in micro-lending, UniFer, and incorporated NuBank into it. Absa immediately gained a significant share in the micro-lending market and at the same time illustrated its commitment to the development of this market.

Notwithstanding all the steps taken by the government and the MFRC to put the micro-lending industry on a sound footing, and the MFRC's view in 2001 that "(l)arge reputable entities have entered the market and have contributed to a significant improvement in conduct" (Micro Finance Regulatory Council, 2001:4), referring to the banks' entrance, the industry suffered a serious setback in 2002. It is ironic that the crisis was largely confined to two of the major bank micro-lenders, UniFer of Absa and Saambou, who, in a very competitive environment, indiscriminately expanded their lending books from 2000 onwards. The background to their actions was the government's decision to halt from the second half of 2000 new micro-loans to public servants linked to its payroll deduction system, Persal, and at the end of June 2001 to terminate all access of microlenders and insurers to Persal (the latter did not materialise). This decision was the result of the government's concern for the excessive level of indebtedness of many of its employees.

For microlenders with a large exposure to public servants, the government's decision was potentially disastrous. UniFer aggressively sought new accounts and nine months after stopping new loan access to Persal, UniFer had nearly doubled the size of its loan book. This was achieved by depending extensively on brokers to sell UniFer loans, while also granting them the power to establish the creditworthiness of prospective clients and of approving the loan.<sup>4</sup> Given that the brokers received commission on the volume of loans sold and, furthermore, that UniFer's

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<sup>4</sup> Other banks in the industry realised the risks involved in making use of brokers and purposefully avoided this route. FNB and Peoples Bank rather used their branch networks, while Abil terminated all its agreements with brokers in March 2000 (Joffe, 23 January 2002).

collection and administration systems could not cope with the volume of loans being granted, this was a recipe for disaster. This it turned out to be. In March 2002, the shortfall in UniFer's provisions for bad debts was R1,8 billion on a loan book of R4,9 billion and its net asset value R1,3 billion in the red (Absa, 2002:22,38). UniFer was subsequently delisted and became a 100 per cent subsidiary of Absa.

The other major bank micro-lender who experienced serious problems with its micro-lending business, Saambou, was ultimately put under curatorship in February 2000. Its assets were put up for sale and Abil bought its R2,8 billion micro-loan book. Given that the loan book of the bank micro-lenders is a substantive portion of the registered lenders' loan book (in the region of 50 per cent), the difficulties at UniFer and Saambou had a detrimental effect, both direct and indirect, on the industry. Bank micro-lenders' disbursements decreased from R4,4 billion to R3,9 billion, i.e. 12 per cent, in 2002 and all other categories of microlenders, except NGO microlenders, followed suit. For the industry as a whole the drop was 13 per cent, from R14,4 billion to R12,6 billion (MFRC, 2002:10).<sup>5</sup>

The industry has apparently weathered the storm. Loan disbursements have been stable for the three months ending February 2003, after the first growth in disbursements for four quarters was achieved in the three-month period ending November 2002. Bank micro-lenders' disbursements were still down in the period

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<sup>5</sup> Bank micro-lending (R7,9 billion as at 30 September 2002) remains a very small proportion (2,5 per cent) of total bank credit to households, excluding micro-loans (Hawkins, 2003:6).

ending February 2003, although only by slightly more than 1 per cent (MFRC, 2003).

This micro-lending crisis, due mainly to inappropriate credit technologies in a very competitive environment, show similarities with what happened in Bolivia in the late nineties. There well-established and successful micro-entrepreneur lenders, in their effort to compete with consumer lenders who entered the market from Chili, tolerated higher arrears rates and overlending, ultimately resulting in a considerable drop in profitability of the micro-entrepreneur lenders and the demise of the consumer lenders (Rhyne, 2001:135-157).

### 3. LENDING TO MICRO-ENTREPRENEURS

The prospect of profitable lending to micro-entrepreneurs - the more risky section of the unbanked lending market - following the 1992 exemption from the provisions of the Usury Act did not inspire the big four banks to enter this market to a similar extent as had lending to low-income salaried individuals. In the first five years after the exemption, very little micro-entrepreneur lending had been done. FNB and Standard Bank introduced pilot projects in 1992 and 1993 respectively, both of which were terminated by 1997, and micro-entrepreneur lending by Absa's NuBank, which commenced operations in 1996, was less than 10 per cent of its loan book. Given that not much has changed since then raises the question if there are, irrespective of the different strategies followed by the banks, structural characteristics unique to the South African economy that explain this lack of progress.

Research done at the time, that took into account the international experience, set an order of preference for the strategies to increase substantially local banks' lending to micro-entrepreneurs, namely linkage banking, downscaling and the least preferred, a dedicated bank (Schoombee, 1998 & 1999). Does this order of preference still apply?

(a) *Linkage banking*

Linkage banking, the then most preferred strategy, is mostly found where banks link with informal financial sector self-help groups (SHGs), grassroots social organisations formed to address the financial needs of their members in a collective manner. NGOs play an important role in this strategy, either as an intermediary between banks and SHGs or in establishing and training new SHGs. The high default risk banks have to face when lending to micro-entrepreneurs is solved by the social collateral (peer pressure) in the SHGs, and the high transaction costs by dealing with groups and not individuals.

Locally stokvels, group-based rotating savings and credit associations, function as SHGs. The prevalence of stokvels was one of the reasons for preferring the linkage strategy for South Africa. However, the lack of suitable NGOs impeded the implementation of this strategy.

The concept of 'village banking', as applied locally, is also a type of linkage banking and was at the time of the research referred to, thought to hold much promise to open up bank lending to rural micro-entrepreneurs. Village banks, known as Financial Service Co-operatives (FSCs) in South Africa, are semi-formal financial institutions owned, via

shareholding, and managed by the members of a specific community/village to create access for its shareholders to basic financial services. FSCs are exempted from the Bank Act's ban on providing deposit facilities, but in terms of the same exemption are required to have a business arrangement with a bank of its choice, the link bank. Deposits received by FSCs are deposited at the link bank and lending is only possible once a certain percentage of the loan has been saved. In addition to the bank/client relationship between the link bank and the FSC, the bank undertakes to provide support, training and advice to the FSC.

FSCs are subject to self-regulation and for this purpose had to be members of either the Financial Services Association (FSA) or FinaSol, both which were recognised by the authorities for this purpose. These two institutions each established its own network of FSCs, providing start-up loans, training and other forms of support to their members. The first FSC was established in 1996 and their numbers increased to just below sixty by 2002 (FinMark Trust, 2003: paragraphs 7.2.2 & 7.2.3).

FSCs suffered a serious setback in 2002. Both self-regulators depended on grants from private donors and the government to undertake their financial regulation and support functions and had to terminate their operations when the grant funding was stopped. This resulted in the closure of a large number of FSCs.

How successful were FSCs in their linkage role, more specifically in regard to opening up access to bank loans for their members? Savings, and not loans, were emphasised by both FSA and FinaSol. Lending to a

shareholder was only possible once a certain percentage of the loan had been saved and, furthermore, accumulated savings were the source from which loans were financed. Given the amount of savings mobilised, lending did not reach its potential. FinaSol, for example, required savings of 30 per cent of the loan amount (Nigrini, 2002). With savings totalling R5,3 million in the middle of 2002, lending of R3,71 million was possible. However, its loan book at the time was only R1,45 million (FinMark Trust, 2003: paragraph 7.2.2.2), less than 50% of what could have been financed by the savings. In the circumstances, no bank lending other than that financed by members' own savings was done. Strictly speaking, FSCs thus failed in linkage lending.

Linkage banking as a strategy to increase substantially the big four banks' lending to micro-entrepreneurs has not been a success locally. Is it still a successful strategy internationally? The linkage project in India, under the auspices of the National Bank for Agriculture and Rural Development (NABARD), is in terms of outreach undoubtedly a winner. It started as a pilot project in 1992, linking in the region of 500 SHGs with half a dozen banks. By 2002, it had grown to 0,5 million SHGs (with 8 million members) linked to 20 000 rural outlets of more than 440 banks, with a loan book of R1,8 billion (Seibel & Dave, 2002:v). NGOs, mostly financed by grants, are involved in 84% of the linking between banks and SHGs (Kropp & Suran, 2002:6), primarily in forming and training new SHGs. This has contributed significantly to the successes achieved. But has it been profitable lending for the banks involved? Seibel & Dave (2002:31-35) indicated that it has and that for a number of banks the returns of the linkage project have significantly exceeded the profitability of

other bank departments. Not all banks, though, find it profitable. Banks that do not make profits from their linkage activities are often those who, because no NGOs are involved, have to establish and train new SHGs, and finance the very costly activities themselves (Harper, 2002:48). Furthermore, when considering the profitability of this linkage project, it needs to be taken into account that the funds lent by banks are refinanced by NABARD, a development bank. The refinance rates, fortunately, are in line with market interest rates (Seibel & Dave, 2002:5). Profitability has thus not been dependent on below market cost of funds.

Linkage banking is still an option for the big four banks to supply micro-loans to micro-entrepreneurs, but no longer the preferred strategy. Although the concept of SHGs is well known and understood by the unbanked in South Africa, the absence of NGOs who can establish and train SHGs, evidently a critical factor in the successes achieved in the NABARD linkage project, will frustrate any attempt to implement this strategy on a large scale. Furthermore, the uncertainty as to the effectiveness of SHGs in the urban areas of South Africa (Schoombee, 1999:448), still remains. Linkage lending via FSCs is also still a prospect, but only if villagers' demand for lending increases substantially (why are villagers not taking up loans? Is it because there is little entrepreneurial activity?) and a speedy solution to the current regulatory predicament is found. The government and/or donor institutions will too need to step in and provide grant funding and/or subsidies for the support, training and advice link banks offer to FSCs, justified by the positive externalities of these actions. These functions are similar to what grant-funded NGOs provide to SHGs in the NABARD linkage project and

which resulted in losses in banks' linkage activities when financed by the banks themselves.

*(b) Downscaling*

This strategy, where existing banks create either a separate division or a subsidiary to enter the micro-lending market, has been the major vehicle of the big four banks to achieve this purpose. As was already discussed in section 2, downscaling has predominantly been used locally to lend to low-income salaried individuals.

Looking at the experience in other developing economies should provide clarity as to whether this strategy is also a viable option to address micro-entrepreneurs' demand for credit. In this regard it should be noted that micro-lending globally had commenced with micro-entrepreneur loans and not with lending to low-income salaried individuals. The experience in other developing countries thus deals primarily with micro-enterprise lending.

Valenzuela (2002) researched the experience of 53 downscalers that have since the mid-1990s opened up their banking services to the previously unbanked. Not all have been successful. Most, though, have succeeded in undertaking micro-lending profitably and, similarly to the linkage strategy discussed above, some even generated higher profits than the other departments in their respective banks. Why did some downscalers do well and others not? The research found that smaller banks performed better than larger banks (problems encountered when integrating micro-lending into a big bank structure); subsidiaries dedicated to the micro-lending market were a better option than establishing a separate division for this

purpose (subsidiaries are more successful in detaching the micro-lending activities from the organisational culture of the existing bank); the presence of an 'operational champion' (an individual who believes in the micro-lending product, knows what it requires to develop it, and is able to manage the provision of this service) guaranteed success; and those downscalers that received technical assistance from international donors (e.g. in regard to credit methodology, service delivery and training) do better than those that did not. The availability of loan funds from donors/governments for on-lending to micro-entrepreneurs has not been a requirement for commencing micro-lending; all downscalers used their own funds and did not identify a shortage of funds as a limitation. Similarly, the availability of guarantee funds, reducing the risk of loan default, did not influence downscalers' decision to begin micro-lending. Only a few of the banks included in the research made use of the guarantee facilities.

Relating the above research to the position locally provides some evidence why downscaling by the big four banks have not resulted in loans being supplied to micro-entrepreneurs. Their size could be a problem, an 'operational champion' has apparently not emerged in any of the banks, and they have not received any technical assistance. The latter is a serious constraint and is possibly the main reason why even the joint venture discussed below has not been very successful. Furthermore, the availability of loan guarantees from Khula Enterprise Finance (Khula) - the government agency entrusted with the task of addressing the financial constraints of small, medium and micro-enterprises - have not attracted the banks to this market, similar to the international experience.

The big four banks themselves identified the lack of managerial and entrepreneurial skills and adequate risk capital in micro- and very small enterprises as major impediments to lending to these enterprises (Tucker, 2000). To show their commitment to serving this market, although not at the lower end, the big four banks decided to attend to the demand for entrepreneurial loans of between R10 000 and R50 000 (since increased to R100 000) by specifically addressing the skills shortage. In terms of a joint project with the Banking Council initiated in 1998, Sizanani Advisory Services provide mentoring to loan applicants and recipients and the Sizabantu Guarantee Company covered the banks from loan defaults.<sup>6</sup> Both companies were set up by a grant of R4 million to fund administration costs, contributed to equally by each of the four banks. The repayment period of the loans was originally a maximum of 3 years, though some banks have since increased it to 5 years. The interest rate was originally the prime overdraft rate plus 6 per cent. Currently it is in the region of prime plus 3 to 4 per cent.

The partners realised that R4 million would not be sufficient funding to cover their costs. Further grants had to be obtained. They were successful in accessing funds from the WK Kellogg Foundation and BankSETA, specifically to pay for the cost of mentorship and mentorship training. Sizabantu, furthermore, provided a 95 per cent indemnity cover to the banks, but was only liable for 15 per cent of the loan amount; the other 80 per cent was provided by Khula. Sizabantu discontinued issuing

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<sup>6</sup> The information on the joint project was supplied by Eddie Johnstone, one of the directors of Sizanani Advisory Services. See Johnstone (2001a, 2001b & 2003).

indemnities on 28 February 2002, the result of a report that advised that Sizabantu would need to register as an insurance company. Since then, Khula indemnifies the banks at a level of 90 per cent.

The skills shortage identified by the big four banks is addressed by providing mentorship to potential entrepreneurs. Those that may potentially qualify for a loan (the owners of formal micro- and very small enterprises, as defined in the National Small Business Act of 1997, who meet certain minimum criteria) are invited to apply for assistance. The mentors only introduce about 10 per cent of the applicants who meet the minimum requirements to the participating banks for finance. The main reasons for this low percentage are the applicants' poor credit records, lack of experience and commitment, and non-viable business ideas.

Mentors help those selected to draw up their business plans. The support and guidance entrepreneurs receive extend to the management of their businesses, available to them for a maximum of one year after having obtained the finance. Sizanani outsourced the mentoring function for a period, but unhappiness with the quality of service resulted in the decision to employ and manage their own mentors.

The experience of the joint project, a concerted effort of the big four banks to breach the divide to very small entrepreneurs, has not shown that downscaling as a strategy is working in South Africa. Up to 30 June 2003, 239 loans to the value of only R8,4 million were approved. on average R2,1 million per annum. The low percentage of applicants finally introduced to the banks for funding, for

the reasons mentioned above, is apparently the constraining factor.

Furthermore, notwithstanding the seemingly strict screening process and aftercare service for up to one year, the proportion of loans in arrears grew from 14,7 per cent at the end of September 2000 to 33 per cent at the end of June 2001. The situation has improved markedly since 28 February 2002, though the arrears are still too high. Of the R0,5 million loans approved since this date, an amount of R63 900 (12,8 per cent) is currently in arrears. Best practice internationally has shown that arrears levels of below 5 per cent can be obtained when lending to micro-entrepreneurs (see, for example, Hulme & Mosley, 1996: 44).

Taking into consideration the international experience and the problems identified in the project, it appears as if the lack of technical assistance from those knowledgeable in serving this market successfully was sorely missed. Appropriate service delivery and proper training of mentors, loan applicants and loan recipients specifically to address entrepreneurial skills could go far in increasing the percentage of applicants introduced to the banks and, more importantly, in lowering the arrears rate,<sup>7</sup> thus making downscaling an attractive strategy in supplying micro-entrepreneur loans. However, the other characteristics of the big four banks, amongst others their large size and apparently not having an 'operational

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<sup>7</sup> The inordinately high indemnity cover provided for the banks - international best practice shows that banks should accept between 30 and 40 per cent of the risk (Nigrini & Schoombee, 2002) - may also explain the high arrears rate. With virtually no risk to the banks, they tend to select high-risk loans. The result is a low quality loan portfolio and consequently a high arrears rate.

champion', will prevent this strategy from becoming the major strategy in lending to micro-entrepreneurs locally.

(c) *A dedicated bank*

The order of preference previously established for the strategies to increase local banks' lending to micro-entrepreneurs awarded the last place to a bank dedicated to exclusively serve this market. It was felt that modest profit expectations in the short to medium term would deter large scale private sector participation, especially if the bank had to start from scratch.<sup>8</sup> Upgrading NGOs if the necessary regulatory changes were put in place and suitable prospects were to appear, would have been preferred. Furthermore, the demise of Community Bank,<sup>9</sup> set up in the mid-nineties to serve the low-income market, did not help to portray this as an attractive strategy.

Globally this approach has gone from strength to strength. The upgrading strategy has been particularly successful in Latin America (see, for example, Rhyne, 2001 on BancoSol in Bolivia, and Campion *et al.*, 2002 on Mibanco in Peru). However, as was mentioned in section 2, upgrading has not been attempted locally and is still not an option. Setting up a new bank has also grown in importance, specifically in Latin America and the emerging market economies of Eastern European. Although it has been

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<sup>8</sup> Both the linkage and downscaling strategies create the opportunity for cross-subsidisation of micro-entrepreneur lending from other departments within a bank, which is useful in the start-up phase of such lending activities.

<sup>9</sup> See Verhoef (2000) for a discussion on the establishment, operations and demise of Community Bank.

shown that micro-finance is profitable,<sup>10</sup> large-scale private sector participation has not yet been achieved. Mommartz & Schor (2002:78-82) discuss why this is the case, amongst others referring to the labour intensiveness of micro-finance and specifically the time it takes for staff to develop the specialised skills required to make a success of micro-finance. This time constraint only allows banks to expand very gradually, resulting in banks having to accept lower profitability for an extended period, which is definitely not conducive to attracting private investors.

What have worked, though, are specialised public-private partnerships to establish new banks (Mommartz & Schor, 2002). Such a partnership typically consists of a commercially oriented multilateral or bilateral development institution (a donor institution that requires of the recipient of donor funds to have reached or be on its way to financial self-sufficiency, e.g. the International Finance Corporation and the European Bank for Reconstruction and Development) and a private investment company that specialises in micro-finance investments. The latter would have extensive experience in and knowledge of micro-finance, allowing them to employ best practices and appropriately trained staff in the new venture, consequently ensuring its success. The reputation of such a specialised investor is of immeasurable value to the new bank. It would be in a position to successfully approach

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<sup>10</sup> Micro-finance is a broader concept than micro-lending and includes services such as deposit-taking. According to the MicroBanking Bulletin (2002), 62 of the 147 reporting micro-finance institutions were financially self-sufficient (financial self-sufficiency indicates how well the micro-finance institution could cover its costs if its operations were unsubsidised and it was funding its expansion with commercial-cost liabilities).

donors for technical support and funds for on-lending, creating the opportunity for the new venture to grow fast and to move rapidly to achieve break-even (normally two to three years) and then profitability. Experience has also proven that extending the range of services beyond pure micro-finance from the outset can be beneficial to the new bank as it creates the opportunity for risk diversification. The foregoing attributes of specialised public-private partnerships should positively influence private investors to become involved in a dedicated bank.

Setting up dedicated banks by means of specialised public-private partnerships is now the preferred strategy to roll out micro-entrepreneur lending on a substantial scale in South Africa. The reason for this choice is twofold. First, both the linkage and downscaling strategies undertaken by the big four banks have not been successful and exhibit certain inherent deficiencies linked to the characteristics of these banks (e.g. their size) and the local environment (e.g. no suitable NGOs). Second, some of the most serious problems experienced by all of the big four banks, namely not having access to the technical know-how of those knowledgeable in serving micro-entrepreneurs and the lack of grant funding and/or government subsidies to finance this access, are addressed by these specialised partnerships. The specialised private investor provides the required technical assistance and the public development institution the funding, which is furthermore deemed more efficient if supplied by the owners and not by a third party (Mommartz & Schor, 2002:87).

What is needed to initiate this strategy is for such a specialised private investor, of necessity from outside South Africa's borders since these expertise are not

available locally, to take the plunge and establish a new bank in partnership with a donor organisation. The demonstration effect, if the venture is successful, should lead to others following suit. There are, however, obstacles that may deter specialised private investors from entering the local market that need attention. Current legislation dealing with banks, namely the Banks Act of 1990 and the Mutual Banks Act of 1993, are not conducive to establishing small, dedicated banks. The latter Act was promulgated to specifically address the development of smaller second tier banks, but has failed to do so, amongst others due to the high minimum capital requirement of R50 000. Appropriate regulation for dedicated banks needs to be put in place and in this regard the research done by Van Greuning *et al.* (1999) and Meagher (2002) is of utmost relevance.

The loss of confidence in small banks after the demise of Saambou in 2002 (see section 2 above), ultimately also leading to the takeover of BOE Bank by Nedbank and the request for withdrawal of their banking licences by Brait Merchant Bank and Corpcapital Bank, will detrimentally affect the prospect of launching dedicated banks in South Africa. That this loss of confidence is a direct result of the incomprehensible decision by the National Treasury/Minister of Finance to put Saambou under curatorship, in contradiction of the advice of the Registrar of Banks (South African Reserve Bank, 2002:8), is unfortunate. It projects a government insensitive to the needs of smaller banks. However, creating an appropriate regulatory framework for dedicated banks, as was proposed in the previous paragraph, should go far in allaying the fears of prospective specialised private investors.

Although each of the above strategies to open up banks' lending facilities to micro-entrepreneurs had its unique problems, resulting in no major successes being recorded, one issue has affected all three negatively. The absence of entrepreneurial skills, which is closely linked to the lack of an entrepreneurial culture amongst the poor in South Africa, is a serious constraint for the banks. The skills required include a basic knowledge of the type of enterprise ventured into and the generic skills - reading, writing, financial and managerial - required in any enterprise. Due to the apartheid policies, many of the poor did not have the opportunity to own fixed property or a business nor had any formal schooling.<sup>11</sup> This aspect requires the serious attention of the government. To the extent that the banks try to bridge this constraint, the government should support them by way of subsidies, grants or tax breaks.

#### 4. CONCLUSION: THE APPROPRIATE STRATEGY FOR THE FUTURE

In their approach to micro-lending, the big four banks have focused up to now on lending to low-income salaried individuals. This was a rational decision as the fast growth of the formal micro-lending industry in the nineties assured the banks of the profit potential of such lending. The banks employed the downscaling strategy and rather

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<sup>11</sup> Meagher and Wilkinson (2001:4) make the interesting point that the lack of an entrepreneurial culture was already evident in the type of loans the poor have for decades demanded from informal lenders (mashonisas, stokvels etc.). Consumption loans, financing for housing, education and emergencies have been the major needs and not loans to generate income (spending on education will of course produce higher incomes in the longer term).

than going it alone, they brought in expertise by teaming up with established formal microlenders. However, inappropriate credit technologies in a very competitive market environment resulted in major problems for some of the banks' micro-lending operations in 2002.

The big four banks' lack of enthusiasm to engage micro-entrepreneur lending is to a certain extent vindicated by the international experience. This experience indicates, amongst others, that big banks have serious problems in integrating micro-lending operations into existing bank structures, making downscaling problematic. The Sizanani project, the combined downscaling effort of the banks, also highlighted the shortage locally of appropriate technical assistance, a crucially important element to succeed in serving micro-entrepreneurs. The international experience has also shown that for linkage banking to be successful, NGOs are needed to establish and train SHGs. Suitable candidates to undertake the latter functions are in short supply locally. But banks' apathy toward micro-entrepreneur lending can also be explained by the absence of entrepreneurial skills among the poor in South Africa.

Given the above circumstances, establishing banks dedicated to micro-finance by means of specialised public/private sector partnerships emerge as the most appropriate strategy to get the banking sector involved in micro-entrepreneur lending. Proceeding along these lines will ensure the availability of the technical assistance and funding vital to successful lending in this market. However, such partners will have to be convinced to invest in South Africa. The regulatory environment needs to be supportive of such ventures and if the government is serious in its efforts to encourage bank lending for micro-

entrepreneurial activities, further support and/or incentives should seriously be contemplated.

In conclusion, it is not foreseen that the big four banks can or will significantly be involved in micro-entrepreneur lending in future. Their focus in micro-lending will remain on consumption related loans for low-income salaried individuals.

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