DRAFT. NOT TO BE CITED WITHOUT AUTHOR'S PERMISSION

RISK-MITIGATION MEASURES IN THE SOUTH AFRICAN MICROCREDIT SECTOR: IMPLICATIONS FOR BROADBASED ACCESS[1]

By:
Iniobong W. Akpan
Tel: +27 84 872 4602 (mobile)
Fax: 046 622 5570 (c/o Wilson Akpan)
E-mail: ini_w_akpan@yahoo.co.uk

Introduction

In the past few years, the South African microcredit sector has been hailed as experiencing a 'boom'. Many lenders have reported increases in the number of loans granted and in total disbursement figures, and there are widespread expectations that growth is likely to continue into the near future. Besides the increased interest among commercial banks in microlending, reasons such as increased financing by non-profit microfinance institutions (popularly known as Section 21 companies) and South Africa's favourable macroeconomic performance have been advanced for the 'boom' in the microcredit sector (MFRC, 2005a). A casual implication of this rapid expansion should be that microcredit is now easily available and is reaching a wider segment of the population including the poor, who typically see this market as a last resort for obtaining credit.

The aim of this paper is to show that there are dynamics in the microcredit market that hamper the translation of microcredit sector growth into increased broadbased access to credit. Among these are the strategies adopted by microcredit operators to mitigate information asymmetries between lenders and borrowers. The paper places the 'boom' in the South African microcredit sector in perspective by examining what risk mitigation measures are in place in the microcredit market and how these measures operate. In the main, the paper argues that the operation of certain risk mitigation

[1] Paper presented at the Biennial Conference of the Economic Society of South Africa (ESSA), 'Development Perspectives: Is Africa Different?' At Elangeni Holiday Inn, Durban, KwaZulu-Natal, South Africa.

measures could produce the outward appearance of a 'boom' while fundamentally reinforcing financial exclusion and undermining access to the type of credit that has positive consequence for the long-term socio-economic conditions of the poor. Critical comparison is made in the paper between 'profit-driven' microlending and 'pro-poor' microlending. For the purposes of this paper, the former is characterised by private-sector lenders while the latter is exemplified by operators linked to KhulaStart, a government-backed microlending scheme that seeks to promote micro-entrepreneurial activities in the historically unbanked segment of the South African population.

Financial exclusion—some preliminary notes

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

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

The introduction of a special savings account for low-income earners in October 2004 and the popular patronage that this account (known as Mzansi) has enjoyed in the country are recent acknowledgments even by the commercial banking sector that

financial exclusion is a major socio-economic problem in the country. The success[2] so far of this scheme (the underlying weakness of the Mzansi initiative and such other schemes are the subject of another paper) probably also belies the notion that poor people cannot utilise banking services. Mzansi's success (for the commercial banks in particular) and its replication in many other forms[3] could also be an indication that there is probably no real basis for the continued exclusion of a vast majority of a country's population from financial services. Not very long ago, about 58% of the adult South African population had little or no access to formal banking (Hawkins, 2001:30). Generally, people find themselves outside the reach of credit because of what is termed 'information asymmetries', which in itself illustrates the important role of information in the financial system.

The role of information in the financial system

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

Imperfect information is considered a major factor in market failure and missing markets, and partly explains why information disclosure forms a major part of financial regulations worldwide. In South Africa, the Banking Act requires banks to publish their accounting information and make it readily accessible to the public.

[2] About 1.5 million Mzansi accounts were opened within the first 11 months of its launch, about 90% belonging to first-time accountholders (Sunday Times, 2005).

[3] Examples of recent initiatives aimed at expanding the reach of financial services include Mzansi Money Transfer, MTN's MobileMoney, Wizzit Banking, ikhaya Protector's housing insurance (recently launched by Alexander Forbes Management Services), Umbono Capital (in conjunction with the South African Post Office) and Edcon's credit card offer with no management fees (Finmark Trust, 2005).

Although information disclosure in the banking system is often criticized as insufficient—given its critical role in the system—the mandate for banks to publish their accounting information still serves the intended purpose of helping interested parties to make efficient decisions. Independent institutions also have specific requirements. For example, it is compulsory for companies wishing to raise equity capital to comply with specific disclosure obligations (JSE, 2004). As Goodhart (1989:21) points out, 'where sufficient information exists and is freely available, efficient and successful markets can be established but where this is not the case, markets will not work perfectly'.

In credit transactions, every effort is made to promote availability of information in order to guide both lenders and borrowers in making accurate credit decisions. The South African government promotes full, simple and clear disclosure of credit cost, management fees and credit terms, as well as simple presentation of contractual language and explanation of contractual clauses by lenders in order to guide borrowers in decision-making (DTI, 2005:21,22). Potential borrowers are also encouraged to offer truthful information about themselves, since credit transactions are based on 'trust'.

In dealing with the problems of information asymmetries, lenders are at an advantage. Although they need as many clients as possible in order to stay in business and make profits, they have the option to use whatever measure they can to exclude those they perceive as capable of opening them to a higher risk of adverse selection and moral hazard. The idea, in short, is to exclude 'risky' borrowers.

Borrowers, on the other hand, are at a disadvantage because of their inability to deal with asymmetries that exist between them and lenders. This is due to the fact that they often have little information about, say, lenders' real cost of credit, actual interest charges, and the implications of some credit clauses on their credit terms. Therefore, they cannot select good lenders from those whose credit terms might be seriously unfavourable.

While absence of complete and accurate information about lenders does exist and may in some ways affect decision-making by borrowers, it hardly constitutes the principal

reason for the exclusion of people from available financial services—credit, in particular. Potential borrowers are not kept outside the financial (credit) system because they lack accurate information about lenders. What keeps them outside the system is lenders' inability to gain information about borrowers. Indeed, what is at issue is lenders' inability to devise appropriate measures to mitigate information asymmetries (existing) between themselves and (potential) borrowers. The next two sections of the paper look at how the credit markets work around the challenge of information asymmetries, and how as a result they (could) institute measures that favour certain kinds of borrowers and exclude others. It will soon become apparent that in devising risk-mitigation strategies that select people into (or out of) the credit market, credit providers could make huge business gains at the expense of the society at large. In such measures lurks the possibility of a microcredit sector growth being exclusionary in essence.

Information asymmetries and risk-mitigation measures in conventional banking

Information asymmetry is a situation whereby important information is not available, or is partially available. Kreps (1989: 8-9) defines it as a situation in which one party 'possessed of superior information, attempts a transaction with a second party who lacks that information'. The situation plays out in the following way. First, borrowers misrepresent their risk characteristics in order to access credit and to secure more favourable terms. Second, if the lender views the potential borrower as a bad credit risk—the conventional banking paradigm presumes people as 'bad credit risks' until proved otherwise—the loan may be refused outright, or unfavourable loan terms are presented as a way of adjusting for the perceived bad risk. Third, the borrower accepts the terms, not knowing that a high price has been put on his risk status; indeed, he believes he has been 'smart' at his game! The most important consequence of the above game, as originally identified by George Akerlof (1970: 495), is adverse selection. This is also sometimes referred to as pre-contractual opportunism or market for lemons. Adverse selection leads to a high probability of loan default. In reality, because of the problem of adverse selection, the financial system operates rather cautiously, as though the market were an endless mass of people who lacked the ability or integrity to repay loans, when perhaps there are as many good credit risks as there are bad ones (Mishkin, 2004: 32). This point must be noted, because it would seem that the assumption of people as 'bad credit risks' until proven otherwise, is

exclusionary. A pro-poor (microenterprise) lending paradigm presupposes that people are 'good credit risks' until proved otherwise.

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

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

In theory, government regulations help to mitigate the problems of adverse selection and moral hazards in the financial sector (specifically formal credit markets). For example, such regulations permit only credible individuals or groups to set up financial institutions (Mishin and Eakins, 2003: 30). Regulations also make financial disclosure mandatory, and define permissible limits within which banks can compete with one another. Paradoxically, it is also a basis for excluding the poor from credit services, as banks typically want to avoid credit transactions that could have the effect of jeopardising their economic viability and eventually undermining their ability to render credit services.

Therefore, banks and other financial institutions have developed risk management measures for dealing with the problems of adverse selection and moral hazards. These include screening, specialization in lending, monitoring and enforcement of restrictive covenants, long-term customer relationships, loan commitments, collateral and

compensating balances, and credit rationing. However, as shown below, the use of these various measures is based on the underlying assumption that all borrowers are bad credit risks until proved otherwise. Let's look at these measures in some detail, to see how they could help to swell the fortunes of credit providers while effectively keeping the poor outside the credit system.

Screening

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

Specialisation in lending

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

Monitoring and enforcement of restrictive covenants

Certain provisions in the loan contract prevent borrowers from engaging in particular businesses. Such provisions include: a) instructions as to end-use of the loan, b)

prerequisite periodic accounting and income reporting, and c) prohibitions of behaviour considered risky (Mishkin, 2004:225). Acceptance of the contract means a borrower gives the bank the authority to monitor compliance. This reduces moral hazard.

Long-term customer relationships

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

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

Loan commitments

Loan commitments are arrangements and obligations that banks enter into with existing borrowers. Essentially it involves banks promising to provide credit to preferred customers whenever the need arises and at agreed interest rates. This commitment obliges borrowers to furnish the banks with information that could be used in assessing their financial standing or credit needs. Without doubt, loan commitments are made only to customers that the lenders consider as 'good' credit risks.

Collateral and compensating balances

This is one of the most frequently used risk management tools – and, arguably, one of the most obvious ways by which the poor are excluded from formal sector credit (Ghosh et al 2000:390). By requiring borrowers to provide collateral – usually property - as security against default, banks not only establish borrowers' credit-

worthiness, but also indirectly place a check against reckless use of borrowed funds. Because the borrower knows that the collateral will be forfeited in the event of repayment default, there is a fair chance that he or she will channel the funds only to the contracted business ends.

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

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

Credit rationing

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

According to Stiglitz and Weiss (1981:1), credit rationing arises because 'prices do not do their job'. Where the market is in disequilibrium there is bound to be excess demand for, or short supply of, loanable funds. This excess credit demand comprises both potentially good credit risk and bad credit risk. Since prices do not adjust to bring about a new equilibrium, banks ration credit in the short term to be able to cope

with these pressures. Thus, they only grant credit to those they consider good credit risks, again effectively excluding the poor.

A number of interrelated questions may now be asked. First, considering that the various measures adopted by formal credit providers exclude a large segment of the population, how does the informal credit sector handle the challenge of information asymmetry? Second, are the measures employed to reduce adverse selection and moral hazard in the informal credit market as well as by providers linked to the KhulaStart scheme sensitive to the needs and other characteristics of the clientele of this market? In one word, do the risk mitigation measures further exclude potential borrowers, many of whom see this market as their last resort? To these questions we now turn attention.

Information asymmetries in microcredit markets

Information asymmetry is compounded in the microcredit markets. This is because most potential clients of this market are rejects of the formal credit sector. However, they are rejects mainly because of assumptions held about them and the risk-mitigation measures in force in the formal credit sector. Most microcredit clients are salaried workers, low-income earners and pensioners. Other potential clients are typically people with no reliable sources of income, no fixed business premises, and no reliable physical addresses. These attributes present information asymmetry. Lenders prefer to deal with people that can be easily traced to places of employment or residence, and people with regular income streams. People that do not meet these parameters are considered special cases of adverse selection and moral hazard.

The problem of information asymmetry in the microcredit sector is not only a question of absence of information about the target market itself, rather, it may also be mainly because lenders in this market do not have information about the productive potentials of the poor who are potential clients of this market. This is because potential clients in this market are also microenterprise credit clients who might require credit for microenterprise purposes. Because lenders have no knowledge of their productive potentials, they are generally typified as bad credit risks and are seldom able to access credit. Microlenders try to circumvent the problem of information asymmetry by adopting risk-mitigation measures that keep 'bad credit risks' outside the reach of credit. How do they do this?

Microlending as profit-making

In South Africa, most microlending is done by subsidiaries of the commercial banks, as well as by private companies and close corporations (see Table 1). Hence, the risk-mitigation measures adopted for microlending are an adaptation of the ones discussed earlier, because the lending motive is the same: profit-making. The measures include the following:

Screening

Microlenders conduct screening in order to prevent, or mitigate adverse selection. Like in commercial bank lending, potential clients are interviewed for purposes of ascertaining personal risk characteristics. Some microcredit subsidiaries of

commercial banks utilise a scoring system. Borrowers who score higher stand a better chance of obtaining credit. By law, all microlenders are required to consult with credit bureaus in order to check the credit history and ascertain credit-worthiness of potential clients (MFRC, 2005b). This helps to reduce over-indebtedness of borrowers and increase lenders' chances of recovering debts. Although the whole process of screening promotes availability of information that aids the decision making process, applying this conventional risk management measure in this market automatically screens out most potential microcredit clients. Whether in the commercial bank lending or microcredit sector, the poor stand very little chance of scaling the hurdles of conventional screening procedures.

Collateral

The posting of collateral – in the traditional banking sense of this term - is not a lending precondition in the microcredit market. However, a borrower will normally be required to present his or her identity document, proof of regular income (sometimes in the form of one to three months' pay slip), and names of personal referees. In most cases, repayment through bank debits is preferred to cash payments because this method is more reliable and ensures that deduction is made at source before the borrower can access the salary or pension account to which the loan is linked. It is also possible that many borrowers know the added legal complication of consistently defaulting on bank debit orders - a psychological self-check which lenders easily capitalise on.

Clients who patronize unregistered microlenders are often required to surrender their personal belongings as well as identity documents and pin codes. (It should be noted here that MFRC prohibit its members from securing loans using these methods). Pawnbrokers often keep the physical assets of their clients, and sell these in the event of default. Although this approach is illegal (Niekerk, 2002:15), to the lenders, it stands as a surety against loan default. . These subtle requirements could be likened to collateral requirement, and serves the purpose of screening out people already pre-classified as 'bad' credit risks – the poor. Only salary earners or, in general terms, those with regular income streams are more likely to survive this risk mitigation strategy.

These various methods arise due to the need to fill a gap that may exist as a result of missing or absence of accurate and complete information between borrowers and lenders. Therefore potential clients that are not formally employed, without regular income streams, with no bank account and with no valuable physical assets are automatically excluded from obtaining credit which could have been used for whatever purposes including microenterprises.

Microlending in South Africa—to whom, and what for?

A closer analysis of microloan disbursements shows that although the microcredit industry is growing at a phenomenal rate, the poor are still outside the reach of credit. The data in Table 1 obviously confirms the notion of a 'booming' sector. It shows significant increases in loan size and number of loans between December 2001 and May 2005. Banks, private companies and close corporations, enjoy the largest industry share in terms of both loan size and number of loan. However, their loans, as noted earlier, are granted mostly to salary earners (workers) who utilise the credit for short-term consumption needs. Section 21 companies, which comprise NGOs and MFIs, focus on microenterprise lending. They are the only categories of lenders that lend to those with no regular income streams. However, their share of total industry disbursements—both in terms of actual amounts disbursed and number of loan recipient—is among the smallest.

Table 1: Loan disbursements by size (December 2001-May 2005)

LENDER CATEGORY	**LOAN DISBURSEMENTS**							
	Dec 2001 – Feb 2002		**Dec 2002 – Feb 2003**		**Dec 2003 – Feb 2004**		**January – May 2005**	
	Loans	**Loan Size** (Rand)	**Loans**	**Loan Size** (Rand)	**Loans**	**Loan Size** (Rand)	**Loans**	**Loan Size** (Rand)
Banks	621,749	1,020,830,776	723,449	1,036,578,566	913,944	1,636,730,124	1,010,950	2,286,434,038
P Co's*	57,050	51,333,224	34,582	40,613,744	2,033	7,277,122	25,898	23,926,085
Pvt Co's**	812,623	1,436,859,286	1,058,480	1,593,465,017	963,275	1,939,882,689	1,075,957	2,345,863,254
CC+	827,960	513,914,841	965,632	569,096,180	1,072,573	678,333,035	1,397,270	940,688,633
Trusts	77,772	42,003,081	82,068	50,395,453	86,274	55,942,936	90,863	56,595,224
Co-op++	24,104	61,569,310	24,226	65,656,324	20949	55,410,450	25,326	67,728,768
Sect 21+++	13,979	20,847,125	13,953	28,375,164	17,548	36,391,908	21,400	47,737,243
Total	**2,435,237**	**3,147,357,643**	**2,902,390**	**3,384,180,448**	**3,076,596**	**4,409,968,265**	**3,264,961**	**5,768,973,246**

Source: **MFRC, 2004**

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

Indeed, this explains the dominance of consumption credit as the preferred type of microcredit in South Africa: consumption credit clients are mostly people in formal (government and private sector) employment. It may even be argued that the South African microcredit sector flounders because of its unwillingness (MFRC, 2000) to mitigate the problems of adverse selection and moral hazards and open up the microcredit sector to other potential users. It therefore faces a major challenge of adopting lending and credit management mechanisms that effectively bring the self-employed, those without regular income streams and the unemployed into the mainstream of credit services.

Broadening access? KhulaStart scheme and the pro-poor orientation

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

Of particular interest to this study is Khula Enterprise Finance's involvement with MCOs and RFIs, which are the retail outlets that service the microenterprise sector. This involvement is formalized through the company's microcredit scheme known as KhulaStart. In reality, many of the MCOs and RFIs are outlets created by existing NGOs and community-based organizations (CBOs) specifically to administer KhulaStart loans. The reason for this is that a number of NGOs and CBOs - especially those already providing business training and advice to local SMMEs - already have established presence and links within the community and can easily, at least in theory, reach the categories of borrowers that the KhulaStart scheme targets.

The KhulaStart scheme is based on the United Nations model of microcredit, which in turn is based on the Grameen Bank model. Thus, it targets South Africa's historically disadvantaged communities, particularly women in rural and semi-urban areas. At least 70% of KhulaStart loans are given to women (Khula Enterprise Finance Ltd, 2004b). KhulaStart sets the lending policies that guide the operations of the MCOs

and RFIs it works with. For example, the group lending methodology employed by the various retail outlets is a policy of Khula Enterprise Finance, and it derives from the United Nations/Grameen Bank model mentioned above.

The operational thrust of the KhulaStart scheme occurs at two broad levels. There are those activities that take place before any actual disbursements are made, but are considered an integral part of the lending process and vital to the success of the microenterprise development objective. These are called 'pre-lending' activities. On the other hand, there are some activities that take place from the time of actual loan disbursements and are considered essential to the success of the 'business' side of the mandate, as they ensure that the loans will actually be repaid – post-lending activities. These activities seek to promote availability of information between the retail outlets and potential borrowers.

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

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

of women reduces the problem of adverse selection among this microcredit clientele because women in most cases are considered 'good credit risk' (Gupta and Lensink, 1996:45) than men.

Inspired by the Grameen model, the KhulaStart scheme uses a group lending methodology. Women are encouraged to form themselves into groups of between 3 and 10 and the retail outlets lend only to them as members of a group. After being assessed and approved a newly formed group is put through three weeks of training on basic financial management. Upon completion, each group member receives a loan of between R300 and R3500. Each group appoints a leader whose duty is to, among others, ensure that members meet repayment obligations – often by collecting the repayment instalments herself and handing these to the staff of the retail outlets at their regular meetings. The group-leader-as-debt-collector practice, however, has its weakness. Occasionally the group leader uses up the instalments, thus technically causing the entire group to default. Despite such weakness, the use of group lending methodology significantly reduces transaction costs - a major deterrent to banks and other microlenders in this business - by eliminating to a large extent the cost of screening loan applicants, monitoring, and enforcement of 'restrictive covenants'. It also substitutes for collateral especially if joint liability is enforced.

No collateral is required but non-refundable registration fees are charged, although there is no uniformity between retail outlets in this regard. The fees are allegedly for 'administrative expenses'. Only applicants who accept this condition are considered for loans. If a borrower cannot afford this payment the amount is deducted from the approved loan. Although the KhulaStart scheme tends to favour business in tourism and local craft sectors, borrowers are nevertheless required to indicate the nature of business they wish to go into. As a rule, loans are granted only for businesses deemed 'viable' and to existing businesses. Group pressure is used to ensure loan repayment but joint liability is not enforced.

The involvement of retail outlets staff by means of feasibility studies on behalf of clients promotes availability of information between them and ensures that clients are genuinely interested in utilising credit effectively. This saves the problem of adverse selection by the outlets.

Usually, only about 30-40% of loan applicants are successful. Unsuccessful applicants are often those considered 'illiterate' and 'untrainable', although no clear criteria exist for determining who fits into these categories. Even so, the classification of potential borrowers as 'illiterate' and 'untrainable' detracts from Khulastart Scheme's mandate, which is to broaden credit access to the poor. If anything, this criterion shows the inability of non-profit microlending to abandon the commercial bank lending paradigm. Like the conventional lending model, it views the illiterate poor as people without any economic potential (see Yunus, 2004). According to Morduch and Haley (2002), 'there is no proof of any inverse relationship between a client's level of poverty and their entrepreneurial skills', therefore the typification of illiterates as 'bad credit risks' is hardly justifiable.

This researcher established during a field interview with operators in Port Elizabeth, Mthatha and Grahamstown that KhulaStart retail outlets have from time to time had to return 'unutilized funds' to Khula. Their excuse is often that their coverage area is 'rural' and that most of their potential clients are 'illiterate'. This therefore means that large numbers of people have been denied credit access on grounds that probably have little to do with people's ability to utilise credit for productive purposes. It also implies that like formal sector credit providers, rural dwellers and 'illiterates' are perceived as people without skills or any economic potential. In this crucial regard, KhulaStart procedures are exclusionary.

Conclusion—going beyond microcredit sector 'growth'

Microcredit arises mainly because the formal credit sector pre-classifies some borrowers as *bad credit risks* and uses specific measures to screen them out. For those shut out of this sector, the microcredit market often becomes a last resort for obtaining credit. Typically, borrowers in the microcredit market lack assets that can serve as collateral, have no special relationship with commercial banks by virtue of their social and economic credentials, and do not belong to specific sectors or preferred groupings within the economy that commercial banks are interested in. This explains their inability to access credit in that commercial banking sector.

On their part, most microcredit providers design their loan products in a way shuts out the poor and those who might otherwise require microloans for entrepreneurial purposes. This explains why, in South Africa, consumption credit is the preferred, and why the celebrated 'boom' in microcredit is essentially a 'boom' in the consumption credit sector. Consumption credit clients are mostly people in formal (government and private sector) employment, low-income earners and pensioners.

There is no doubt that the South African microcredit sector wears the paradigmatic prisms of the conventional lending sector, which sees the poor as bad credit risks, to be avoided outright or courted with extreme caution. While this paper does not suggest that everyone or all poor people are eligible to access credit, it does maintain that poor people have economic potentials that could be tapped into. Credit should not be refused on grounds of poverty, illiteracy, irregularity of income or geographical area. Indeed, in the particular case of South Africa, booms in microcredit sector growth are achievements that should be interrogated rather than simply celebrated.

REFERENCES

Akerlof, G.A., 1970. The Market for "Lemons": Quality Uncertainty and the Market Mechanism. **The Quarterly Journal of Economics.** Vol. 84, No.3. July. 488-500.

Annan, K. 1998. 'The Role of Microcredit in Eradication of Poverty'. **United Nations Report.** [Online]. At: http://www.microcredit summit.org/campains/resolution.htm. [Accessed 18 March, 2004].

Berger, A.N. and Udell, G.F., 1990. Collateral, Loan Quality and Bank Risk. **Journal of Monetary Economics.** Volume 25: 21-42.

Conlin, M., 1999. Peer Group Microlending Programmes in Canada and the United States. **Journal of Development Economics**. Volume 60, Issue 1. 249-269.

Curry, P., 2003. The Power of Credit Scores. [Online] At: http://www.bankrate.com/brm/news/credit-scoring/20031104a1can.asp. [Accessed October 23, 2004].

Degryse, H. and Ongena, S. 2003. The Impact of Competition on Bank Orientation and Specialization. [Online] At: http://www.uni-kiel.de/ifw/konfer/banken/ongena.pdf. [Accessed November 30, 2004].

Department of Trade and Industry (DTI), 2005. Making Credit Markets Work. A Policy Framework for Consumer Credit. [Online] At: http://www.dti.gov.za/ccrdlawreview/consumercredit/C-Creditpolicy.pdf. [Accessed September 5, 2004].

Finance24, 2005. JPMorgan Admits Slave Links. January 21. [Online] At: http://www.finance24.com/Finance/Companies/0,,1518-24_1650367,00.html. [Accessed January 21, 2005].

Finmark Trust, 2005**. Finmark News** Issue 37, September 2005. [Online] At: http://www.finmark.org.za/newsletter/Issues/2005/NL_Sept05.pdf. [Accessed September 5, 2005].

Ghatak, M. and Guinnance, T.W., 1999. The Economics of Lending with Joint Liability: Theory and Practice. **Journal of Development Economics.** Vol. 60. 195-228.

Ghosh, P., Mookherjee, D. and Ray, D., 2000. Credit Rationing in Developing Countries: An Overview of the Theory. In Mookherjee, D. and Ray, D. (eds), **A Reader in Development Economics.** London: Blackwell. 383-301.

Goodhart, C.A.E., 1989. **Money, Information and Uncertainty.** 2nd Edition. New York: Palgrave Macmillan.

Gupta, K.L. and Lensink, R., 1996. **Financial Liberalisation and Investment.** New York: Routledge.

Hawkins, P.A. 2001. **Liberalisation, Regulation and Provision: The Implications of Compliance with International Norms for the South African Financial Sector.** Unpublished lecture notes, M.Com (Financial Markets). Department of Economics and Economic History, Rhodes University, Grahamstown.

Hubbard, R.G., 1997. **Money, the Financial System and the Economy.** 2nd Edition. New York: Addison-Wesley Longman.

Johannesburg Stock exchange, 2004. Listings on the JSE. [Online] At: http://www.jse.co.za/informational/guideline/guidelines_05072004.doc. [Accessed December 22, 2003].

Khula Enterprise Finance Ltd, 2004a. Report of Ad-Hoc Committee on Trade and Industry. [Online] At: http://www.pmg.org.za/docs/2003/comreports/040607pctradereport.htm. [Accessed November 10, 2004].

Khula Enterprise Finance Ltd, 2004b. Products/Loans/KhulaStart Programme. [Online] At: http://www.Khula.org.za/start.html. [Accessed July 12, 2004].

Kreps, D.M. 1989., Out-of-Equilibrium Beliefs and Out-of-Equilibrium Behaviour. In Hahn, F. 1989 (ed) **The Economics of Missing Markets Information and Games.** Oxford: Clarendon.

Law, R., 1999. Finance and Credit in Pre-colonial Dahomey. 15-37 in Stiansen, A. and Guyer, J.I.(Eds), 1999. **Credit, Currencies and Culture: African Finanacial Institutions in Historical perspective.** Stockholm: Nordiska Afrikainstitutet.

Meagher, P. and Wilkinson, B., 2001. **Filling the Gap in South Africa's Small and Microcredit Market: An Analysis of Major Policy, Legal, and Regulatory Issues.** Maryland: IRIS Center, University of Maryland. [Online] At: http://www.mfrc.co.za/detail.php?s=10. [Accessed August 6, 2004].

MFRC, 2005a. 16th Published Stats 02 December 2004. [Online] At: http://www.mfrc.co.za/detail.php?s=363. [Accessed August 31. 2005].

MFRC, 2005b. NLR Roles and Responsibilities [Online] At: http://www.mfrc.co.za/detail.php?s=66. Accessed August 31, 2005.

MFRC, 2004. Industry Information: Quarterly Statistics. [Online] At: http://www.mfrc.co.za/detail.php?s=91. [Accessed October 10, 2004].

MFRC, 2000. **Executive Report of the Microfinance Regulatory Council Covering the Period 16 July 1999 to 31 July 2000.** [Online] At: http://www.mfrc.co.za/files/first_annual_report.pdf.. [Accessed November 13, 2004].

Mishkin, F. S. and Eakins, S.G. (eds.), 2003. **Financial Markets and Institutions.** 4th Edition. New York:Addison Wesley.

Mishkin, F. S., 2004. **The Economics of Money, Banking and Financial Institutions.** 7th Edition. New York: Addison-Wesley Longman.

Molho, I. 1997. **The Economics of Information: Lying and Cheating in Markets and Organisations.** Oxford: Blackwell Publishers.

Morduch, J. and Haley, B., 2002. Are Microfinance Programmes Effective in Reaching the Poorest? **NYU Wagner Working Paper series.** [Online] At: http://www.nyu.edu/wagner/public_html/cgi-bin/workingPapers/wp1014.pdf. . [Accessed September 10, 2004].

Niekerk, V. L., 2002. Microlending. Standard Equities Research. [Online] At: http://www.equities.co.za. [Accessed August 16, 2004].

Rodriquez, F. and Carbo, S., 2004. Microeconomic Determinants of Bank Lending: an Application to Spanish Case. [Online] At: http://www.revecap.com/iiieea/autores IR/274.pdf. [Accessed August 20, 2004].

Stiglitz, J.E. and Weiss, A., 1981. Credit Rationing in Markets with Imperfect Competition. **American Economic Review.** Volume 71, Issue 3: 393-410.

Studart, R., 1997. **Investment Finance in Economic Development.** New York: Routledge.

Sunday Times, 2005. Mzansi money transfer launched. September 6. [Online] At: http://www.sundaytimes.co.za/zones/sundaytimesNEW/business/business1126010590.aspx [Accessed September 6, 2005].

Tassel, E.V., 1999. Group Lending Under Asymmetric Information. **Journal of Development Economics.** Volume 60, Issue1. 3-25.

World Bank, 2001. Causes of Poverty and a Framework for Action. **World Development Report 2000/2001.** [Online] At: http://siteresources.worldbabk.org/INTPOVERTY/Resources/WDR/English-Full-Text-Report/ch2.pdf**.** **[**Accessed November 3, 2004].

Yunus, M., 2004. What is Microcredit. [Online] At: http://www.grameen-info.org/bank/WhatisMicrocredit.html. [Accessed December 27, 2004].