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Regulation and Supervision of Microfinance Institutions in South Africa

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LIST OF ABBREVIATIONS

ABSA	Amalgamated Banks of South Africa
AMEDP	Alliance of Micro-Enterprise Development Practitioners
ANC	African National Congress
CEO	Chief Executive Officer
DBSA	Development Bank of South Africa
DED	Deutscher Entwicklungsdienst (German Development Service)
DFI	Development finance institution
DTI	Department of Trade and Industry
FSB	Financial Services Board
GRQ	Get rich quick
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit GmbH (German Technical Cooperation)
MFI	Microfinance institution
MFRC	Micro Finance Regulatory Council
MLA	Association of Micro Lenders
NASASA	National Stokvels Association of South Africa
NGO	Non-governmental Organization
NHFC	National Housing Finance Company
R	South African Rand
RFF	Rural Finance Facilities
RoSCA	Rotating savings and credit association
SACCOL	Savings and Credit Cooperative League of South Africa
SARB	South African Reserve Bank
SMME	Small, medium and micro enterprises

WDB	Women's Development Banking

1 INTRODUCTION[1]

The issue of regulating and supervising microfinance institutions (MFIs) is attracting growing interest. So far though, no clear agreement has been reached on who and how to regulate. At issue are questions like: Should MFIs be subjected to government regulation at all? If so, all or only some with certain features (e.g. those engaged in retail deposit-taking)? What adjustments need to be made to regulations for traditional financial institutions to do justice to the specific features of MFIs? Are other regulatory approaches (e.g. self-regulation) perhaps superior to statutory regulation via legal provisions?

Although there are now a number of publications dealing with the theoretical side of the topic,[2] there is still a lack of detailed country studies that evaluate practical experience with regulating and supervising MFIs. The present study is an attempt to close this gap. It focuses on the institutional design of a suitable regulation of MFIs, as discussion has just begun in South Africa on practical regulatory measures. First, however, we shall outline the role of MFIs for the economic development of South Africa and the latest developments in the financial sector.

1.1 Role of microfinance in economic development

South Africa is in a state of radical change. Because of the high hopes that have been pinned on the 'New South Africa', there is a danger that sluggish improvements in economic and social living standards will disappoint the mass of the population and quickly end in disillusionment. One of the most pressing problems with far-reaching political and economic repercussions is high unemployment, particularly in the former townships. Small and micro enterprises in the informal sector are frequently the only source of employment for the urban black majority of the population (Reinke 1996: 269). According to the Central Statistics Service, approximately 71 per cent of all private enterprises fall into the category of micro enterprise.[3] They account for some 14 per cent of total employment in South Africa (Mlambo-Ngcuka 1997: 1). A key problem is their inadequate access to financial services, particularly loans to make investments and savings facilities for efficient liquidity management.

MFIs try to close this gap in the market. Growth in the microfinance sector with a simultaneous improvement in the efficiency of the financial services provided can therefore have a beneficial impact on employment amongst small, medium and micro enterprises (SMMEs) and contribute to economic consolidation in South Africa. Growth and higher efficiency are important reasons for regulating the sector. Regulated, i.e. formalized, MFIs have better and possibly also cheaper access to refinance sources (due to a lower risk premium), since they are obliged to meet certain minimum standards.

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[1] This case study is the outcome of an almost four-week long stay in South Africa by the author from 14 March to 10 April 1998 (cf. Annex 1). In January 1999 the information was updated through consultations with the main interlocutors.

[2] The most important are Chavez/Gonzalez-Vega (1992), Rock/Otero (1997), Berenbach/Churchill (1997) and Van Greuning/Gallardo/Randhawa (1999).

[3] Micro enterprises are defined as enterprises with fewer than five personnel, a maximum annual turnover of R 150,000 and assets of up to R 100,000 (Mlambo-Ngcuka 1997: 1).

1.2 Developments and reform approaches in the financial sector

A hallmark of South Africa is the coexistence of a modern 'first world' financial sector and an informal 'third world' financial sector typical for developing countries. More or less, an estimated 60 per cent of the population must rate as 'unbanked', i.e. they have no access to the formal banking sector (Wiese 1996: 8).

Major reforms were already underway in the South African banking sector before the end of apartheid. Between 1965 and 1980, the sector was heavily regulated, while the eighties can be described as a phase of deregulation (cf. Falkena/Kok/Van der Merwe 1992: 29f.). This development was speeded up by the recommendations of the De Cock Commission appointed in 1987 to examine the effects of monetary policy on the financial system. The Commission criticized overregulation in the banking sector, which had made it inefficient and uncompetitive. It recommended a departure from institutional regulation, which had brought about unfair competitive advantages. The focus should instead be on regulating specific activities, i.e. functional regulation. It also argued for risk-weighted equity rules (Wiese 1996: 4).

These recommendations were implemented with the adoption of a new Banks Act in 1990. In a second step in 1993, the Mutual Banks Act was adopted, which defined a new type of institution to bridge the gap between commercial banks and unregulated financial institutions. These two acts are described in detail in the next chapter.

In 1995, President Mandela appointed the Commission of Inquiry into the Provision of Rural Financial Services, called the Strauss Commission for short (after its chairman). This submitted its interim report in March 1996 and its final report in September 1996 (Strauss 1996a and b). First it looked at demand in the rural financial sector, at least in qualitative terms, described the financial services of the different financial institutions and made extensive recommendations based on this. The recommended measures primarily aimed at improving access to financial services in rural areas, where there was a lack of supply. An equivalent study for urban areas has yet not been made.[4] Alongside the rural financial sector, the microfinance sector is also receiving increasing attention from the government and the central bank.[5]

The present phase of radical change in the financial sector is both a chance and a risk. On the one hand, the ANC-dominated government is pressing to have inefficient institutions reorganized or closed down. On the other, in a heavily politicized situation, reforms can change direction at any time, which impairs confidence in the improvement of the national economic climate. Like any change of government, Nelson Mandela's replacement by Thabo Mbeki as President this year makes for uncertainty about future national economic policy. Influential members of the ANC who belong to the socialist wing would like to see the government adopt more of an interventionist policy.

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[4] Though the Strauss Commission classified 101 of the 104 Districts in the previous Homelands as rural areas, thus including them also (Strauss 1996a: 33).

[5] In August 1997 a one-day Workshop on Microlending was held in the South African Reserve Bank (SARB), in which the Deputy Minister of Trade and Industry also took part. On this occasion, the Registrar of Banks, C. F. Wiese, stressed that government would play an important role in promoting the SMME sector (Wiese 1997: 6).

2 REGULATION AND SUPERVISION OF THE FINANCIAL SYSTEM

In recent years, banking regulation in South Africa has undergone a continuous process of change aimed at taking better account of the specific needs of the microfinance sector. In the following we trace the development in chronological order and make a provisional assessment of the status quo in 1998 (section 2.3). In sections 2.4 and 2.5 we look at the supervisory authorities and the system of safeguarding deposits as two further key elements of the regulatory framework.

2.1 Point of departure: Banks Act and Usury Act

Banking legislation in South Africa is promulgated in the form of so-called acts. These can be supplemented and specified by Government Notices published in the Government Gazette. Frequently the general scope of the acts has been restricted by numerous special regulations, because the provisions proved to be impracticable or unenforceable. The important laws for the microfinance sector are the Banks Act and the Usury Act.

Banks Act

In 1990, the Banks Act dating from 1965 and a number of other laws (particularly the Building Societies Act) were superseded by a new Banks Act (No. 94, 1990) intended to simplify banking legislation in large measure.

The Banks Act is geared to "first world criteria and principles, focusing on risk management" (Strauss 1996a: 184).[6] It complies for example with the recommendations of the Bale Committee on Banking Supervision on capital adequacy and effective banking supervision. Instead of the approach adopted by its predecessor, institutional regulation, the new act is concerned with functional regulation: "By contrast to institutional regulation, functional regulation attempts to regulate each common activity under a common set of rules, irrespective of the type of institution involved (Van Zyl 1993: 78)." In general then, it should apply for all financial institutions performing the 'business of a bank'. This entails two functions, "namely, that of accepting deposits as a regular feature of the business in question, and that of acting as a financial intermediary in the employment of funds accepted by way of deposits (SARB 1996: 21)." This is why the original title of the Act was also the Deposit-taking Institution Act. The term 'deposit' is very broadly defined, but expressly rules out borrowing from banks.[7] Due to this definition of a bank as a deposit-taking institution (as opposed to a credit-granting institution), all credit-only institutions and hence a large part of the microfinance sector remain unregulated. As soon as a financial institution engages in deposit business that falls under the definition of deposit taking, though, it is obliged to register as a bank and meet the corresponding requirements of the Banks Act.

The perceived advantage of functional regulation is that the different types of financial institutions are regulated by one single law and the same conditions apply for all. This

[6] Falkena/Kok/Van der Merwe (1992: 32-36) provide an overview of the regulations.

[7] "'The business of a bank' means the acceptance of deposits from the general public" and "'general public' does not include a bank", Banks Act, Chapter I, 1.

approach rules out the possibility of gaining competitive advantages simply by shifting to another regulatory framework (so-called regulatory migration, e.g. converting a bank into a building society). The Strauss Commission presumes that the departure from conventional institutional regulation will create "a more level playing field" (1996a: 184), but it mistakenly assumes that the same regulations for all means equal opportunities for all. For example, Section 70 of the Banks Act, which stipulates a minimum equity of R 50 million (approximately DM 18.5 million) for MFIs that mobilize deposits in one form or another and thus comply with the definition of the 'business of a bank', poses an insurmountable barrier to market access.[8] The Banks Act cannot apply for all financial institutions alike, as it purports to, because the so-called prudential requirements in Chapter VI are tailored to the requirements of traditional commercial banks far more than to those of microfinance institutions.

The Banks Act's focus on the requirements of commercial banks stems from a philosophy of banking supervision that is solely concerned with the 'first world banking sector'. According to the Registrar of Banks, the central bank (South African Reserve Bank, SARB) is primarily concerned with the safety of the financial system and less with the security of single financial institutions (Wiese1996: 4). Provided the external effects of individual institutions do not pose a systemic risk – which is the case with MFIs due to their small size - the SARB is not interested in regulation. A question to examine is whether this stance does not neglect depositor security as another important aim of regulating financial institutions, or whether this can be effected by other means (e.g. by internal self-regulation). This is of paramount importance in microsavings.

Usury Act

The second law on banking regulation, which is of immense significance for the microfinance sector, is the Usury Act (No. 73, 1968). On the one hand, it is supposed to protect the borrower from exploitation and therefore serves a major goal of regulation, i.e. consumer protection. As is generally known, clients of MFIs are in particular need of protection, which is why usurious interest must be effectively prevented. The Department of Trade and Industry (DTI), which is responsible for the Usury Act, is therefore subject to heavy political pressure to ensure consumer protection. On the other hand, South African microfinance experts unanimously reject the Usury Act as an unsuitable regulatory measure, since it prevents MFIs from full cost recovery. Due to high administrative costs as compared with traditional bank loans, a usury law clearly discriminates against microlending.[9]

Apart from a single interest ceiling for all loans (35 per cent at present), the Usury Act stipulates rules of disclosure and reporting for certain transactions. These are so complex that exact compliance overtaxes the resources of financial institutions (Strauss 1996a: 188).

8 Non-banks are excepted from the ban on deposit taking in the case of forced savings that serve as security for loans; Banks Act, Ch. I, 1, 'deposit' (b) (ii).

9 By international standards also, South Africa's usury law is especially strict. A study of 16 countries reveals, for example, that SA is the only one with a regulated interest rate (Baydas/Graham/Valenzuela 1997: 28).

2.2 Treating the symptom: 1992-98

2.2.1 Exemption from the Usury Act in 1992

In response to the demands of the microfinance experts, lending under certain conditions was exempted from the provisions of the Usury Act in 1992 by a Government Notice (No. 3451 of 31.12.1992). The most important of these conditions is a maximum loan amount of R 6,000, a maximum term of 36 months and a so-called cooling-off period of three days, i.e. loan payout three days after conclusion of the loan agreement at the earliest.[10] Exemption from the Usury Act was in recognition that cost-effective microlending is only possible at higher interest rates. The bulk of MFIs have since then invoked this exemption and are subject to no limitations on interest rates.

Via another Government Notice (No. 15836 of 30.06.1994) in 1994, however, the Minister of Trade and Industry announced that he was revoking exemption from the Usury Act. Since then, this threat has been hanging over the entire microfinance sector like a Damocles sword. The response to this announcement was more lobbying on the part of the microfinance sector, for example with a policy paper by the Alliance of Micro-Enterprise Development Practitioners (AMEDP), which compiled the findings of a survey amongst its members and presented these to the minister (AMEDP 1996). It also suggested alternative methods better suited to protect consumers against exploitation. These are more market-style measures, relying more on the power of the consumer instead of rigid interest capping. Through sufficient information about the conditions of loan agreements and recourse to legal means of enforcement, they should be able to oust inefficient and exploitative MFIs from the market (ibid.: 14).

2.2.2 The adoption of the Mutual Banks Act in 1993

Exemption from the Usury Act enabled cost-effective microlending, but only unregulated MFIs did business in this area. A large gap in the South African financial system emerged between these and the banks regulated under the Banks Act. The Mutual Banks Act (No. 124, 1993) was introduced to close this gap and give the South African financial system greater depth. For financial institutions in the informal sector there was no way to upgrade, i.e. a gradual advancement to fully fledged regulated banks. The Mutual Banks Act was supposed to facilitate this. Mutual banks differ from equity banks in two key respects - less strict equity rules and a co-operative organization: “The emphasis [is] on the protection afforded by mutual membership in order to compensate for less onerous and stringent financial reserve requirements and regulation (Strauss 1996b: 59).“ In contrast to the R 50 million minimum capital for banks, the Mutual Banks Act requires only R 10 million (Section 48). Mutual banks are not permitted to raise venture capital. Their shares are interest-bearing and may not be traded on the stock exchange. There is no separate registrar, i.e. mutual banks are also answerable to the Registrar of Banks. They should be domiciled in the regions where they establish their branch offices. The members of the respective populations are thus expected to purchase shares in the mutual bank over the medium term.

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[10] This right of withdrawal is supposed to prevent the overhasty conclusion of a loan agreement. At the time of the case study, R 6,000 was equivalent to approximately DM 2,200.

2.2.3 Exemptions from the Banks Act from 1994 and 1998

The Banks Act only permits financial institutions registered as banks to engage in retail deposit-taking. In fact, however, many financial institutions in South Africa have always done savings business although they are not registered as banks, largely the so-called stokvels (RoSCAs) and savings and credit cooperatives.[11] The legislative recognized that subjecting these institutions to the Banks Act was inappropriate and legally untenable because of their informal status. A cooperative was allowed to borrow from its members under the Banks Act, because it did not come under the definition of deposit taking: "'The business of a bank' [...] does not include [...] the borrowing of money from its members by a co-operative subject to such conditions as may be prescribed" (Banks Act, p. 1). They were not, however, permitted to mobilize savings of non-members, also a common practice.

The SARB recognized the problem of generally prohibiting almost all MFIs from engaging in deposit business under the Banks Act and published a Government Notice in 1994 stipulating precise conditions for exemption from its provisions.[12] Under certain conditions, the Government Notice exempted MFIs designated as so-called common-bond institutions from the Banks Act. This enables them to take up deposit business, although they are not registered as a bank. Besides the cooperatives, this also concerns stokvels and employees' savings clubs. This 'common-bond exemption' endorses the reservations of these MFIs towards formal regulation. In addition, a common-bond institution was enabled to take deposits as a non-bank by applying for exemption from the Banks Act. However, by no means all common-bond institutions have made such an application to date so that by law many still infringe against the Banks Act with their deposit-taking business.

The Government Notice specifies conditions for exemption from the Banks Act, so it acts as a kind of **indirect regulation** since although the Act's provisions no longer obtain the ones governing common-bond exemption do.[13] One requirement is membership in an umbrella organization. For stokvels, this is the National Stokvels Association of South Africa (NASASA) and for cooperatives, it is the Savings and Credit Co-operative League of South Africa (SACCOL). In the third group, the employees' savings club, the employer is assumed to exert the necessary control. They must also meet certain requirements. The main ones are:

- The three types of institution are defined exactly, specifically the existence of a 'common bond' amongst the members and lending solely to members are constitutive attributes (Paragraph 1).

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[11] There is a separate law for cooperatives, the Co-operatives Act (No. 9, 1981). This does not, however, exempt them from compliance with the provisions of the Banks Act. The Co-operatives Act prescribes a minimum deposit for members of a cooperative of R 1,000, a minimum term of 12 months and repayment up to a fixed date or with 30 days advance notice (Coetzee/Goldblatt 1998: 8).

[12] Printed in: Government Gazette, No. 16167, 14 December 1994.

[13] „In general, the legal consequence of such an exemption is that the persons designated by the Minister [of Finance] or the Registrar, by notice in the *Government Gazette*, may lawfully conduct business tantamount to 'the business of a bank' without being registered as a bank in terms of the Banks Act or as a mutual bank in terms of the Mutual Banks Act, 1993, **provided** that the designated persons conduct their designated activities strictly in accordance with the provisions of the notice (emphasis in original, SARB 1996: 21)."

- The use of funds is specified in detail in Paragraph 2 (e.g. for health care, the acquisition of land or movable goods or starting a business).
- Accounting procedure must properly reflect the financial status of the institution and with equity capital above R 1 million annual accounts must be published (Paragraph 3) and certified by an auditor.
- So as not to undermine the provisions of the Mutual Banks Act (cf. Chap. 2.2.2), which stipulates a minimum capital of R 10 million, equity may not exceed R 9.99 million (SARB 1996: 23).

The banking supervisory authority justifies the exemption as follows: “The Bank Supervision Department recognises the fact that such groups are essentially **self-regulated (by their members)** and that strict regulation would drive up costs, or force the participants into other informal financing arrangements (Wiese 1996: 8; Hervorh. St. St.)." The theoretical rationale for doing without direct statutory regulation therefore is that with member-driven institutions, the members or owners can exert control, i.e. there is largely no need for external regulation where there is sufficient internal self-regulation. Also, due to their small size and isolated activity they pose no systemic risk to the financial system as a whole.

Another institutional type exempted from the Banks Act are the so-called village banks (Government Notice 18741 of 10 March 1998). The condition for exemption is that a village bank (the full name is village financial service co-operative) must be registered as a cooperative, operate in a clearly demarcated unbanked area and have a business arrangement with a bank. As with common-bond institutions, the maximum permissible deposit is R 10 million. The task of supervision is entrusted to the Registrar of Co-operatives (SARB 1997: 15).[14] Village banks are described in more detail in Chap. 3.2.3.

2.3 Assessment of status quo in 1998

At the time this study was conducted in spring 1998 then, some attempts had already been made to mitigate the repressive elements for MFIs in the regulatory framework – primarily the Banks Act and Usury Act, but it became evident that the strategy of 'treating the symptom' – the symptom being the lack of an appropriate regulatory framework for MFIs – was not successful in every respect.

2.3.1 Shortcomings of the Mutual Banks Act

The new regulatory framework for mutual banks has been anything but a success story. The remaining mutual building societies were automatically transformed into mutual banks. In addition, the only ones to apply for a licence were the Community Bank and the Credit and Savings Help Bank. According to the latest information from the SARB (July 1999), only four financial institutions are still registered as mutual banks after the Community Bank closed because of financial problems. Branching in rural areas proved to be far more expensive than expected, so consideration was given to using existing structures, such as post offices (Strauss 1996b: 59f.). Mutual banks cannot compete with the banks in deposit business. They have narrow limits to growth, since they cannot mobilize venture capital due to their

[14] It is questionable, however, whether he possesses sufficient knowledge, since only a small part of the members are savings and credit cooperatives.

cooperative structure and their shares may not be traded on the stock exchange. Generally perceived as one major contributory factor to the new regulatory framework's poor reception is the specification of a co-operative structure. Others are the still excessive equity requirements and duties of disclosure and reporting which financial institutions in the informal sector cannot usually comply with. This problem is exacerbated by the SARB's view that the statutory R 10 million is insufficient and in reality a multiple of this figure is frequently required.

The Strauss Commission cites five more reasons why this regulatory framework has been adopted by so few financial institutions (1996a: 185f.): Registration is seen as a curtailment of independence by a 'hostile' (state) institution. Second, banks do not enjoy a reputation amongst lower-income earners for being forthcoming to clients, so the legitimacy of the financial institutions might suffer. Third, registration incurs unreasonably high costs that are difficult for the institutions to bear. Fourth, the high liquidity requirements act as an impediment to capital use and finally NGO executives have serious misgivings towards a banking culture geared to profit maximization.

Summarizing then, the Mutual Banks Act has not succeeded in establishing an intermediate institutional type between equity banks and unregulated MFIs. Cooperative institutions prefer exemption from the provisions of the Banks Act as common-bond institutions or institutes whose equity capital exceeds R 10 million favour direct registration as an equity bank under the Banks Act. This enables them to refinance via the capital market and in practice the same regulations apply as for mutual banks, except for minimum equity.

If the Banks Act actually did treat all deposit-taking institutions in the same way, as it purports to do, there would be no need to introduce another regulatory framework for small financial institutions from the informal sector. So it would appear more important to provide a functional regulation by discriminating amongst provisions within the Banks Act in line with activity performed and the size of the financial institution than to introduce another act.

2.3.2 Mixed success of umbrella organizations

For the most part, common-bond institutions are expected to regulate themselves. There is agreement that direct regulation by the banking supervisory authority is undesirable. The respective umbrella organization should also ensure that the institutions are subject to at least a certain measure of external regulation. The task of the umbrella organizations should be to advise members, represent their interests in dealings with other bodies and monitor their business success. The SARB however is dissatisfied with the work of NASASA, because it is regarded as very inefficient. Added to this, many stokvels are still not members of NASASA, so they do not meet the Banks Act requirements for exemption, but they take deposits nonetheless. Due to their large numbers and their informality, however, the SARB cannot enforce the actual ban on deposit taking for all non-banks **without** an exemption from the Banks Act. It can simply offer the stokvels the option of running a lawful deposit business with its members under the common-bond exemption. It is then left up to them to take up this offer. On the other hand, due to their small size and the attendant peer pressure exerted, there is no imperative need for external regulation.

The situation is somewhat different with cooperatives. They are limited in number, so that compulsory membership in the umbrella organization SACCOL can actually be enforced. The example of a cooperative that announced its withdrawal from SACCOL and rejoined

after a short time because it was required to comply with the provisions of the Banks Act illustrates the effectiveness of this regulation. Thought should be given to whether it would be better to entrust the supervision of the indirect regulations of the common-bond exemption to the umbrella organizations, since they would be far better able to do this than the SARB, which has little knowledge of this sector. With open-common bond savings and credit cooperatives that do not do business just with a closed, numerically limited group, a greater measure of external regulation may be required (Van Greuning/Gallardo/Randhawa 1999: 13).

2.3.3 Persisting refinance problems of MFIs

The regulatory framework described narrowly curtails MFIs' refinance options, since they are not permitted to engage in retail deposit taking with non-members or finance via institutional investors or the organized capital market (wholesale deposit taking).[15] In theory, they are only allowed to borrow outside capital from banks or other financial institutions not registered under the Banks Act but with express authorization to lend to non-banks. Due to the generally very high risk rating of microfinance business however, banks charge annual interest of 50 to 60 per cent. The main wholesale financial institutions therefore are development finance institutions (DFIs), such as the Development Bank of South Africa (DBSA) and the two new institutes set up in 1996, the National Housing Finance Corporation (NHFC) and Khula Finance Ltd. All three finance themselves via subsidies and loans from the government and national and international donors. The DBSA is now mainly responsible for infrastructure projects, while Khula has taken over SMME finance and NHFC, housing finance.[16] Another major source of capital are funds from national and international donor organizations.

Altfin and King Finance, two leading South African finance companies, have, however, already issued debentures too, without being disciplined by the Reserve Bank.[17] There is general agreement that this is illicit deposit business: „When money is taken against debentures and that money is used for the granting of loans to the general public, there is little doubt that deposit-taking has taken place (Van Zyl 1995: 4)." The SARB refrains from intervening, however, as long as the finance company is not large enough to endanger the stability of the financial system. So many finance companies do actually breach the Banks Act.[18] This legal uncertainty ought to make for a higher risk premium when refinancing via the capital market.

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[15] According to a personal mail from David Porteous (Senior General Manager, NHFC), the term 'wholesale' primarily denotes the size of the loan (he suggests loans above R 1 million) and secondly the identity of the borrower (i.e. not individuals, but retail financial institutions). *Wholesale deposit taking also includes refinancing via capital market instruments such as debenture issuing.*

[16] Since DFIs are not banks in terms of the Banks Act, they are not actually permitted to lend to non-bank institutions. The NHFC and DBSA, however, enjoy exemption from the Banks Act, so they can also finance non-bank institutions. By law, Khula is not allowed to do this, but the Reserve Bank tolerates it.

[17] NGOs in South Africa are registered under Section 21 of the Company Act. If they expand and want to make profits, they frequently convert to for-profit organizations, so-called finance companies. This was also the case with Altfin and King Finance.

[18] Finally, though, the Reserve Bank intervened with the Cash Bank, compelling it to change into a bank.

The Banks Act's failure to distinguish between retail and wholesale deposits discriminates against MFIs. In contrast to small savers, institutional investors or banks are far better able to control a MFI.[19] This is why Van Greuning, Gallardo and Randhawa think that for MFIs also engaged in wholesale deposit taking not exceeding a specific amount it is enough to register as a corporation and submit to the supervision and regulations of the stock exchange (for issuing securities) with a view to investor security (1999: Table 2).

2.4 Existing supervisory authorities

In contrast to the Scandinavian countries, where there is only one supervisory authority, or to Great Britain, where the regulatory framework is being simplified, banking supervision in South Africa is diffuse. This results in overlapping responsibilities and incurs unjustifiably high regulation costs for the financial institutions (Van Zyl 1998: 9).

As head of the Bank Supervision Department in the **South African Reserve Bank**, the Registrar of Banks is in charge of supervising banks and mutual banks. He wields far-reaching powers. All non-banks that also provide financial services (e.g. insurance, pension funds and investment companies), are supervised by the **Financial Services Board** (FSB).[20] This was founded in pursuance of the Financial Services Board Act of 1990. The President and the Minister of Finance appoint the members of the supervisory board and the managerial board. The supervisory board reports annually to the minister. Otherwise however, the FSB is independent and finances itself solely from private sources, mainly by charging for the services provided (Van Zyl 1994: 2).

In 1993, the **Policy Board for Financial Services and Regulation** was founded to advise the Minister of Finance in matters relating to financial services and regulation: "The Board's scope of advice includes laws that affect financial regulation, policy considerations that impact from regulation, and any matter referred to the Board by the Minister (Willemse/Goldblatt 1997: 106)." It is also supposed to improve communication between the Reserve Bank and the Financial Services Board.

The trend worldwide is more towards a concentration of supervisory tasks on one or at least a few institutions (examples are Great Britain, Japan and Australia). South Africa has followed this trend by setting up a single supervisory institution for equity and mutual banks. However, there are still overlapping responsibilities between the SARB and the FSB resulting in excessive regulation costs for the financial institutions (Van Zyl 1998: 9). It is improbable that founding another supervisory authority specially for MFIs will result in a reversal of the reforms already made to streamline the regulatory framework. This tallies with the statement by the Deputy Registrar of Banks that a special law for MFIs was seen as a step backward. There is even a proposal to streamline the structure of the financial system further by merging the Bank Supervision Department of the SARB, the FSB and the Registrar of Companies (which in turn reports to the Department of Trade and Industry) in a single institution, the so-called Financial and Investment Services Committee (Field 1995: 109).

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[19] They too are exposed to 'opportunistic behaviour', i.e. MFI enrichment at their expense, since there is an information asymmetry between them. However, 'market discipline by depositors' is higher with them, as the costs of supervision are lower compared with their deposit amount, cf. Staschen (1999).

[20] A summary of the inception and tasks of the FSB is given in Van Zyl (1994).

The figure on page 12 provides an overall picture of the structure of government regulation in the South African financial system. Of the MFIs only the common-bond institutions figure here, which are regulated indirectly by the provisions for exemption from the Banks Act. To date, all other MFIs have not been subject to any government regulation.

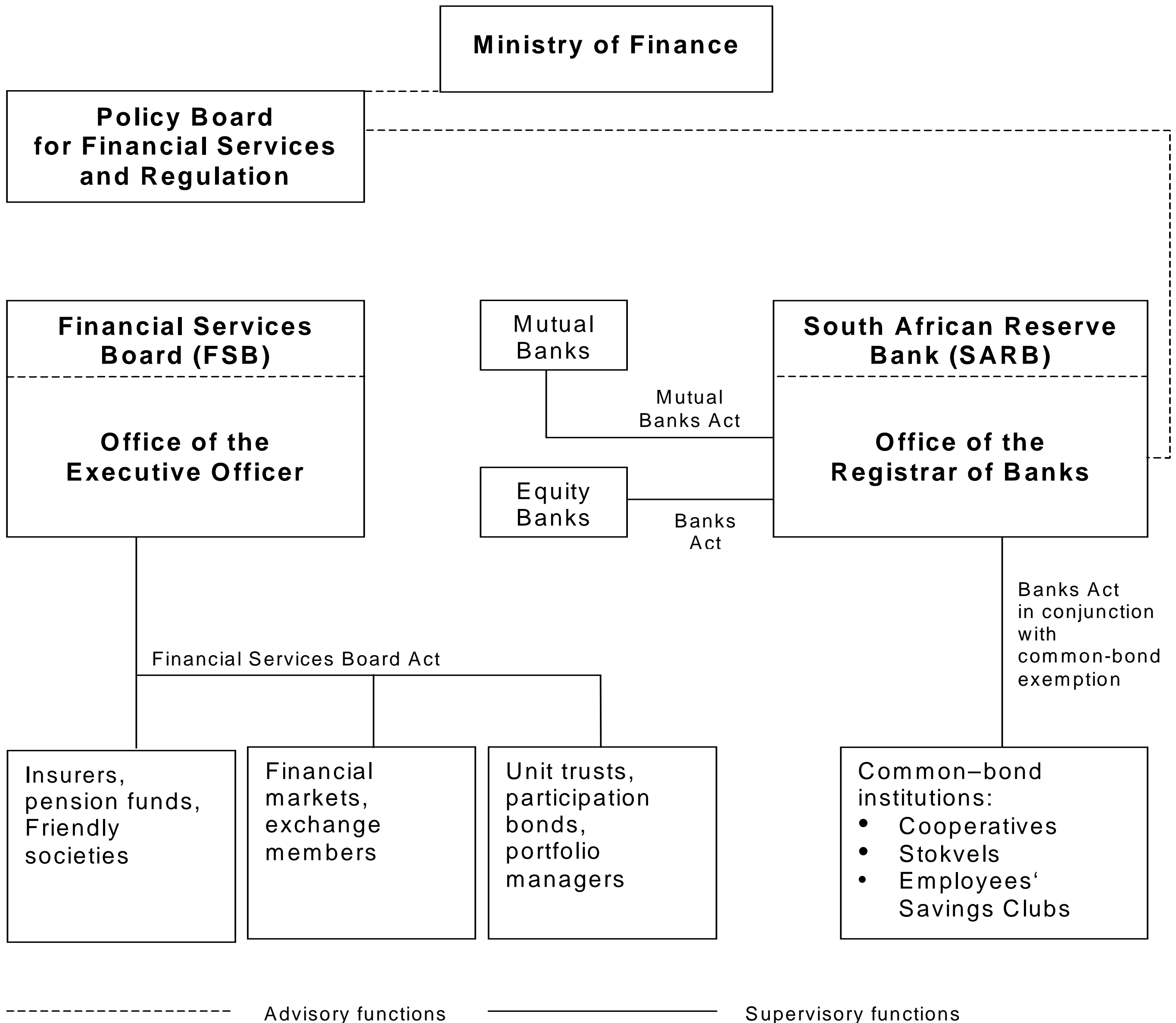
2.5 Safeguarding depositors' accounts

So far, no system for safeguarding depositors' accounts exists in South Africa. The large lending institutions only have arranged internal reinsurance. A suggestion was made as early as September 1996 to the Committee for the Revision of the Banks Act on setting up such a system, but no agreement has been reached till now (SARB 1996: 25). There is no clear bankruptcy law for banks, an important prerequisite for safeguarding depositors' accounts. The four big banks appear to be apprehensive of having to shoulder responsibility for the riskier business policy of smaller banks. They also assume that because they are 'too big to fail' they can rely on an implicit guarantee by the SARB.

Malan/Willemse (1996) propose setting up a guarantee fund for safeguarding depositors' accounts. They see a special need for village banks (cf. Chap. 3.2.3), since these are not regulated by the Banks Act and their clients belong to the poorer sections of the population. They view assistance to village banks as in the public interest ("to empower the rural disadvantaged and poor"; ibid.: 625), which is why depositor security should be financed by government.

The latest annual report of the Bank Supervision Department in the SARB endorses the establishment of a deposit guarantee fund. The proposal is for repayment in the event of loss of 90 per cent of the deposit and limitation on deposits under R 50,000 (SARB 1998).

Figure 1: Regulatory structure of the South African financial system



Source: Field (1995), Exhibit 9.1a, modified.

3 SUPPLY AND DEMAND IN MICROFINANCE

The developments in the South African financial sector up until 1998 have been described in Chap. 2. This review of the regulatory framework is necessary for understanding supply and demand relations in microfinance in 1998, which, however, for their part have repercussions on the future development of the regulatory framework. In the following we shall provide a kind of a snapshot of supply and demand in 1998 which together with the legal background from the last chapter will give us the foundation for understanding future developments.

3.1 Demand

No systematic studies on the demand for financial services in microfinance are available for South Africa. The Strauss Commission (1996b: 24-27) has attempted to break down the rural population into subgroups and identify the features of each group. The main findings are:

- There are very many women working on farms, who have to rely on themselves and are in special need of access to emergenc credit as well as savings and transmission facilities.
- For the landless and unemployed rural poor, it is important that they can receive transfers from members of the family who are either employed or in receipt of a pension.
- For 1.2 million or so South African pension claimants (1996: R 410 per month) the monthly payment of the whole amount is a large security risk. Payment transactions must be reformed accordingly.
- Rural small and micro entrepreneurs, mostly women, need seed capital of approximately R 2,000. The NGOs cannot provide sufficient funding. The formal financial institutions favour men as clients, which is why women micro entrepreneurs are put at a particular disadvantage in access to loans.
- Black businessmen in rural areas have sufficient start-up capital as a rule (frequently from prior employment as a wage labourer), but need to borrow for extension investments and operating inputs.

A study by the Department of Trade and Industry found an unmet demand for credit in the R 6,000 to R 50,000 bracket. Below this range MFIs grant loans thanks to their exemption from the Usury Act; commercial banks lend above it.

In the estimation of most experts, demand for savings facilities exceeds supply. Evidence of a high propensity to save is provided by two studies on farming households in individual provinces, which reveal that 30 per cent (Northern Province) and 48.7 per cent respectively (KwaZulu-Natal) of households save with banks, although these are resp. 60.7 km and 45 km away on average (Coetzee 1997). In rural areas there is a gap in the market particularly for savings amounts under R 500, which could, though, be filled by village banks.

The final report of the Strauss Commission concludes that there is a widespread desire to save, but formal financial institutions are frequently too remote. The rural population prefers the Post Bank to banks, which are seen as unfriendly or even hostile institutions (Strauss 1996b: 27). Since doing business with microsavers is not worthwhile for the banks and they are under heavy pressure to raise their efficiency, there is reason to fear that they will increasingly retire from this area, making the situation even worse. The Commission specifies three priorities in rural areas:

1. Savings products: “greater availability of and access to appropriate savings products and opportunities“;

2. Transmission services, particularly for payment of pensions and facilitating monetary support amongst members of the family

3. Consumption smoothing, for which access to short-term loans is important (Strauss 1996b: 3).

3.2 Supply

There is a large number of lending institutions in microfinance that differ by lending technology and degree of formality. No systematic studies on the supply side in microfinance are available. Table 1 shows the variety of products in lending business and annual turnover of the respective MFI.[21] Although the detailed delimitation of categories may be difficult and many figures must remain rough estimates due to measurement problems in the informal sector, the table conveys a first impression.

Table 1: Supply in microlending

	Loan amount in R	∅ Loan amount in R	Loan term	Interest rate in per cent	Annual turnover in R
Niche banks (e.g. NuBank)	n/a	n/a	n/a	50/a	6 million
Development loans (e.g. from NGOs)	n/a	500	12 months	Key rate up to 50/p.a.	0.6 billion
Microlenders	50-1000	450	30 days	25-35/m	3.6 billion
Stokvels	n/a	n/a	n/a	10/m	n/a
Credit cards from dept. stores and banks	1000-1200	n/a	6-12m	28/a	8.6 billion
Loans by furniture shops	n/a	n/a	18m	32/a	2.1 billion
Overdraft loans	n/a	n/a	12m	20-30/a	n/a
Pawnbroking	n/a	n/a	30d-6m	30/m	2.9 billion
Informal, short-term loans	n/a	> 50	< 30 days	10-100 per loan	2.2 billion

m: months, a: year, n/a: not available.

Source: Study by Dicke & Wicharz, Cachalia & Mothupi

3.2.1 Banks

The financial institutions with the best branch network in rural areas are the banks (Strauss, 1996b, p. 58: 4055 branch offices at start of 1995). This distinguishes South Africa from many other African states, where banks are usually mainly located in the urban centres. In

[21] This is a study from 1996. Latest estimates put annual turnover of microlenders at R 6 billion (interview with Bezuidenhout) or R 8 billion (interview with du Plooy).

South Africa, one branch office serves 15,000 clients, while the ratio for the whole of Africa is 1:450,000.[22] Obviously this ratio is untenable for reasons of cost. As business with the poorer clients – due partly to lack of know-how in this segment - is not cost-effective and the banks are under pressure to increase their efficiency, rationalization measures are likely to be at the expense of the lower income brackets in rural areas. The trend towards much cheaper electronic banking can place the rural population at an even greater disadvantage, since they have had hardly any access to the necessary technology till now (Coetzee 1997).

For the banks lending is uneconomic under R 50,000 to R 60,000. Khula has tried to induce the banks to lend to MFIs by bearing 60 to 70 per cent of the risk. These loan guarantees have been so unsuccessful so far, however, that risk bearing has now been raised to 80 per cent. The few microloans made in the R 500 to R 6,000 range are secured by pension entitlements or against payroll deductions (Strauss 1996b: 5). In savings business, minimum deposits are relatively low, but employment in the formal sector is usually a precondition for opening a savings account. Business with employees is not very lucrative for the banks either, as due to low client confidence in the banks pay remitted onto accounts is usually withdrawn in full at once, so the average savings amount is very low. Frequently, the expensive method of payout at the bank counter is chosen, which makes this business even less attractive to the banks.

In rural areas, access to savings business is better than to lending (Coetzee 1997: 4). According to two studies, in 93.3 per cent (Northern Province) resp. 73.3 per cent (KwaZulu-Natal) of small start-ups resorted to private savings (Coetzee 1997). This highlights the role of savings business for assisting SMMEs.

The second-largest South African bank, ABSA (Amalgamated Banks of South Africa), founded a subsidiary in 1996, the NuBank, specializing in microfinance business. This is the only regulated financial institution doing business in the microfinance sector, mainly in the client market segment of R 500 minimum income a month.[23] Two points need stressing in our view: For one thing, it is particularly important for ABSA to improve its image in the eyes of the ANC-dominated government, as it stems from banks dominated by Boers. In the words of Mogase: "Banks have political dues to pay". For another, NuBank is particularly successful in lending (in the R 500 to R 6,000 range), so that the loan portfolio now totals R 10 million, whereas savings business has mobilized just R 1 million so far. Consequently in future branch offices will be set up for lending business only. The advantage of microfinance windows in formal banks is easy refinance from the parent bank. If, however, they do not adapt their finance technology to the special features of the microfinance sector the disadvantages outweigh as against specialized MFIs.

3.2.2 Post Office

The Post Office Savings Bank, renamed Post Bank as of 1993, has the largest outreach of any single financial institution in South Africa. Coetzee (1997) estimates it has 2,400,000 savings accounts in its portfolio, 80 per cent of which with a credit balance of under R 500.

[22] For urban areas the ratio is estimated at 1:9,500, in rural areas it amounts to approximately 1:22,000 (Coetzee 1997: 2).

[23] Standard Bank set up a microlending department in 1992 but gave up this business again in 1996, cf. Montagnon (1998: 10).

Due to extremely high costs, however, it has not yet managed to reach break-even point. Almost half these savings were lent to the state telephone company, Telkom.

In 1996, the Strauss Commission still envisaged a leading role for the Post Bank in savings mobilization and transfer facilities. It described the maintenance or extension of the branch network as a 'society entitlement' and therefore recommended state assistance to uneconomic branch offices as well. A criticism was that low interest on credit and hence negative real interest in deposit-taking was used as implicit cross subsidies for other business (Strauss 1996b: 14f.). Another criticism was that the Post Bank did not participate in the interbank market of the commercial banks, offered only relatively few products and its branch network density differed greatly by province (ibid.: 55ff.). The great hopes attached to the Post Bank have not been met so far, although the NHFC has made great efforts at cooperation. Of particular interest would be for other financial institutions to use the infrastructure, since setting up their own structure is very costly.

3.2.3 Finance NGOs and finance companies

There are only about 25-30 NGOs in microfinance in South Africa which together manage a lending portfolio of 30,000 to 35,000 loans. Far more common are group lending technology (an exception is the Start Up Fund, cf. Reinke 1996) and the principle of graduation (maximum loan amount increases after successful repayment). The first finance NGOs were set up in the mid-eighties (Get Ahead and Get Up), when their operations were still officially illegal. Today many NGOs are still headed by their then founders, mostly people with great personal dedication. Relinquishing responsibility to a new managing director (frequently also to professional bankers) often heralds a difficult phase of reorientation, as happened with Get Ahead.

Although no studies are available on the efficiency of finance NGOs for the whole of South Africa, we know that none have reached full cost recovery (financial self-sufficiency) and many are a long way from meeting their operating costs (operational self-sufficiency).[24] The DBSA and Khula have commissioned a study on 13 NGOs which have received loans from the DBSA. This sample includes the major NGOs so that the following findings are of general application cum grano salis (Kane/Manala/Richards undated):

- Considering the several millions of micro enterprises in South Africa lending by NGOs is very limited.
- There are serious capacity problems, particularly in management, lending and information systems.
- Incentive systems for staff are virtually unknown.
- Very few products, if more than one, are on offer.
- Almost half the NGOs examined run savings programmes in one form or another, so they contravene the Banks Act where these are not compulsory savings components in lending business.

[24] An exception is the Start Up Fund. Figures from interviews are: Get Ahead has an operating efficiency of 85 to 90 per cent and a financial efficiency of 75 per cent. Break-even point should have been reached in March 1999. The SEED Foundation just about covers 36 per cent of its costs, the Women's Development Banking (WDB) expects operational self-sufficiency in four to five years at the earliest.

- The loan portfolio is mainly financed by subsidized loans from donors, a small part also by bank loans.
- Administrative costs are met largely from grants.
- On average, total income can only cover 25 per cent of all costs (incl. imputed costs for capital), the mediate is only 17 per cent.

The efficiency problems of finance NGOs are known from other countries and are in large measure attributable to their unfavourable governance structure.[25] Comparing the three best-known South African NGOs (Small Enterprise Foundation, Get Ahead Foundation and Rural Finance Facility) with a study of fifteen Latin-American NGOs by Schmidt and Zeitinger, Coetzee, however, comes to the conclusion that the costs (all apart from interest expenses) are also above average compared with other NGOs (1997: Table 9.4). Another reason for efficiency problems are overlapping financial and social goals. For example, approximately 90 per cent of the work of Nations Trust is 'social work', so that full cost recovery is impossible. The Get Ahead Foundation could serve as an example here: It severed its financial services from its other activities by founding Get Ahead Financial Services. The outcome of this widespread inefficiency is heavy subsidy dependence with a general decline in donor funding. The main sponsors for many NGOs are the DFIs Khula, NHFC and DBSA. Given their dependence on everyday politics, a diversification of the refinance portfolio would be very desirable.

There is no substantial growth in the NGO sector in the 'New South Africa' either. Not one start-up was recorded between 1994 and 1996. The reasons for this are presumably on the one hand the limited refinance facilities due to the ban on wholesale deposit taking, the overexpensive loans of the banks and the decline in donor funds: "There is a general squeeze on donor funds, with many donors shifting their funds to state programmes (Strauss 1996b: 66)." On the other, some microfinance experts complain that there is no dynamic entrepreneurial class in South Africa and experience gained is not passed on to the next generation, so that the low density of micro enterprises hampers cost-effective lending.

Due to efficiency problems, retail deposit taking is a long-term goal at most. Arguments against savings mobilization are the heavy demands on financial management which NGOs have hardly met till now, and the availability of other much cheaper sources of finance for lending business. We must also ask whether other financial institutions are not better suited to carry on efficient deposit business with lower income groups. The Strauss Commission recognizes the role of deposit taking and appears, however, to consider NGOs as suitable institutions, when in its final report it makes the following recommendation: "The Commission recommends that legislation that currently prevents NGOs from taking deposits should be reconsidered (Strauss 1996b: 20)."

After the disappointing record of the Mutual Banks Act, high expectations are now pinned on the village banks, which are supposed to improve access to financial services in remote rural areas. These are decentralized financial institutions that are not required to have a formal legal structure. They emerged from a pilot project in the Northwest Province initiated by the International Fund for Agricultural Development and the African Rural Agricultural Association. A village bank is a "community based intermediary that can act as an effective

[25] Cf. for example Schmidt/Zeitinger (1994).

window between the community and the formal financial sector.“[26] The long-term aim is the provision of a „comprehensive range of financial services including savings facilities, transfer services, loans, cheque cashing facilities and insurance services on a commercial viable basis through effective linkages with the formal financial sector (ibid.).“ Under the ‘savings first’ approach, lending business should only be taken up after several years of experience in savings business (Coetzee 1997). Village banks are run and owned by their members. The savings are deposited with banks, which can also provide a liquidity balance under the obligatory business arrangement. The clients/owners can save the expensive journey to the next town and they need not save large sums to qualify for the minimum deposit requirements of the banks. Despite the introduction of another intermediary between clients and bank, this is intended to lower transaction costs.

Some NGOs, such as Rural Finance Facility (RFF), King Finance and Altfin have now converted to for-profit organizations and are registered as finance companies. Via the holding Theta, King Finance and Altfin are also very successful on the stock exchange, although this is an infringement of the Banks Act. Their growth prospects are excellent.[27] They are particularly engaged in so-called payroll-based lending, where interest and redemption payments are deducted directly from pay in a trilateral transaction amongst employer, employee and financial institution. Besides unsecured microloans, Rural Finance also grants building loans, which is a very lucrative business that can offset losses from microlending if necessary.

3.2.4 Microlenders

The so-called microlending industry is in the process of closing a gap in the market in South Africa's financial system and is making a big success of it: personal loans with short handling time and without conventional collateral. As can be seen from Table 1, its turnover now amounts to a multiple of development loans from NGOs or finance companies. There are many different names for these MFIs, the most frequent being microlenders or cash lenders. These are professional moneylenders who are not regulated at all and mainly located in urban areas. Refinancing is mostly via family members and relatives (strictly speaking deposit taking under the Banks Act and thus illicit without a bank licence), with some larger ones also via securities (convertible loans in the case of Unity for example). The industry is split into two groups, the informal microlenders with no permanent office who operate completely outside the law and semi-formal microlenders who have permanent offices and are registered as companies. The loans tend to be more short-term (mostly a month) small loans of R 450 on average at an interest rate of between 100 per cent daily and 10 per cent monthly.[28] The rapid growth in this area was initiated by the exemption from the Usury Act for loans under R 6,000. Nearly all microlenders use the so-called manual card method of lending. Borrowers are required to present their payroll records over the last three months, their last three bank statements and their identity cards. The microlender keeps their bank cards and notes their secret personal identity number (PIN) so that he can draw interest and

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[26] Schoeman (1996), *Village Bank Project - Project Description*: 8, cited from Malan/Willemse (1996: 617).

[27] According to a study by Deutsche Morgan Grenfell, the income of King and Altfin in 1998 ought to rise by about 55 per cent and 66 per cent resp. on the previous year.

[28] Here and in the following, the author refers primarily to a study by the University of Stellenbosch: du Plessis (1997).

redemption payments from the cash dispenser after pay has been remitted to the borrower's account.

Criticism of the small loans industry centres on the following points:

- Due to the danger of fraud by microlenders, the manual card method is quite unacceptable. Disclosing the personal identity number and surrendering the bank card are in violation of the rules of banking confidentiality. Furthermore, this method frees microlenders from the duty of making a thorough credit rating assessment.
- The high interest is not warranted by the risk and the costs of lending business. Thanks to the manual card method repayment rates are very good apart from a few exceptions and the handling costs are low due to standardized lending procedure.
- The borrower is in great danger of falling into a debt trap. An indicator of this is that 9 to10 loans on average are taken out in sequence so that the expensive short-term loans develop into extremely costly medium-term to long-term loans. In addition, several persons in a family can often borrow from microlenders and avail themselves of numerous other sources of credit as well (cf. 3.2.6). Studies have shown that the pay deductions are often too high, leaving less than R 800 on the account for the whole month.
- Almost all loans are for consumer purposes, i.e. they cannot be repaid from the return from an investment. Typical uses are the purchase of food, the payment of rent, school fees or even means of transport and financing weddings and funerals. This compounds the danger of overindebtedness.
- Microlenders exploit their monopolistic position and the financial difficulties of their clients. This is particularly easy because of their clients' lack of experience in personal finance. High interest differentials amongst different providers with identical products indicates a lack of market transparency and a lack of experience in borrowing.

3.2.5 Common-bond institutions

The most important common-bond institutions are stokvels and savings and credit cooperatives. In part, savings mobilized by stokvels are deposited in the formal banking system and used there as loan collateral. Case studies show that they are in the majority in rural settlements and villages (Strauss 1996a: 153).

The umbrella organization of the cooperatives, SACCOL, is primarily assisted by Canada. The cooperatives have not, however, recorded strong growth. This has to do with the extensive reporting requirements stipulated in the Cooperatives Act (No. 91, 1981): "However in respect of the rural poor, the formation of a cooperative is a difficult option as it has complex statutory reporting requirements similar to those of a limited liability company (Strauss 1996a: 182)."

3.2.6 Provision of credit from other financial institutions

For employees in the formal sector, furniture and clothing shops offer special credit lines or payment by installment. It is important that clients specify an address where the articles are located (Strauss 1996b: 64). Department stores like Woolworth pay a lot of money for extensive scoring procedures after a case where an incompetent credit rating incurred a loss of R 40 million. South African lending culture resembles the US American more than the

German system: Almost all durable consumer items can be bought on credit and electronic means of payment are very common.

A savings option which appears to be very lucrative at first sight is also available to small savers in the form of so-called 'get-rich-quick' (GRQ) schemes, which pay their clients exorbitant interest. The SARB deals in detail with this illegal deposit business in its 1996 annual report (SARB 1996: 21-25). The institutions involved claim to fall under the common-bond exemption and thus outside the Banks Act. In the view of the SARB, however, they fail to meet a number of requirements specified in the Government Notice as a prerequisite for exemption. In particular, there is no common bond criterion at all in the choice of new clients, they are not members in any established umbrella organization (NASASA or SACCOL) and grant no loans. They therefore clearly violate the Banks Act and are guilty of a criminal offense. The GRQ schemes are particularly critical as they are so-called pyramid schemes that are only able to pay the promised interest from the deposits of new members. This inevitably leads to insolvency in the long term and some spectacular collapses have now occurred.

Finally, in South Africa too of course there is the usual source of informal lending from pawnbrokers, moneylenders and family members and relatives. While moneylenders frequently charge usurious interest, payments by family members and relatives are mostly a kind of present due to the general reciprocity (no setoff of payment and counterpayment). Important here are above all money transfers from urban to rural areas.

The following table sets the supply of financial services against demand. The figures for the self-employed pertain to micro-entrepreneurs in the informal sector, because there are of course also self-employed with a higher income.

Table 2: Credit supply and demand in microfinance

Loan use	Consumer capital	Housing capital	Working capital	Education capital
Employment in formal sector, income above R 1,500	Ample supply from microlenders, installment payment, overdraft loans, etc.; danger of overindebtedness	Ample supply from banks and finance companies at incomes above R 2,000, below that primarily from RFF; danger of over-indebtedness	No demand, because employed	Supply available
Self-employed, income under R 1,500	Supply only from informal sources (moneylenders, pawnbrokers, families, etc.)	No supply (also inadvisable due to danger of over-indebtedness)	Excess demand, supply only through NGOs and finance companies (primarily members of AMEDP, cf. Chap. 4.2)	Possible, but difficult

Source: Interview with Chris Höck, revised.

3.3 Remaining problems

Despite some attempts at aligning the regulatory framework with the special features of MFIs, major problems remain unsolved. As Chapters 2 and 3 have shown, access of micro enterprises to financial services is still inadequate. This is due, though not solely, to inappropriate general conditions for MFIs that make cost-effective microfinance business on a larger scale very difficult. The most important challenges in regulating the microfinance sector are:

- The growth of successful MFIs is constrained by a lack of refinance facilities – particularly the ban on wholesale deposit taking.
- At the same time, however, the standards in microfinance are generally still so low that there is a shortage of efficient MFIs deserving of promotion. This results in problems with outflow of funds on the part of the development finance institutions.
- There is a gap between the regulated banking sector and the largely unregulated microfinance sector that has not been filled by the mutual banks, either.
- A consequence of these institutional deficits is unsatisfied demand for financial services in certain areas, particularly microloans under R 1,500, transfer facilities and savings deposit facilities for the clients of MFIs.
- Another result is that overindebtedness is threatening to become a grave problem for employees, since a number of sources of borrowing are available to them against payroll deduction.

4 REGULATORY APPROACHES

In the last two or three years in South Africa different approaches to regulating the microfinance sector have been discussed and in part already implemented. These different approaches will be explained in some more detail in the following - in chronological order where possible. First, let us look at the major actors. Particular attention will be paid to their motivation for supporting regulation of the microfinance sector. This approach is intended to underline the dynamic development of the regulation debate and the role of the political process.

4.1 The self-regulatory approach of the Association of Micro Lenders

Since its foundation in early 1996, the lobby organization of microlenders, the Association of Micro Lenders (MLA), has sought a self-regulation of the microfinance sector. It groups approximately 1,200 microlenders as members. Their main features, which also distinguish them from the members of the Alliance of Micro-Enterprise Development Practitioners (cf. Chap. 4.2) are as follows:

- Almost exclusively, the members of the Association grant very short-term emergency consumer loans. Only recently have they started providing longer-term loans as well, primarily for housing.
- At 30 per cent a month, the interest charged is very high.
- Cash loans are a very profitable business, so that the financial institutions involved can achieve high growth rates.
- There have always been cash lenders in the informal sector and there always will be regardless of legal regulations, so regulation in this field must cater for the possibility of these 'going underground'.

MLA cites as a motivation for regulating the microfinance sector on the one hand the pre-emption of inappropriate regulation or even a ban by government and on the other the improvement of refinance facilities available to their member organizations. A third reason is the enhanced public status of microlenders and their disassociation from so-called loan sharks.

As early as spring 1998, the Association claimed to have set up a self-regulatory system for the microlending industry. MLA has a code of conduct which sets standards and a disciplinary committee. The chairman can exclude members on violation of the code of conduct. However, some weaknesses to the approach cast serious doubt on the effectiveness of self-regulation:

- There is an evident conflict of interest between safeguarding the interests of the members and promoting the industry on the one hand and its regulation and supervision on the other. The Association is interested in as large a membership as possible to wield greater influence. Only rarely or never has an application for membership been rejected to date (the information is inconsistent). So there is reason to doubt a consistent enforcement of the code of conduct.

- At least the large microlenders such as Unity and Louhen will not have to fear sanctions, as they are also traditionally represented in the supervisory board, which in turn decides on the members of the disciplinary committee. Johan Jonck for example is both Chief Executive Officer (CEO) of Unity and Chairman of MLA. In addition, no independent external auditing is carried out.
- The disciplinary committee can expel microlenders from the Association, but it cannot stop them from continuing to issue loans. Self-regulation only works when complying with the regulations of the regulatory institution affords clear advantages. The Association is trying to achieve this by developing a brand name to show clients that they are doing business with a professional, fair partner. For the reasons mentioned above, though, there is no guarantee.

The Association has been reproached for two main reasons: Its members charge usurious interest and the manual card method is unacceptable. The reason given for the interest rates is the high risk entailed in lending. The high profits earned in this industry, however, are more attributable to the monopolistic position of microlenders for lack of adequate lending facilities. It is therefore important to expand supply and facilitate client choice through information campaigns. There is already a general trend towards declining interest rates.

The manual card method is obsolescent. Thanks to its cooperation with the Boland Bank, Unity for example can now dispense with it altogether. Unity is accorded a preferred debit order and no longer needs to keep the card.

MLA has rebuffed this criticism, stressing high customer satisfaction. No client has complained till now, although a special hotline has been installed free of charge. Furthermore, studies have shown that only 0.32 per cent of clients are unhappy with the interest rates.

The Association is planning to step up its advertising campaign. It wants to promote a brand name by ’signalling’, so that all clients who see the MLA emblem in a credit sales agency recognize it as a 'stamp of quality'. Posters have been printed with the following text: “There’s only one way to make sure you are dealing with a member of the Association of Micro Lenders - **ASK**. Ask and demand to deal with a member of the Association of Micro Lenders and be sure of professional financial assistance.“ Advertising is also planned via newspapers, radio and television.

Summarizing, for lack of effective enforcement mechanisms, a system of self-regulation in the form described primarily helps improve the image of regulation but does not serve its actual aims: consumer protection and safeguarding the stability of the financial system.

4.2 The hybrid regulatory approach of the Advisory Panel of Khula and NHFC

In 1996, Khula and NHFC appointed an Advisory Panel with half the members made up of their borrowers and half including representatives of institutional investors, the DTI, the SARB, the Landbank, the Institute of Chartered Accountants. The South African consulting firms Deloitte & Touche and EFK Tucker were commissioned to make recommendations for a so-called 'hybrid regulation' of the microfinance sector. The expression 'hybrid' was chosen because both government and private actors were supposed to be involved in regulation: Government sets the general legal parameters, while a private institution, the supervisory

body, gives this practical shape by specifying regulatory measures and monitoring them. The primary objective of the regulatory framework should be: "the promotion of the micro-lending industry so as to 'serve legitimate unserved credit needs' (Advisory Panel 1997: 2)." In August 1997, the report by David Porteous, the present Senior General Manager of NHFC, was presented to the Micro-Lending Workshop of the SARB.[29]

The major actors in this process were the two DFIs Khula and NHFC as well as the Alliance of Micro-Enterprise Development Practitioners (AMEDP). First, a brief profile of these two is given below.

Khula Finance Ltd. and National Housing Finance Company (NHFC)

Due to their financial and personnel resources, the so-called National Development Financial Institutions Khula and NHFC play a major role in microfinance. They are parastatal organizations which are not engaged in retail business, but refinance MFIs. Khula also guarantees commercial bank loans to MFIs. Khula is also aiming at soliciting private investors. This poses problems, however, as long as they perform development tasks in addition to their role as wholesalers: "Khula can use government finance to help develop the market, but it cannot attract private finance while charging low rates and fulfilling a development function (Montagnon 1998: 15)."

For many NGOs the DFIs Khula and NHFC are by far the most important source of funding. They are also advocates of the industry in dealings with the government and above all advocates of its regulation. After establishment and capitalization by the government they were faced with the problem of defining criteria for selecting which MFIs were eligible for promotion. So they had the Advisory Panel on Sound Practice draft the Statements of Sound Practice. These demarcate four important areas for assessing MFIs:

- Code of governance
- Code of conduct
- Credit risk management
- Financial sustainability and solvency requirements

The extensive requirements need not be met in full from the outset, but "a programme would be required which would ensure full compliance within a defined time period (NHFC/Khula 1996: 1)". Khula and NHFC, however, are subject to a conflict of interests between their role as 'players' and 'referees'. On the one hand as lenders they are 'players' and have a vital interest in growth within the industry. Both DFIs have problems with allocating funds, since there is a shortage of efficient MFIs in South Africa. As a consequence, twelve more MFIs were supposed to be established in the course of 1998 and then given financial support by Khula. There is a danger here of an externally induced establishment of MFIs primarily aimed at tapping sources of development funding and guaranteeing fund disbursement on the part of the DFIs. On the other, Khula/NHFC are also 'referees', since they must supervise compliance with certain industry standards for lack of general regulation.[30]

[29] The following information stems from: Advisory Panel (1997).

[30] On this conflict of interest between the market development role and the intermediation role, see also Gonzalez-Vega 1998.

Khula and NHFC therefore are primarily interested in a regulation of MFIs, so they can divest their supervisory tasks to an independent institution and benefit from its monitoring activities. In addition, from a risk standpoint both DFIs would like to see MFIs diversify their portfolios, i.e. refinance via the capital market and private investors also. This would prevent a disproportionately large involvement by individual MFIs. A prerequisite is a credible regulation of MFIs to gain the confidence of investors.

A healthy self-interest therefore figures in the motivation of DFIs to advocate regulating the microfinance sector. This way, they would not need to concern themselves with an efficiency analysis of MFIs and would profit from generally higher standards in the microfinance sector.

The Alliance of Micro-Enterprise Development Practitioners (AMEDP)

The AMEDP groups practitioners in microfinance. The majority of members are NGOs, but finance companies, banks, the DFIs Khula and NHFC described above and microlenders are also represented. Their common aim is to promote micro enterprises. Informal meetings had been held since 1992, AMEDP was officially founded in April 1994 and since October 1996 it has a permanent, full-time Executive Director (Sharda Naidoo) and Personnel Assistant. The Alliance had 79 members in April 1998, of whom only some, however, had paid regular membership dues.[31] The Work Plan for September 1997 to December 1999 foresees covering 21 per cent of recurrent costs by income in the last quarter of 1997, 39 per cent in 1998 and 62 per cent in 1999 (AMEDP undated). Till now then, there has been a heavy dependence on donor funds. A survey amongst the members between November 1996 and February 1997 found the following:

- 58 per cent of clients of member organizations are women, 99 per cent black.
- In the supervisory board or executive committee 30 per cent of members are women and 48 per cent are black.
- Average annual loan interest of the member organizations amounts to 30 per cent a year, for short-term loans 17.25 per cent a month. So in any case it is lower than with members of the Association; how much lower is impossible to quantify exactly.[32]
- On average, the members have already been doing business for 8 years (AMEDP undated: Annex 1).

The work of the Alliance focuses on five main areas: advocacy, capacity building, networking, information and publications and building standards. It distinguishes between a vision and a mission:

> The vision of the Alliance is SMME support services of the highest standards building towards a thriving micro enterprise sector in the mainstream of the economy.

[31] As at October 1996 only 20 of the 75 organizations had remitted regular contributions. This figure has, however, improved since the appointment of the Executive Director (AMEDP undated: 2).

[32] Davel maintains they are three to four times lower. However, comparing Van Huyssteen's statement that no member of the Association charges more than 30 per cent a month with the interest rate cited for short-term loans of AMEDP members (17.25 per cent), the difference cannot be so great.

The mission of the Alliance is to enhance the capacity of, and to represent, micro enterprise development organisations (AMEDP undated: 4).

As a result of the survey amongst the members a code of conduct was drafted. This contains a stipulation that all members grant loans "primarily for the purposes of small enterprise development, provision of shelter or education". Microlenders issuing consumer loans only are therefore not eligible for membership of the Alliance. The situation is different for those granting building loans in addition to consumer lending. Examples of this are King Finance, Credit Indemnity and Altfin, which are members of the Alliance.

Progress towards cost recovery is stipulated as an aim in the code of conduct. Since, though, it is only a code of conduct without measurable targets, it is more a description of the members' sense of identity rather than a set of quality standards.

Another outcome of the survey is that the Alliance wants to step up efforts in advocating the regulation of MFIs. In February and March 1998 two self-regulation workshops were held. According to members of the Alliance, reasons for regulating this sector are:

- Cheaper and lawful refinance on the capital market and permission for payroll lending in view of declining international donor funds;
- Averting inappropriate regulation by government (e.g. by abolishing exemption from the Usury Act for small loans, which due to the resultant interest ceilings would preclude cost-effective microlending) and eliminating uncertainty about state intervention (e.g. prosecution of banned refinancing via the capital market);
- Exclusion or at least relegation of microlenders (e.g. by means of authorizing wholesale deposit taking for members of the Alliance only) that impair the stability and the reputation of the whole sector through improper practices (manual card method, usurious interest).

Despite the obvious differences, even representatives of the Reserve Bank repeatedly confuse the Association and the Alliance. In a self-portrait, MLA cites as one of its aims: "Becoming the official and authoritative mouthpiece of the [micro-lending] industry." The AMEDP Work Plan includes the following statement of intent: "The Alliance should be recognised as the one institution nationally that represents the small enterprise sector and its developmental interests (AMEDP undated: 18)." As the boundaries between both groups grow less sharp - the interest rates are converging, some microlenders are also members of the Alliance, while more members of the Association issue longer-term loans and provide housing finance - in the long-term only one of the two will be able to act as representative of the interests of MFIs in the public domain and in dealings with the SARB and DTI.

Hybrid regulatory approach

So, the DFIs NHFC and Khula and AMEDP share a common interest in regulating the microfinance industry. The consultants charged with designing a hybrid regulatory framework had to take two primary interests into account, which were not mutually independent: the interest of AMEDP in easier refinancing and the interest of the DFIs in selecting MFIs eligible for promotion.

The draft argues provisionally against permission to engage in retail deposit taking, since the collapse of a single MFI could cause lasting damage to the reputation of the whole industry.

A more important argument in this connection would be the risk of contagion caused by a run on an individual MFI.

It does, however, advocate permitting wholesale deposit taking, since the prospective investors could gauge the investment risk and possibly contain it with appropriate contractual provisions. Better access to capital is also a prerequisite for growth and hence the survival of the industry, the consultants argue.

A supervisory body should be founded as a company with limited liability under the Companies Act. The owners of this 'mini reserve bank' (AMEDP 1998a) could be the NHFC, Khula, the Landbank, the SARB and DTI. NHFC and Khula should promote the industry while safeguarding its stability at the same time; the participation of the SARB and DTI will increase their knowledge of the microfinance sector and lend authority to regulation. The owners shall appoint the majority of members of the supervisory board, a minority shall be representatives of the microfinance sector. Three committees of microfinance experts shall be allotted the task of advising management.[33] The management itself shall be appointed by the supervisory board and consist of about 8 full-time personnel.

The regulatory authorities remain the Reserve Bank and the Department of Trade and Industry. They should, however, leave it to the private company to set specific regulations. All that is needed is for the Registrar of Banks and the Minister of Finance to issue a Government Notice delegating the task of regulation and supervision to the supervisory body. The specific regulations for MFIs are laid down in so-called proclamations, which can be amended from time to time at no great effort. They should ensure sufficient consumer protection and the stability of the financial system (Advisory Panel 1997: 3).

The main tasks of the supervisory body are dealing with complaints (complaints section) and monitoring quarterly reports that must be submitted by all regulated MFIs according to the proposal (compliance monitoring). To give 'bite' to this regulatory framework the supervisory body should also be empowered to impose sanctions or even expel individual MFIs. If membership also entailed exemption from certain provisions of the Banks Act and the Usury Act, this would constitute a strong incentive for MFIs to join and remain members. Alongside the sanctions of the supervisory body, the regulations of the Banks Act that define violation of the Act as a criminal offense remain in force. The supervisory body is not itself authorized to close MFIs. In the case of illicit deposit business, however, the regulations of the Banks Act obtain so that the central bank can shut down individual institutions.

The proposal envisages permission for members to take deposits upwards of a certain minimum amount (wholesale deposits) and to charge higher interest rates for loans below a certain amount than specified in the Usury Act. The latter is already allowed today for loans under R 6,000, but would then only apply for MFIs regulated by the supervisory body. This way, microlenders could only continue business, if they submitted to this regulatory framework. Otherwise their high interest rates would contravene the Usury Act.

There was prolonged discussion in the Advisory Panel on the question of whether a development focus of MFIs should be a precondition for registration and hence exemption from the Acts. The idea was to require a certain percentage of the portfolio to be dedicated to

33 Accreditation and Disciplinary Committee, Monitoring Committee and Audit Committee.

housing finance, micro enterprises and training, for example. Finally, the decision was against, because it would exclude the many microlenders engaged almost solely in granting consumer loans (Advisory Panel 1997: 4). This is certainly one reason why this proposal managed to gain the support of both the Alliance and the Association of Micro Lenders.

Prudential ratios have not been specified so far. The Statements of Sound Practice by Khula/NHFC can serve as a starting point for setting standards for the supervisory institution. However, on the one hand these have been developed without sufficient consultation with MFIs and on the other, they are far too detailed for use as minimum standards.

The proposal foresees the supervisory body meeting half its operating costs from government subsidies and the other half from a single admission fee and annual membership dues. It also recommends that the government bear the start-up costs. Grants could, however, be confined to a limited period.

The interesting aspect of this proposal is that the supervisory authority, South Africa's central bank, is to be replaced by a private company run by microfinance experts. This makes sense considering the limited capabilities of the SARB and its meagre knowledge about the microfinance sector. The central bank is involved indirectly, though, since as a member and joint owner of the company it co-elects the supervisory board, which for its part appoints the management: "The State would be involved in the policy decisions, while the members would be involved with the setting of standards, the application of rules, and obtaining feedback from the sector and consumers (AMEDP 1998a: 1)."

The composition of the supervisory board is very important for the issue of enforcement. It is sensible to keep the representatives of the microfinance sector in the minority on the supervisory board, since they could not effectively supervise themselves. The majority of these representatives are elected by the owners which includes the various stakeholders. The Reserve Bank is unlikely to confer the mandate on the supervisory body for regulation and supervision and grant its members exclusive exemption from the provisions of the Usury and Banks Acts, if the representatives of government are not in the majority on the supervisory board. Otherwise there is a danger that the provisions could be diluted, since growth in the microfinance sector could be accorded precedence over the stability of MFIs. Khula and NHFC in particular might have an interest in this to solve their fund outflow problems. It would appear very optimistic to assume that "Khula and NHFC, especially, have a clear incentive to support industry growth **while maintaining stability** (Advisory Panel 1997: 6, emphasis by St. St.)". The proposal does not seem to have quite thought this point through. Regulation and supervision should not be delegated without clear sanction powers by government over the supervisory body, should it fail to carry out its task properly.

Initial lack of interest on the part of the SARB and DTI

The Advisory Panel proposal was submitted to the DTI and the Reserve Bank for comment. At first, the response was disappointing: The DTI took three months to answer, was also interested in principle, but pointed out that the Usury Act would have to undergo general reform. The SARB only managed to answer after almost a year. This lack of interest is understandable if we consider the positions of the two supervisory institutions on regulating the microfinance sector a little more closely.

According to the Deputy Registrar, the philosophy of the SARB is that no direct influence should be exerted on the allocation of financial resources in a free-market system. Directed lending in favour of SMME finance as practiced in other countries is not an option in South Africa. For the Reserve Bank, there is no public interest in a direct regulation of MFIs as long as they are not engaged in deposit business and therefore pose no systemic risk. In the view of the SARB the Alliance has failed to demonstrate that it is not simply demanding regulation in the interests of the industry, but of the public. It is unconvinced that capital access and hence the ban on deposit taking is the decisive problem in the microfinance sector. More important for the SARB are improper practices such as repeated borrowing and massive consumer lending, which are problems it is not responsible to solve. The industry itself should seek the best institutional solution here. So the central bank does not see itself as an important stakeholder in the regulation debate at all, rather as an actor in the background, who only intervenes when non-banks impinge on the traditional domain of banks (e.g. by retail deposit taking).

The DTI is in a somewhat different position. Part of its policy mandate is to protect consumers, i.e. the customers of financial institutions. It sees the Usury Act as its major instrument for this. It is, however, difficult to convey to politicians that particularly in business with the very poor there are no limitations on interest rates. On the other hand, there is the familiar problem that a uniform interest cap hampers cost-effective business in microfinance and threatens to simply criminalize microlenders. When the DTI was presented with the hybrid proposal by the Advisory Panel in autumn 1997, topmost priority had been accorded to reforming the Usury Act, not to regulating the microfinance sector. The response was accordingly reticent.

4.3 AMEDP's self-regulatory approach

At the beginning of 1998, it looked as though the hybrid regulatory approach as recommended by the Advisory Panel would not be implemented in the foreseeable future for lack of interest by the SARB and DTI. As an alternative, the Alliance decided to set up its own system of self-regulation (i.e. without involving the state supervisory institutions). It held two workshops with invited consultants to discuss a possible self-regulation of the microfinance sector:[34]

- The starting point was the hybrid regulatory approach of Khula/NHFC. The intention was to modify it in line with the requirements of a 'self-regulatory body'. The proposal was retained "that the body would attend to complaints from the industry but that a board of auditors and accountants would be responsible to implement the regulations (AMEDP 1998b: 4)."
- To expedite the discussion, a four-member steering committee was to be founded with a representative of MLA to ensure the participation of the Association. This seemed important for strategic reasons as the only way to forestall the accusation that the committee only represented a small part of the industry.
- Consultants were commissioned to adapt the suggestion by Khula/NHFC to the requirements of self-regulation, develop aims and a strategy, draw up a business plan and design a self-regulatory institution based on it.

[34] Cf. minutes of both workshops: AMEDP 1998a and b.

- The Alliance would continue to represent the interests of micro enterprise development practitioners, while the self-regulatory body would be in charge of regulating and supervising the industry. The survey amongst its members found that because of possible conflict of interests as lobbyist and regulator of the industry, AMEDP should not undertake this task itself.
- To ensure that this approach would be effective the members of the regulatory framework would receive exclusive exemption from the Usury Act and Banks Act, so that no interest ceilings would apply for them and they could refinance via private investors. This would attach real disadvantages to cancelling membership. On just this point, though, a self-regulatory approach needs the consent of politicians. The Minister of Finance and the Minister of Trade and Industry need to be convinced that self-regulation of the microfinance sector warrants exemption from the respective acts. This is the cardinal point of the whole regulation debate in South Africa, where government assent is essential.

A point at issue was how far to involve the Association of Micro Lenders. Numerically, it represents by far the largest part of MFIs in South Africa, so it could not simply be left out. On the other hand, there was a danger that chances of exemption from the Usury and Banks Acts would rapidly worsen, as soon as microlenders were tangibly involved in regulation. The self-regulatory body should not of course reject microlenders that keep to its regulations.

This approach was made redundant by the developments in summer 1998 (see following section). It did, however, serve its purpose by preventing the process from coming to a standstill and thus underscoring how genuine efforts towards regulating the sector were.

4.4 Implementing the hybrid regulatory approach

Partly thanks to the different attempts to install a self-regulatory system for MFIs and the vigorous efforts of AMEDP to induce the state banking supervisory authority to take part in regulation, the deadlock was broken in summer 1998. The institutions concerned – primarily the Alliance and the Association as representatives of MFI interests, the supervisory authorities, the SARB and DTI, and the DFIs Khula and NHFC - agreed on the proposal of the Advisory Panel for a hybrid regulation of the microfinance sector. At the same time, a basic reform of the Usury Act is planned in tandem with the discussion on regulating the industry. Both processes – the revision of the Usury Act and the implementation of the hybrid regulatory approach – are not complete yet, so we can only summarize the provisional results here:

A Micro Finance Regulatory Council (MFRC) has been founded under Section 21 of the Companies Act. Members are the MLA, AMEDP, Khula and NHFC, as well as one representative each from the Bank Supervision Department and DTI. The Secretary is Rudolph Willemse, who was already involved as a legal expert in drafting the hybrid approach. Consultants have been commissioned to draw up a business plan, submit proposals for the organizational structure and provide advice in recruiting staff.

Khula and NHFC define their role in the Regulatory Council as follows “to become active board members and provide strategic guidance“. Khula would like to see a cooperation agreement with the Council to enable Khula to use its information for loan decisions.

The revision of the Usury Act is proceeding parallel to this. The DTI published a draft of the new act for comment in November 1998. This envisages raising the upper limit for loans exempted from the Usury Act provisions from R 6,000 to R 50,000. This exemption shall not apply for overdraft loans, though, and is not intended to culminate in a general abolition of an interest ceiling for loans below this limit. Rather, the intention is to assign special regulatory institutions licensed by the DTI the task of setting various interest ceilings for different kinds of loan (consumer loans, building loans, etc.) themselves. So this means delegating the task of deciding the maximum permissible interest rate to a specialized regulatory institution. This is just the task MFRC is eligible to perform. The draft foresees that the DTI only prescribes the minimum requirements for the respective regulatory institutions published in an exemption notice. It also reserves the right to withdraw the licence again if these provisions are not kept to. The regulatory institutions themselves shall be entitled to impose sanctions on their members on violation of their regulations, ranging from a fine to prohibition of business activity. The latter would exceed the authority conferred on the supervisory institution under the hybrid regulatory approach.

The DTI hopes that this proposal does justice to both aims alike: Protecting the consumer from exploitative practices and improving the supply of financial services for those denied access to the formal banking sector till now. Having maximum interest rates specified in a discriminate way not by the Minister of Trade and Industry but by special regulatory institutions would constitute a big step forwards from the uniform interest ceiling applied to date. There is, however, opposition from consumer organizations, which have described the proposal as 'unconscionable' (Haffajee 1998). An article in the renowned South African newspaper Mail & Guardian carries the title "Consumer Rage at the Kindness to Loan Sharks" and speaks of a "complete shift in government thinking". This shows that lobbying by the microfinance sector has been successful but also reveals how little consumer organizations and some of the media appreciate the repressive effects of a usury law.

The DTI has two special requirements of the regulatory institution, which the MFRC has not met so far. For one thing, it argues for more representation for final borrowers in the institution, for another it wants to see a general ban on certain practices such as the manual card method. Both concerns are quite understandable, considering that the DTI's prime task is to protect the consumer, i.e. the borrower. Undue influence by clients can, however, jeopardize the credibility of regulation. As for the problem of undesirable practices in loan collection, the main point is to offer alternatives to avoid microlenders being forced 'underground'.

This recent development is very encouraging. It enables a balance between the interests of MFIs themselves (permission for wholesale deposit taking, disassociation from 'black sheep' in the industry), the banking supervisory authority (as much self-regulation as possible), the Department of Trade and Industry (consumer protection and good access to financial services) and the DFIs (more efficient MFIs and freedom from part of their 'monitoring burden'). The daily business, of setting prudential regulations – including interest ceilings – will be in the hands of a single institution, which will have information advantages over the supervisory authorities, the SARB and DTI. To guarantee an effective regulation of the

microfinance sector, however, the regulatory institution itself is answerable to the banking supervisory authorities.[35]

Table 3 recapitulates the major regulatory institutions and regulations in South Africa:

Table 3: Regulation of the different types of institution

Institutional type	Major legal regulations	Regulatory and supervisory institution	Key regulations
Equity and mutual banks	Banks Act or Mutual Banks Act, Usury Act	Regulation and supervision by the Bank Supervision Department, SARB	All usual banking transactions permitted
Finance NGOs, finance companies and micro-lenders (regulation till now)	Banks Act and exemption from Usury Act	No regulation, but must be licensed by the SARB to conduct banking business	Retail and wholesale deposit taking prohibited
Finance NGOs, finance companies and microlenders (planned regulation)	Exemption from Banks Act and Usury Act as member of MFRC	MFRC	Ban on retail deposit taking, different interest ceilings, depending on loan type
Common-bond institutions and village banks	Exemption from Banks Act via exemption notices, exemption from Usury Act for loans under R 6,000	Compliance with provisions for exemption monitored by the SARB and/or DTI, otherwise unregulated	Indirect regulation through exemption provisions

Source: Own compilation

After implementation of the hybrid approach, MFIs will have three different regulatory framework options to choose from, applying cost/benefit yardsticks. Table 4 gives an essential outline of the three options.

[35] Many MFIs exempted so far from the Banks Act as common-bond institutions can be expected to apply for membership of MFRC, since this is the only way to gain exemption from the strict interest ceiling after the reform of the Usury Act.

Table 4: Possible regulatory frameworks for MFIs

	Unregulated MFIs	MFIs with Banks Act exemption (common-bond institutions)	Members of MFRC
Conditionalities	None	Provisions of common-bond exemption	Provisions of MFRC
Refinancing	• Bank loans • Donor funds • Loans from DFIs	Savings of members	• Bank loans • Donor funds • Loans from DFIs • Wholesale deposits
Permissible business	Lending business, interest ceiling under the Usury Act	Loans to members for certain activities, deposit business with members, interest ceiling under the Usury Act	Lending business, discriminate interest ceilings up to R 50,000, above that regulations of the Usury Act

5 CONCLUSIONS

5.1 General recommendations for regulating MFIs

As the reader will have grasped, the situation in South Africa is very special and the experience gained cannot therefore be simply transferred to other countries. Nevertheless, some findings are of general relevance:

- Motivation for regulating MFIs can differ greatly. There is a difference between the self-interest of the industry (e.g. growth by improved refinance facilities) and public interest (e.g. consumer protection, limitation of systemic risk) in regulation. In the latter, the state ought to have an interest in regulation (which can, however, be privately organized). The former only calls for state involvement, if assistance makes economic sense due to market shortcomings.[36]
- A major problem with a self-regulatory system is the lack of an effective sanction mechanism. A possible avenue here is for government to grant exclusive privileges to the self-regulatory institution by law. This presupposes, however, that government can rely on the regulatory institution doing a good job. As a rule, it will not confer full discretionary powers on it but will reserve certain rights and options of intervention, as is the case, for example, in the hybrid regulatory approach of Khula/NHFC with participation of the central bank in the supervisory board. Self-regulation proper with no government participation at all suffers in particular from credibility problems, if - as at times in South Africa - there are several rival competitive regulatory approaches. It can, however, serve as a temporary second best solution, if the microfinance sector is accorded low priority by politicians and the banking supervisory authority and they show no interest in getting involved in regulation. Self-regulation can prepare the way for government institutions to participate in or take over supervision. The initiative taken by the Alliance to set up a system of self-regulation in the microfinance industry has speeded up the process considerably in South Africa.
- Direct regulation of MFIs by the supervisory authority, i.e. usually the central bank, appears to make little sense due to its restricted capabilities and lack of knowledge of the microfinance sector. In any case, educational work with the regulatory authorities and politicians is a good idea to avoid possible counterproductive interventions (cf. the example of legislation on usury in South Africa). The recognition of self-regulatory capabilities amongst so-called common-bond institutions by the banking supervisory authority in South Africa deserves praise, however.
- There is general approval for functional banking regulation as the functions of a financial intermediary are relatively constant and in contrast to institutional regulation the best institutional solution can be found via competition.[37] South Africa, however, illustrates that it does not make sense to stipulate the same regulatory measures for all institutional

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[36] Possible theoretical rationales for the need for state involvement are information assymetries between financial institutions and their clients and free riding by financial institutions in industry regulation, as this is definable as a public good; on this, see Staschen 1999.

[37] E.g. Merton (1995).

types. The aim ought to be a 'level playing field'. Precisely this, however, cannot be achieved with uniform regulations, as their effects can differ greatly depending on the type of institution. For example, a minimum capital of R 50 million for stokvels is inconceivable, although they conduct banking transactions according to the Banks Act definition. A possible solution might be to discriminate more amongst functions, so that only certain provisions in the law apply depending on institutional type. Cooperatives, where the depositors are also the owners, for example, should be allowed to conduct savings business without having to meet the very strict requirements for a bank. In retail deposit taking a distinction must be made between deposit business with members and with the general public. One way would be a functional regulation of all activities carried out by the many different institutional types, while very special activities (e.g. issuing business or possibly also granting unsecured microloans) remain subject to institutional regulation (Van Zyl 1993: 79).

- When licensing retail deposit taking the development of the microfinance sector should be taken into account. Deposit business calls for expertise in risk management, which almost all South African NGOs obviously lack. The consequences of a possible MFI bankruptcy would be particularly serious, because it could cause lasting detriment to the incipient confidence in this sector and harm lower income groups in particular. In very underdeveloped microfinance sectors, consideration should be given to whether or not MFIs specialized in deposit business or new institutions planned as fully-fledged intermediaries from the outset would be better suited for savings mobilization.
- The practice to date in South Africa of adopting laws and then exempting certain institutions from the provisions would appear inadvisable. The upshot of this is that only the conditions of exemption apply instead of the detailed provisions in the law.[38] Drafting a separate law could prevent a further fragmentation of the regulatory framework, improve its transparency and allow for discriminate provisions in the process.
- Under present legislation in South Africa, the Registrar of Banks is theoretically obliged to supervise **all** existing financial institutions directly or indirectly. In direct regulation, it performs the classic task of a banking supervisory authority, monitoring compliance with the regulations of banking legislation by the banks (equity and mutual banks). It must examine all other financial institutions to check whether they meet the requirements for exemption from the Banks Act, if they have applied for such exemption, or whether they conduct banking business in terms of the Banks Act without possessing a bank licence. This task overtaxes the resources of the banking supervisory authority. Direct supervision of MFIs by a specialized institution – possibly the umbrella organization could play a role – is preferable to the present regulation. As this example shows, the legislative should only promulgate regulations that the executive can in all probability supervise.
- The mutual banks example shows how unreasonable or repressive banking regulation can heavily restrict the development prospects of a certain type of institution. Together with the high equity requirements, specifying a co-operative structure, which is a major obstacle to capitalization for mutual banks, poses an enormous market hurdle. This was not the way to deepen the financial system.

[38] In the exemption example from the Usury Act the relevant Government Notice specifies some conditions that just about fill a page. If these conditions are met for the corresponding loan agreement, none of the far more sophisticated provisions of the Usury Act apply any more, although some of them could certainly sensibly apply to microloans as well.

- Finally, South Africa is a clear example of how regulation is a process. It took more than two years of negotiations by the different stakeholders to arrive at the present point. An analysis of the interests of all stakeholders can reveal possible strategies. In South Africa, individual forerunners (e.g. AMEDP) were able to speed up the process. The self-interest of the actors must be taken into account, since it by no means corresponds automatically with the aim of market-style financial system development.

5.2 Assessment and outlook

Microfinance in South Africa is often understood to mean the microlending industry alone (cf. for example SARB 1998). This reflects the status quo in microfinance, since apart from small, informal institutes no MFIs have been engaged in retail deposit taking till now. This is also a hallmark of the regulation debate in South Africa. The prime issues remain whether and under what conditions MFIs should be permitted to conduct wholesale deposit business and how the Usury Act ought to be reformed so as not to place MFIs at a disadvantage and prevent exploitation through usurious interest at the same time. The implementation of the hybrid regulatory approach is a promising solution which will now have to prove its worth in practice.

As the Strauss Commission rightly pointed out, however, it will still not remedy the lack of savings facilities for a large part of the population. The village banks are an initial and so far very successful attempt to deepen the financial system in savings mobilization. There is, though, still no appropriate regulatory framework for MFIs that engage in lending and deposit business. The present exemption of the village banks from the Banks Act leaves these largely unregulated and therefore provides no model for the future. Possibly after its successful implementation the hybrid regulatory approach can be developed to enable MFIs to conduct retail deposit taking as well. The planned securing of deposits up to a certain amount would figure as an important element in this regulatory framework for MFIs. Alternatively, thought could be given to introducing a Microfinance Institution Act with its own Registrar and applying to all MFIs alike. This law should then contain graduated provisions depending on institutional type.[39] In any case it will still take prolonged discussion and much experience will have to be gained before a microfinance sector providing a broad range of financial services is assimilated as an integral component in the South African financial system and is accessible to large parts of the population.

[39] Coetzee calls this the tiering approach: „Effective tiering implies that each tier has distinctive characteristics which address a market niche and that legislation provide for transition between niches (1998: 12)."

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ANNEX 1

Interlocutors in South Africa, March/April 1998

Name	Function, organization
Deepak Adhikari	GTZ, contact person CEFE Network
Lin Anderson	Honorary Secretary, Get Up! Lending Trust
Paul J. Bendix	Director DED Lesotho and South Africa
André Bezuidenhout	Deputy Registrar of Banks, Deputy Head: Bank Supervision Department, South African Reserve Bank
Ghaleb Cachalia	Dicke & Wicharz, Cachalia & Mothupi, Management Consultants
Gerhard Coetzee	DBSA: Principal Policy Analyst
Gabriel Davel	Senior Consultant, Financial Institutions Team, Deloitte & Touche
Douglas Graham	Visiting Professor, Department of Agricultural Economics, Extension and Rural Development, University of Pretoria
Chris Höck	Managing Director, Rural Finance Facility
Rubin Japhta	Manager of Operations, Khula
Marie Kirsten	DBSA, on the Executive of AMEDP and the Small Enterprise Foundation
Astrid Ludin	Assistant Director, Centre for Small Business Promotion, Department of Trade and Industry
Nomsa Manqele	Executive Director, Nations Trust Youth Enterprise Project
Sitembele Mase	Operation Manager, Get Ahead Financial Services
Mutle C Mogase	Operating Executive, NuBank
Veronica Mohlala	Marketing and Communications Co-ordinator, SEED Foundation
Daphne Motsepe	Executive Director, Women's Development Banking
Sharda Naidoo	Executive Director, Alliance of Micro-Enterprise Development Practitioners
Morgan Pillay	General Manager, Niche Market Lending, NHFC
Flip du Plooy	Chief Executive Officer, The Association of Micro Lenders
David Porteous	Senior General Manager: Operations, NHFC
Lizell Schultz	Assistant Director, National Consumer Affairs Office, Department of Trade and Industry
Wessel Smit	Vice Chairman, Association of Micro Lenders, and Legal Advisor, Unity Financial Services Ltd.
André Swartz	First National Bank
Siswe Tati	Managing Director, Khula Enterprise Finance Ltd.
Nick Van Huyssteen	Director, Unity Financial Services Ltd.
Franso H. Van Zyl	Head: Research, Financial Services Board
Rudolph Willemse	Chairman of E.F.K. Tucker