Group Solidarity and Transaction Costs

Micro-credit in South Africa

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Abstract

This thesis analyses alternative models for the provision of micro-credit, with a particular focus on the role of solidarity. It produces a critique of the lending model developed by the Grameen Bank and copied in many parts of the world. The critique focuses on the claim that such schemes are well suited for delivering micro-credit in a sustainable, ie self-financing manner. I argue group solidarity is not an essential component of successful micro-credit schemes, and that lending to individuals can be at least as efficient.

I argue that solidarity groups do not perform economic exchange on the basis of ad hoc contracts, as existing literature implies. Rather, solidarity groups are institutions; as such, they are costly. Groups, therefore, require resource input from their members as well as regulations. These findings are shown to be relevant both for informal rotating savings and credit associations (ROSCAs) and solidarity groups of formal micro-lenders.

A case study of a South African, Grameen-type lender illustrates that the staff-intensive group interaction implies a cost structure that cannot be supported by the interest income from its micro-credit portfolio. A second case study of a micro-lender giving credit to individuals finds that sustainability has been achieved with innovative lending technology. Self-selection and cost-saving measures are shown to be effective. The importance of innovation, finding its expression in reduced

unit costs rather than enhanced solidarity, leads to a particular perspective on micro-finance: rather than viewing micro-finance as an issue for donor-funded, isolated development projects, micro-finance is seen as part of the financial system.

The thesis concludes by pointing out that these findings may be relevant in other fields of development practice. Participatory project design involves costs, not only in micro-credit. However, such costs depend on the specific social environment and may well be justified if they contribute to desirable social processes which are not adequately captured by criteria of self-sustainability.

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Preface

Currently, a paradigm is developing that proclaims solidaristic group credit schemes as the foremost solution to problems of credit rationing in the context of poor entrepreneurs in developing countries. Government and donor policy is increasingly influenced by this thinking. My research finds flaws in the underlying theory and refutes the conclusions of this paradigm in application to South Africa on the basis of two case studies. This thesis hopes to provoke the development community into rethinking the premises of policy on micro-credit, and especially group-based schemes.

Chapter 1 introduces the theme by discussing the role of micro-finance in development policy in general, and its role against the background of discrimination in South Africa specifically. It also outlines the conceptional approach of this study. Chapter 2 sets out features of micro-lending technology, with specific emphasis on linkages with commercial banks. It describes the tension between the demands for professionalism and efficiency and those for compassion in lending to the poor, which leads to two different 'philosophies' in micro-lending. Chapter 3 discusses the history and roots of solidaristic financial institutions, starting with informal groups, moving on to formalised self-help institutions from the Raiffeisen Banks to modern Grameen-type lenders. It then discusses the recent history of formal solidaristic finance in South Africa. Chapter 4 sets out my main critique of group credit schemes, which focuses on the conditions and costs of group solidarity. It argues that solidarity is a costly intermediate good, created to facilitate joint production of credit and creditworthiness. Chapter 5 serves as an introduction to the field of micro-finance in South Africa. It outlines the economic legacy of Apartheid and the challenges in the phase of political transition, and provides an overview of the financial landscape in South Africa with particular weight on development and micro-finance institutions. Chapter 6 illustrates the theoretical insights of chapter 4 through a case study of a group lender. This micro-lender is found to be non-sustainable due to its resource-intensive group credit approach. Chapter 7 demonstrates that a 'mass-minimalist' lending approach enables a individualistic lender to save the costs of solidarity and operate profitably. Chapter 8 discusses the social impact of mass-minimalist lending in the context of the results of a small survey. Finally, chapter 9 concludes by comparing the results with evidence from international micro-lenders, reconsidering the future of micro-credit and identifying three fields for further research.

On several occasions, preliminary results were published independently. Chapter 2 is based on two papers which, though originally written for presentation at conferences, are now published in the Bank of Botswana Research Bulletin and in a recent volume on micro-finance (Appui a Develloppement Autonome, *Micro-finance - Banking sector: a challenge*, 1997, Luxembourg), respectively. Chapter 6 is based on a shortened version of a paper forthcoming in *Development and Change*, and chapter 7 on a paper recently published in the *Journal of*

Development Studies (Vol. 34, No. 3). Ideas and analysis presented in an earlier article, "Alternative Models for Micro-Credit in South Africa - Theoretical Foundations and two Case Studies" (*Savings and Development*, Vol. 20, No.3, pp. 269-83), influenced the writing of chapters 1 and 3. Editors and referees of these journals provided valuable comments and helped to improve not only the papers already published, but, by implication, this thesis.

My greatest thanks are reserved for my supervisors who guided my research with dedication and patience. All remaining errors, in fact or in judgement, are of course mine.

1. Introduction

Micro-credit is now one of the most popular forms of development assistance, a prime tool for poverty alleviation. Rather than hand-outs, credit, so is the perception, promises to enable poor people to 'take charge of their own destiny'. It seeks to empower the powerless, and, as market-oriented policies are the core of current wisdom, the entrepreneurial flavour of micro-enterprise credit adds the appropriate business-mindedness to poverty alleviation. However, if markets are efficient, why are people denied access to financial services - credit - in the first place and how does it influence their choices as 'responsible individuals'? Why is the exclusion from financial services a concern for policy-makers and aid officials the world over?

Financial services provide a mirror-like image of the real economy; structures and decisions within the financial sector shape the economy at large. Exclusion from financial intermediation, and specifically from access to credit, is quite different, and more important, than rationing in most other markets: it does not deny access to a single good, but to the medium for intertemporal economic transaction. Exchange in all markets is constrained; without venture capital entrepreneurial skills and industrialism may never see the light of the market; without saving and loan facilities individuals are constrained in markets such as housing and insurance. This thesis develops a critique of the most popular solution for micro-lending: the group credit approach inspired and instituted by the Grameen Bank in

Bangladesh, and it focuses specifically on the inability of this approach to deliver its promises to the 'unbankable' in South Africa.

Section 1.1 explains the importance of credit in development thinking and the rise of micro-credit to its current status in development policy. Section 1.2 sets this in the specific context of South Africa. Section 1.3 sets out the conceptual approach for the rest of the thesis.

1.1 Micro-credit in development policy

The importance of credit as a developmental tool stems from the perception of credit rationing as a socio-political evil. Credit rationing diminishes the 'life chances' of those affected, thereby undermining the foundations of democratic, equitable societies. It is accused of being blatantly unjust because it affects those who are least able to deal with it: those who possess least resources, least opportunities. Especially in South Africa, it has been linked with racism. It is based on previous injustice, and punishes again those who were yesterday's losers. Credit rationing stirs emotions as it hurts the poor, the rural, and the unemployed, while the suave and urban and educated are unaffected. Hence, it has been accused of aggravating social imbalance, hastening the decline of disadvantaged neighbourhoods, holding ambitious and able people in permanent disadvantage and poverty.

Rationing seems incompatible with rational allocation in reasonably free markets. Rational lenders, however, refuse to lend if risks are not measurable, loan contracts are not enforceable, markets are unknown, or information not available. Banks may not lend without collateral, mortgages cannot be secured by non-marketable property. Credit rationing, from this perspective, does not constitute a case of discrimination; merely, credit criteria are applied equally and justly to whoever applies.[1] The allocation of credit, therefore, reflects the pattern of economic and social advantage and disadvantage in society. This mechanism leads to the fact that poor, disadvantaged people have less access to credit. Access to credit constitutes an opportunity, and the exclusion from credit markets further reduces the economic mobility of poor people. The observation of this pattern is typically called 'credit rationing', although others may argue that it only constitutes uneven access to credit.

Credit rationing has sparked academic debates, policy measures and private sector action for a long times. Credit rationing as a concept is relatively new, yet the

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[1] The definition of rationing is far from clear; in many instances, rationing appears to be confused with non-availability or unaffordability. A simple example could illustrate the conceptual problem: if a person wants to fly, and is willing to part with the amount of money that is equivalent to the price of an airticket, but the plane is fully booked, then the person is rationed. If the person wants to fly in a private jet, but is in possession only of enough money for an economy fare ticket, she is not rationed, but maintains desires beyond her means. If that person, however, has enough money to hire a plane, but has no pilot license, she may still be refused access because she does not fulfil the non-monetary conditions of this transaction. Similarly, '[c]redit rationing is a condition of loan markets in which the lender supply of funds is less than borrower demand at the quoted contract terms' (Jaffee, 1987, p.719). As in the example of planes, non-monetary factors influence those 'quoted contract terms' because '[t]he price of a loan consists of the interest rate and possibly the non-rate terms such as collateral requirements' (*ibid.*). Therefore, it appears not fully adequate to label the exclusion of poor people from formal credit markets as 'rationing' (Neary, 1987). However, the term is now in wide use so that, keeping in mind the difference between exclusion and rationing, I will use the term in this thesis.

problem already existed before the establishment of modern financial markets. Mediaeval guilds sought to provide credit to their members on a mutual help basis, because craftsmen did not have access to the moneylenders who served the then dominant economic class, the feudals. Rural co-operatives in 19th-century Germany are sometimes claimed to constitute the earliest model of modern mutual banks.

Because credit rationing does not affect a random cross-section of a society, it is also important to understand who is affected, and why. In South Africa, credit rationing mainly affects blacks who have been marginalised by Apartheid policies in the past. Credit rationing, therefore, appears as the long arm of Apartheid, a vicious cycle that perpetuates black poverty even after the abolition of racial legislation. Accordingly, there is the need for conscious policy to overcome the effects of previous, unjust policy - its mere abolition does not suffice.

Economic research has not offered a sufficient explanation for credit rationing, nor has research yielded generally accepted policy recommendations for overcoming unequal access to credit. The most accepted 'classical' analysis finds credit markets hampered by asymmetric information. Proponents of this approach argue that adverse selection[2] on the credit market may constrain the price of credit to assume its market clearing level, and excess demand was possible (Stiglitz and

[2] Adverse selection denotes a change of the composition of borrowers dependent on the interest rate, ie the higher the interest rate the bank sets, the higher is the share of 'bad risks', due to self selection.

Weiss, 1981). They base their analysis on the assumption that lenders cannot distinguish between potential borrowers and thus ration randomly. Hence, such an analysis is not applicable to systematic patterns of rationing as found in South Africa and elsewhere. Credit rationing is a political subject precisely because it is not random: it is the black, the poor, the disadvantaged who are affected. Poor entrepreneurs are credit rationed because of visible characteristics distinguishing them from other borrowers: they want to borrow small amounts, lack collateral and business documentation, and are vulnerable to variation in their cash-flow.[3]

Fried and Howitt (1980) have used 'customer relationship' as a rationing criterion. Such analysis is aimed at questions of rationing in corporate America, not informal sector Africa. While it is obvious to observers that the communication between aspiring borrowers and bankers is a critical condition as it may remove information deficiencies and suspicion, such contact is not an option for poor people in developing countries. Duca and Rosenthal (1993) provide a quantitative assessment of credit availability against the background of the redlining debate in the USA.[4] Based on survey data of American households, they find that race is a

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[3] Bester (1985) argues that in a model following Stiglitz and Weiss (1981) no rationing could occur if credit applicants were not constrained by collateral. Therefore, access to collateral, ie wealth, would determine access to credit markets. Basu (1997) shows that institutional credit does not reach the rural poor in India because of their lack of assets for use as collateral and their specific relationship with landlords.

[4] Redlining describes the alleged practice of American banks to discriminate against minorities, and inner cities, by rationing credit and mortgage. Legislation has been passed to enforce 'fair' lending. Various positions in the continuing debate are captured in Squires (1992). Similar campaigns were fought between township residents and mortgage lenders in South Africa, specifically in Gauteng. Banks argue that violence and lawlessness inhibits the repossession of houses and this prevents the enforcement of contracts; residents felt victimised and pointed out

significant variable for explaining why households have their credit applications turned down. This finding suggests that 'irrational' credit rationing may exist in addition to rationally explicable exclusion. However, their approach precludes the analyses of the economic rationale, and possible remedies, of the rationing they observe.

Despite the failure of mainstream economic theory to arrive at a convincing analysis and solution, credit rationing of poor people can only be understood adequately if the focus is on the systematic exclusion of poor people, rather than the random or irrational rationing discussed in mainstream literature. Systematic rationing is common fact for poor people in developing countries, and it is accepted as a policy problem (Aryeetey, 1997). It is perceivable that each credit transaction by a formal sector bank causes fixed costs; these are usually related to handling a credit application and making a decision. As poor people would borrow small amounts, the returns for the bank are too small to cover the up-front costs. Therefore, banks act rationally if they refuse to even consider credit applications from 'unbankable' people.[5]

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that mortgage lending in 'white' suburbs was often scarcely profitable, but favoured by white bankers for reasons of cultural affinity and prejudice.

[5] In addition to the fixed costs of credit, the costs of collecting information and the lack of enforceable contracts are often singled out. Section 1.3 discusses the transaction costs approach in greater detail.

In the first decades of development economics and policy, three options were followed for overcoming the 'finance gap' of credit rationing to poor, rural people.[6] In developing countries with a nationalised banking system, the profitability of banks was accepted as secondary to credit extension. Hence, bank branches were established in rural areas where they could not be profitable. Lending - not only to rural smallholders, but to projects in industry - was viewed as a development tool and therefore not relegated to commercial, market-related decision-making. Countries with private or mixed banking sectors emulated those policies by imposing regulatory conditions on their banking. These usually comprised lending quotas which stipulate minimum lending to small industries and rural borrowers, and a distribution of branch network and lending volumes to favour regional equity. Anecdotal evidence portrays how banks and their customers tried, often with good success, to circumvent such regulation. Both bank nationalisation and regulatory intervention sought to fill the finance gap by cross-subsidising 'development credit' from the returns of mainstream lending, or from general government income. Finally, in addition to both approaches, many developing countries established specialised institutions for providing finance to rural borrowers and small industry. These were often established by national development banks and received support from foreign donors.

[6] Lending to poor, urban people was not seen as a policy objective. This is mainly due to the fact that at this time urbanisation and urban poverty were only starting to pose a challenge.

These approaches were discredited first by their dismal performance. Then, from the early 1980s, several economists - many of them based at the Ohio State University - started to develop a critique of subsidised and directed credit (Adams *et al*, 1984; Tybout, 1984). The critique focuses on the fact that the credit policies resulted in less equitable access than anticipated, as institutional constraints invited lending practices favouring well-off borrowers (Kane, 1977). Further, repayment rates were extremely poor as subsidised credit was perceived as government service and repayment seen as optional. Hugh losses ensued and led to limitations of credit extension, as subsidies and grants were exhausted quicker, following fewer loans, than planned. While subsidised credit was thus more costly and less productive than hoped, the Ohio School economists also argued that such credit hindered the development of viable, private credit markets in rural areas of poor countries.

As a result, the focus in lending policy shifted to emphasising cost recovery of lending. At the same time, poverty alleviation assumed greater importance in the agenda of international development agencies, owing to the fact that official development assistance over two decades had achieved little for the poorest people in developing countries. Also, it became accepted that poor people were able to uplift themselves, if provided with appropriate opportunities and implements (Adams and Nazarea-Sandoval, 1992; Alfonso *et al*, 1992).

Also, during that time, the view of the informal economy changed. Previously the perception had been dominated by a dualistic perspective, viewing informal sector activities as pre-modern and a relic of traditional society that would be overcome by industrialisation. New research started to present it rather as a rational, modern form of business in an environment with many constraints, many of which were caused by undesired effects and poor implementation of modernising development policy (Ghate, 1986; Lamberte, 1988). Specifically on informal finance, the view changed from one of undercover crooks to legitimate and important small-scale bankers. The provision of subsidised rural credit was partially explained by the usurious nature of client-lender relationships in informal markets, from which subsidies were meant to offer an escape. When policy-makers realised the true costs of subsidised credit programmes, moneylenders looked less usurious. This change in perception owes, arguably, also much to the Financial Repression paradigm, which holds that financial policy in developing countries retarded savings, investment, and institutional development in the financial sector through interest rate ceilings and regulatory burdens, including those aimed at making credit available to rural target groups (McKinnon, 1973; Shaw, 1973; Fry, 1982, 1987).

Then, in a climate increasingly less welcoming to cheap credit policies, came reports about the successes of the Grameen Bank in Bangladesh. Similar institutions mushroomed all over the developing world, first in Asia and Latin America, and now also in Africa. The services of these institutions came to be known as micro-credit as they sought to target the very poor, lending very small amounts of money.

The rise of micro-finance in international development circles was not unchallenged. In the late 1980s the increased popularity of supposedly self-sustainable lending models in the donor community led to criticism focusing on their reductionism, ie the assumption that social intervention could be reduced to the provision of credit alone. In 1989, a provocative study by ACCION International, the inter-American micro-finance institution, posed the rise of 'new wave' micro-finance institutions as a challenge for non-profit organisations (Otero, 1989; see also Drake and Otero, 1992).[7] Others, like the case studies of the GEMINI project, reported about financially successful lending schemes in Indonesia (Boomgard and Angell, 1990; Rhyne, 1991), Latin America (Alfonso *et al*, 1992; Fischer *et al*, 1992; Boomgard *et al*, 1992) and Africa (Ashe *et al*, 1992) and thus heightened the stakes in the competition between different approaches and their proponents.[8] The GEMINI project produced over 100 case studies and

[7] Maria Otero is a director of ACCION International (a prominent micro-credit NGO based in Boston and working mainly in projects in Latin America) and has worked as an economist for USAID. She is one of the individuals most closely associated with the rise of micro-finance in development circles.

[8] GEMINI stands for Growth and Equity through Microenterprise Investments and Institutions. It was a project for conducting research and publication activities and was sponsored by USAID. GEMINI was based at the offices of Development Alternatives Inc. (DAI), a development NGO now in Bethesda near Washington DC. DAI still maintains close links both to ACCION International and USAID. These three institutions have had a profound influence on the development of debates around micro-finance, and in after-dinner discussions in micro-finance circles they are sometimes referred to as 'the Mafia'. DAI and USAID cooperate the Microenterprise Best Practices Project, which makes advice available to development practitioners and publishes a newsletter.

technical notes (issue-oriented reports such as Weidemann, 1992) between 1989 and its termination in 1996, including many on finance schemes. Mostly written by development consultants, the most significant GEMINI reports have since been included in publications such as Otero and Rhyne (1994), while its initial insights were further developed by more recent research such as Hulme and Mosley (1996) and Johnson and Rogaly (1997). GEMINI studies were, arguably, rather partisan but contributed to getting micro-finance institutions on the international stage. Berenbach and Guzman (1994) trace the origins of the debate between 'minimalist' and 'integrated' approaches to the early 1990s, when GEMINI was most active.

Much of this debate centred around the best approach to enterprise development.[9] NGOs which focus at enterprise development in the informal or micro-enterprise sector and which follow the integrated approach usually run training programmes both for appropriate production skills as well as business acumen. NGOs which primarily focus on poverty issues tend to cover health and basic education issues as well as social 'empowerment'. The precise nature of intervention of 'integrated' institutions depends on the nature of their objectives, the characteristics of the target group and the constraints of their environment. Integrated institutions will in all cases, though, use a mix of tools, and they tend to organise localised projects

[9] However, there are both integrated and minimalist institutions whose objectives are related to poverty alleviation. Although enterprise development and poverty alleviation are often seen as closely related and mutually supportive objectives, one of them inevitably dominants the agenda of NGOs.

which are responsive to local needs and constraints. This portfolio of intervention tools may involve credit, and integrated lenders sometimes use credit in kind.[10] However, the credit function remains subordinated to the more 'holistic' nature of their activities.

In contrast, minimalist programmes design their intervention around credit. They usually also offer some limited training, but this would be in direct relevance to their lending function. They pursue a profit objective which casts them as a financial institution although 'profits are seen as essential to long-run sustainability and expansion, but not as ends in themselves' (Otero, 1994, p. 102).

From the mid-1990s onwards, this debate has mostly abated. In 1994, Berenbach and Guzman conclude that the 'correct balance of specialisation and diversification is specific to each organisation, reflecting the existing organisational capacity, management talent, and judgements of the board of directors' (p. 139). In policy terms, the debate was solved by identifying two different, but compatible and often mutually supportive roles for different approaches. Institutions following the 'integrated' line continue to offer mostly non-credit services, from training to business mentoring. Out of the 'minimalist' approach developed the modern micro-finance sector. Micro-finance institutions

[10] A typical example is the scheme run by the Triple Trust Organisation in South Africa where some clients receive training in sewing and financial planning, and are then loaned a sewing machine and material. The loan agreement is similar to a hire-purchase arrangement, but is directly related to the training programme. Following the inception of clients' sewing enterprises, they receive further training and mentoring as required.

focus on credit and specialise on a narrow set of functions by emphasising their role as financial institutions.[11]

The most important difference is that micro-finance institutions accept that their role as subsidy-receiving NGOs is temporary. By aiming for financial sustainability, they develop their capacity as the 'demand among the poor for financial services is so great that it requires a more effective response than small programs that depend on outside funds' (Otero, 1994, p. 94). Micro-finance institutions therefore develop visions of turning themselves into commercial banks, non-profit mutual banks, or foundations and trust.[12] Whatever form they choose, it assumes a business-minded approach to their own development and a market-related rate of return.

[11] This development is illustrated by the of the Consultative Group to Assist the Poorest (CGAP), 'a multi-donor effort to systematically increase resources in micro-finance to broaden and deepen the success of the work done by pioneering institutions in this field' (CGAP, 1996a, p. 1), financed by major bilateral and international donors. CGAP was constituted in 1995, and soon started to dominate international debates jointly with its partner organisation, the World Bank. Since earlier debates about the general direction of development finance have levelled off, CGAP discusses issues mostly of a technical nature, such as interest rate determination (CGAP, 1996b), access to commercial capital markets and the role of savings (CGAP, 1997). The rise of CGAP was, one could conclude, the final stamp of approval by international donors for the micro-finance movement.

[12] Whether their legal form is profit or non-profit making, they will in all cases need to achieve commercial rates of return on their capital in order to gain access to commercial capital markets. Access to capital markets is essential in order to expand the loan portfolio. Institutions offering savings services also need to offer sufficiently attractive returns. In fact, financial sustainability has come to be seen as a market-oriented return on assets (Mosley, 1996).

The active pursuit of profits in development finance was a novelty.[13] Micro-credit has an expansionist agenda and needs to account for its subsidies. Long-term sustainability and expansion capacity is therefore linked to producing positive returns. Yaron (1991) formulated a Subsidy Dependency Index that takes into account the implicit subsidy of low-interest loans, grants and free seed capital. Mosley (1996) shows that financial sustainability is not equivalent to showing profits in the annual audit. In fact, the strict definition of financial sustainability, which is now universally accepted in the micro-finance field, means that all assets under a micro-finance institution's control yield real market-related returns even when the actual costs of some assets is low because of low-interest loans and grants.

'Integrated' institutions, in contrast, are NGOs with a charitable role and a redistributive agenda. They will measure sustainability not in financial, but in institutional terms.[14] Sustainable micro-lending does not constitute a redistribution of wealth. By definition, a financially sustainable micro-finance institution does not administer a flow of resources from rich donors to poor recipients, as the

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[13] Rotating credit funds, equipped with free seed capital, could survive with a rate of return equalling the inflation rate, thus holding their net endowment constant. This would make them institutionally sustainable, but unable to expand. Free seed capital represents a permanent subsidy, as the rotating credit fund does not account for the opportunity costs of its capital endowment.

[14] Rashid mentions institutional sustainability ('willingness and capacity of the organisation to take full responsibility to continuing positive changes'), behavioural sustainability ('demonstrated knowledge or skill developed as a result of organisational involvement') and policy sustainability ('acceptance and replication of policy by other organisations, such as government, donors and other national or international institutions') as measure of the sustainability of integrated NGOs (1997, pp. 200-1).

recipients are paying for the services they receive. However, the rise of the micro-finance industry to prominence in development practice was accompanied by significant donor commitments. Financial sustainability is an objective of NGOs in micro-finance, but only a minority have attained this status yet. The expansion of micro-finance requires large amounts of additional funding, and potentially squeezes the funding available for other forms of development intervention.

Truly staggering amounts of funding are earmarked for micro-credit. At a well-publicised world summit for micro-credit in Washington, DC, in February 1997, the 'human right to credit' was announced, the aim 'to reach about 100m of the world's poorest families, by the year 2005' (*Financial Times*, 6 February 1997) was accepted by delegates who included senior representatives of donor governments and NGOs. Further, it was estimated that US$ 21.5 billion of grants, concessional loans and commercial capital would be needed to reach this target (*Financial Times*, 31 January 1997). The United Nations Development Programme used the occasion to unveil a programme, including the commitment of US$ 41 million, for micro-finance initiatives, and other bilateral donors pledged further funding the establishment and portfolio expansion of micro-lenders (*Business Day*, 6 February 1997). All major donors now run micro-credit schemes;[15] in the few remaining developing countries where such schemes do not

[15] Although USAID and GTZ are perhaps the most visible donors in micro-finance projects, the official aid agencies of all major donor countries, including for instance the British DFID, the Swedish SIDA and the Danish DANIDA, support this sector as well. Further, many well-known private development NGOs from donor countries, such as Oxfam, provide support for micro-finance institutions. Further support is available from charitable as well as political foundations, including for example the Ford Foundation and the Friedrich Ebert Foundation. Especially in

yet exist, donors scramble to implement them. Invariably, micro-credit is under pressure to deliver; expectations are very high.

Such expectations, combined with the large resources reserved for micro-credit, have drawn criticism. Some have argued that the focus on sustainability, and earning a return on credit portfolios for covering costs, undermines the good characteristics of development NGOs; according to this view, NGOs derive their most valuable characteristics from their nature as non-business, non-profit organisations which allows them to take a more holistic, all-encompassing view on development (Dichter, 1996).[16] Others have argued that current thinking and policy on micro-credit puts rather too much faith into credit; access to credit alone will not establish entrepreneurs nor reduce poverty (Buckley, 1997). In fact, in the scramble for ever larger, more self-sufficient micro-credit schemes, good judgement is sometimes lacking.[17] This rejection, though, must be seen in the context of overstretched expectations. While micro-credit alone will not solve the

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South Africa, but also in other developing countries, wealthy individuals and large companies contribute finance. In South Africa, the Anglo American Chairman's Fund donates to a variety of charitable causes, including micro-finance, while ADEMI, a sophisticated micro-finance institution in the Dominican Republic, was set-up by the initiative of wealthy local business people. Various Bolivian micro-lenders have also benefited from sizeable private donations.

[16] Dichter does not criticise the development of the micro-credit sector as such, but finds it regrettable that all major NGOs now seek to initiate micro-credit schemes in order to look 'modern'. The focus on financial objectives in micro-finance projects and the scramble for setting them up, inspired by donor pressure in many cases, leads to undesirable changes in NGOs internal culture. It is difficult not to agree with this critique.

[17] At a recent workshop in Mozambique, to which I was invited as a resource person, someone asked me how micro-credit schemes could be implemented in the northern provinces of Mozambique where there are no roads, school or any other physical infrastructure. My advice to build roads and primary schools first was not taken seriously.

problem of poverty, establishing access to credit has clear welfare-enhancing effects and may help some poor people to move out of poverty by investing in income-earning assets. Given its right place, credit for poor people can be a valuable development tool, but not a panacea. Difficult questions about the social return of lending - the developmental effect that should be paid for by donors - are a priority only if such subsidies are assumed to persist. Then, the good of credit must be weighed against the good of subsidising education, health, and the provision infrastructure, all of which are part of donors' portfolio. If, however, micro-credit fulfils its promise of offering credit to poor people in a self-financing manner, then such choices are no longer required, and donors and NGOs should indeed be advised to concentrate on other, less commercial activities. This study will find that micro-credit can be self-financing, even profitable, albeit only with initial grant support. Therefore, micro-credit remains an issue for donors and NGOs - to the extent that micro-credit leads to better lives for poor people - as long as micro-credit remains experimental and in need of 'infant industry' support.

1.2 Micro-finance in South Africa: giving credit to Apartheid's victims

The process of introducing credit to people beyond the outreach of mainstream banks is of political and economic importance in all developing countries. South Africa occupies a high place on the agenda due to its history of apartheid, which marginalised black people economically. Though financial dualism in South

Africa is often understood as a consequence of apartheid, financial markets were never explicitly racially divided, and are certainly not so today. The indirect exclusion of apartheid's victims has to be attributed to the discriminatory practices in other fields of policy. The Group Areas Act, Job Reservation systems for whites, and discriminatory education and training reinforced the income gap existent between the races in South Africa (Porter, 1984), and indirectly moulded financial markets. Blacks are more likely to be denied finance because they were denied education, employment, income opportunities, and property rights before.[18]

Regulation of financial institutions strengthened the dynamic of innovation that concentrated on the white, First World sector (Munro, 1988; Jones, 1992). By setting cartel prices, and allowing a high level of concentration, price competition was sacrificed, instead competition aimed at modernising high-margin 'white banking' (South Africa, 1985). The outcome is that South Africa has one of the most modern financial systems of the world, but before the 1994 elections bankers considered 70% of its population 'unbankable'.[19] Also, it has since been argued in many debates that it was absurd for financial institutions to continue administering

[18] Black South Africans were not allowed to own land in townships, because these were, according to Group Areas Act legislation, 'white' areas. As citizens of 'independent' or autonomous homelands, their right to own land was restricted to those 'black' areas (for a biased exposition of this policy and its motivation, see Bureau for Economic Research re Bantu Development, 1976). Therefore, almost all buildings in townships were owned by the government, and the residents were supposed to pay rent. This led to the politically induced rent boycotts, starting in the 1980s. The lack of property ownership, and subsequent difficulty of establishing credible and enforceable ownership and transfer rights, resulted in restricted access to mortgages and property-secured credit. Chapter 5 sets out the political context in greater detail.

[19] During preliminary fieldwork in 1993, several bankers stated that figure as the percentage of individuals in the South African population who they considered 'unbankable'. On this point, there was remarkable consistency across numerous banks.

a net capital flow from black to white - as black people deposited substantial savings but had virtually no access to credit from the same institutions - considering the relatively low saving capacity of poor people, their hunger for capital, and the low profitability of the formal, and predominantly white, industrial sector.

The end of Apartheid in South Africa accordingly determines the agenda for economic reform: while a systematic lack of opportunity has created a racially skewed income distribution and black poverty, policy now seeks to extend opportunities to the previous disadvantaged. Though an important reservoir of labour, the majority of blacks existed on the margin of white economic development. The real measure of successful democratic transition is increasingly taken to be the full integration of all South Africans into mainstream economic life. First and foremost, this means increased employment, including self-employment, and a credible commitment to individual economic and social upward mobility. Yet the traditional providers of employment and income are overburdened: mining is the traditional backbone of the South African economy. Though remaining important, the mining industry experiences problems of its own and is more likely to shed workers than to expand its workforce. Manufacturing industry - much of it import-substituting - will be hard pressed to maintain present employment levels in the face of trade liberalisation. Foreign direct investment remains sluggish. Land reform remains half-hearted (see chapter 5) and agricultural production has seen sharp decreases recently. Between 1990 and

1995, formal non-agricultural sector employment has declined by 6.6% and has continued to fall further since (South African Reserve Bank, 1997).

The stimulation of a vibrant, indigenous private sector is the single most important potential source of future employment and income. Entrepreneurship, self-employment and township enterprises are often the only avenues open for the disenfranchised urban poor. Yet entrepreneurs need venture capital. When emerging from the isolation of the Apartheid years, South Africa's financial system was notoriously unprepared for these demands (Munro, 1988). The ANC-led government understood the importance of credit, and other forms of support, for entrepreneurs. This led to the formation of a small enterprise division in the Ministry of Trade and Industry, a national conference in February 1995 and the subsequent White Paper on the 'National Strategy for the Development and Promotion of Small Business in South Africa' (Kirsten, 1997).

This demonstrates that policy-makers understood that exclusion from formal finance is, in South Africa, heavily politically induced. Earnest political reform set out to address the racial injustice embedded in market structures, supported by the NGO sector and foreign donors. This is reflected in the discussions around the financial marketplace: bankers, regulators, and donors became engaged in the negotiation of changes of the financial system aimed at the 'hitherto unbanked'.[20]

[20] Main positions from that time are outlined in: 'Blazing new Trail', *Executive*, October 1992 (new institutions in the struggle for 'unbanked classes'); 'Banking in the new South Africa' (discussion with Liebenberg, of Nedcor, who subsequently become Minister of Finance), *Banking World*, October 1993; 'Reconstruct - Making homes affordable' (discussion of housing finance and policy)

Since then, a new policy framework has been put in place. Most important in the field that this thesis addresses, Khula Enterprise Finance was set up as a national retailer for financing micro-credit institutions and other forms of small enterprise credit.

In the initial phase of democratic change - before the 1994 elections - several new forms of credit extension to 'unbankable' people were tried out. Some of them focused on business lending, others on housing or on a full range of banking services. These schemes did not adopt a micro-credit approach, but were first steps in changing the frontier of banking in an apartheid-determined economy. Members of the South Africa Black Taxi Association (SABTA) experienced a business boom after liberalisation of the public transport business in the late 1970s and early 1980s (Bank, 1991). Subsequently, the sector experienced sharp capital scarcity. As entrepreneurs from low-income backgrounds, informally operating 'taximen' were clearly beyond the frontier for the formal market of venture capital: they had no proven financial record, no collateral and vehicle finance companies had no experience in dealing with taxi entrepreneurs. However, as entrepreneurs with a firm economic base, little capital and a stable and proven customer base, they constituted an obvious market potential (Khosa, 1991).

Work in Progress, September/October 1993; 'Reconstruction and Development - Where does the money come from?' (Mboweni outlines ANC position towards financing social expenditure), *Mayibuye*, November 1993.

Hence SABTA, itself a formal and established institution, operated a scheme with Wesbank through which it opened access to vehicle finance to its members: SABTA screened and selected its members, aided by its superior knowledge compared to Wesbank, guaranteed their repayments of loans on a group basis and maintained the enforceability of contracts through the leverage it had on its members, and the members on each other. The formal loan contract between financial intermediary and borrower was facilitated through the information and enforcement power generated from informal economic activity.[21] Hence the 'best of both worlds' was combined, extending the reach of formal capital markets, thereby extending Wesbank's market share.[22] However, third-party transaction costs applied because SABTA acted as a broker of information and provider of screening and insurance services, and commanded a fee for doing so.

Another early and bold attempt to combine formal and informal financial technologies was the Community Bank, which opened for business in 1994. Its concept combined, in house, different technologies. It sought to be, simultaneously, a commercial bank and a formalised player aimed at intermediation beyond the frontier. This plan entailed the development of parallel channels for intermediation of both types, like different branches employing different screening methods and selling different types of contracts. However,

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[21] The scheme started in the mid-1980s suggesting that moral suasion was not a relevant determinant of Wesbank's involvement. At the end of 1989 Wesbank had financed R100 million (Barolsky, 1990).

[22] Wesbank was then in the process of re-orienting itself towards the core business, aggressively seeking co-operation with the motor trade (Jones and Scott, 1991).

both channels were meant to benefit from supplementing each other. Because the Community Bank was capitalised through a foundation, it was thought that it could afford to cross-subsidise the administration costs of the soft-loan arm.

However, the Community Bank implemented standard banking practices in inappropriate conditions. It established large banking branches in politically correct, but unremunerative locations, employed large numbers of staff in shiny but idle banking halls, and discovered that their target group of clients was not as eager to open accounts and queue at tellers as anticipated. The combination of high costs and small customer base with low profitability led to financial difficulties. The Community Bank went into receivership in 1996 and attempts were made by the trustees to sell it to a commercial bank.

Other examples of relatively old developments include the Seven Buildings Project and the Permanent Building Society. The former allowed the occupants of seven blocks of flats in Hillbrow to secure mortgages to buy out their buildings; their repayment contracts were guaranteed by peer enforcement. The Permanent Building Society engaged itself in the low-income housing market, but did so in a rather traditional manner. Peer-based technology, in the strict sense, was not applied; 'the Perm' rather attempted to create a progressive and community-oriented image of its activities in order to gain legitimacy. Part of the image campaign was the opening of 'club accounts' aimed at traditional savings clubs.

The current owner, one of the large commercial banks in South Africa, claims this approach was not viable.

The model of the Grameen Bank is the most popular for formalising group credit, but the older example of local credit unions also falls into the solidaristic category. Both ideas had repercussions in South Africa. ROSCAs, locally known as 'stokvels', are organised in the 'National Stokvel Association of South Africa' (NASASA) that makes formal finance available, currently in conjunction with First National Bank of South Africa and with support from USAID. Credit Unions are organised in the Credit Union League of South Africa which pools credit funds nationwide and acts as an international fund-raiser. Many other financial organisations have instituted group credit schemes, among them the Group Credit Company (Cape Town) and the Small Enterprise Foundation (Tzaneen, Northern Province).

1.3 Methodology and Scope

My research aims to tackle deficiencies in economic theory. Policy-makers, bankers and aid workers struggle with it, as the redlining debate, banks' small business schemes and NGO involvement in credit programmes testify, but credit rationing has not yet been analysed in a fashion applicable to the experience 'beyond the frontier'.

Notably, the issue of transaction costs - and banking technology - has not been given sufficient prominence in banking theory, although the technology of producing financial services determines and shapes financial markets and defines access to credit. Mainstream theory has not illuminated why formal banks 'ration' poor customers while informal lenders manage to lend profitably to them. Some have argued that financial innovation implies that formal financial institutions learn from informal lending practices, adapt and imitate their comparative advantages in low-income client bases. Vermeulen (1989), writing about the formal banks' dealings with poor entrepreneurs, asserts that 'the formal sector has to educate itself about how the informal sector works' (p.12). Studies setting out to explain the difference tend to focus on those institutions' transaction costs, or aspects of transaction technology with relevance to information, contract enforcement, and defaults. However, this body of research has a practical development focus and generally lacks coherence. Outside the eclectic field of development theorists, the problems of transaction costs constitute 'one area where analytical rigour so far has not caught up with economic insight' (Niehans, 1992, p. 686).

Within the theory of the banking firm, there are two distinct approaches: First, there are those who see the bank mainly as a place for exchanging liabilities and claims, and second, there are those who see the banking firm as a production unit for financial services (Santomero, 1984). Rationing does not exist in models of the first version, such as that developed by Pyle (1971). He understands the financial intermediary as a holder of financial liabilities and claims, ie deposits and outstanding loans respectively. The banking firm engages in intermediation when there is a positive spread of real expected interest rates. Intermediation, in this model, can be characterised as arbitrage. Baltensperger (1972, 1980) views banks as producing firms and finds that Pyle's approach does not represent the actual production process, ie the combination of resources through which the firm produces value. The production process of financial intermediaries consists of organising transactions, and implies transaction costs.[23] Including transaction costs into Pyle's model precludes intermediation if transaction costs are not outweighed by interest spread. In the traditional view, credit is 'allocated' by intermediaries according to interest rates. Understanding financial intermediation as the production process of services, rather than mere 'allocation' of capital, allows a different view of exclusion from credit; costs and affordability of credit, and other financial services, determine its distribution. Information costs and contract enforceability are important factors in the production function of credit; the costs may thus give rise to perceived 'rationing' where these factors vary.

In financial markets, 'informational asymmetries are the most basic form of transaction costs' (Bhattacharya and Thakor, 1993, p. 8). However, there exists some confusion in the literature about the 'labelling' of cost components: transaction costs are to encompass production, information, enforcement costs and

[23] Because banks production process consists of 'intermediation', the difference between production and transaction costs is blurred. This is different from manufacturing firms, where production costs would describe the resource costs of physical manufacturing. Banks, like other service sector firms, have the facilitation of transactions at the core of their production process.

risk (Coase, 1937; Williamson, 1985), all of which overlap. At issue are all those costs which would not arise if a certain expenditure was self-financed, but which do arise when borrowing is involved (Diamond, 1984).[24] Hence transaction costs encompass two categories of costs. There are, first, real resource costs involved in acquiring, screening, selecting and enforcing contracts, in gathering relevant information, and, second, costs which materialise when bounded rationality, moral hazard and opportunism could not be averted which shows in a (higher) default rate, the subjective riskiness of lending.

Transaction technology determines the costs to individual intermediaries. It 'specifies what resource inputs are required to achieve a given transfer' (Niehans, 1992, p. 683). The internal management and decision structure, and the level of appropriate skills, are the crucial inputs. In most credit market situations, technology also encompasses experience, trust and 'instinctive knowledge' of customers and markets, because they determine the lender's subjective evaluation of risk. Factors beyond the influence of individual intermediaries are also important: the legal system and its efficiency, regulation, and unwritten 'rules of conduct'. In this study, technology is taken to denote the institutional construct, decision-making processes and product choices of a lender. Hence a frontier exists which denotes the limit of the market activities of formal financial institutions:

[24] Diaz-Alejandro (1985) illustrated the peculiarity of credit markets by comparing them with the transaction between a butcher and a 'cash carrying customer' (p. 2). Before the term 'transaction costs' became known, Schumpeter wrote that 'the banker must not only know what the transaction is which he is asked to finance [...], but he must also know the customer, his business and even his private habits, and get, by frequently 'talking things over with him' a clear picture of his situation (1939, p.116). In today's terminology, information costs arise.

Poor entrepreneurs are rationed - behind the frontier - because formal lenders find it too expensive to process small transactions, because the absence of collateral and legally enforceable contracts prohibits normal banking procedures, and because lenders have incomplete information about informal sector activities. It is important to understand that these characteristics impose specific transaction costs on lenders to poor entrepreneurs. These costs are the reason for credit rationing, and not necessarily the commercial banks' malpractice.

This view implies that banks, including micro-lenders, should be seen as 'firms'. As financial firms, they produce services such as credit and savings facilities; different firms may produce different products, although these products are likely to be close substitutes in many cases. The technology these firms apply determines their production function and thus their unit costs. Hence a frontier exists beyond which arbitrage would be possible if there were only negligible real resource costs (in the spirit of Pyle), but the available banking technology prevents the exploitation of this opportunity through the transaction costs it imposes. In this thesis, 'frontier' means the limit of the market activities of formal financial institutions (Von Pischke, 1991). This limit is defined by the technological and institutional organisation of their activity, and by the regulatory framework they are subjected to. The introduction of innovative technology seeks to lower the real resource costs of financial production.[25] In this process

[25] This analysis is relevant to all firms, not only banks. Micro-lenders seek to make credit available to people who were, previously, too poor to afford credit. This mirrors the process of industrial development, during which the costs of producing many consumer products declines so that poor people can afford them, thus raising their net welfare. Probably the most remarkable example is

'unbankable' entrepreneurs become viably bankable. 'The more transaction costs decline under the pressure of financial innovation, the more highly developed will be the division of labour in financial services' (Niehans, 1992, p.685) including the proliferation of specialised lenders beyond the frontier. This view does not understand micro-finance as mere aid projects; rather, innovation stemming from the development of micro-finance is seen as interdependent with macro-economic financial policy and development (Townsend, 1995).

This thesis finds that the paradigm that proclaims participatory financial institutions as the solution to 'banking the unbankable' offers no viable solution for banking the poor. Participatory principles inhibit the scale economies needed to make credit affordable. Community-oriented banking technology is staff-intensive and its unit costs remain high. Therefore, the 'group credit' approach falls more easily into the category of subsidy-dependent development services than into market-enlarging 'Fordist' innovation. The critique of the paradigm, developed in chapter 4, is derived from theoretical considerations and is thus relevant independent of location. The empirical evidence in support of this critique is discussed in chapter 5, while chapter 6 draws on a non-participatory lender to demonstrate the potential of 'lean lending'. In the spirit of 'Fordism', the focus of the analysis is on the unit costs of credit provision - the costs per period of time of servicing one client with micro-credit services - in relation to the

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the introduction of Taylorist production methods, including simplified tasks and division of labour, in the factories of the Ford Motor Corporation, which sparked the mass motorisation in the USA. Micro-credit could lead to a Fordist revolution in the production of standardised, mass-produced financial services.

revenue-generating capacities of micro-loan portfolios. The unit costs of micro-credit production include both the real resource costs of micro-lenders and the portfolio shrinkage due to default. The study shows that group credit is not the innovative panacea for making lending affordable. However, the study also points out that lending to groups and lending to individuals do not create identical micro-credit products. Although micro-loans of various kinds are close substitutes, non-economic factors may influence the choice of lending technology in a developmental context.

While important insights of this study are relevant to micro-credit everywhere, the institutional and social environment of the institutions analysed in chapters 5 and 6 is specific to South Africa. Several commentators have pointed out that 'guilt money' - which is mentioned as a source of funding in chapter 6 - from 'white' corporations is a source of funding only in South Africa. However, it would probably be misleading to conclude that access to funding was unusually easy in South Africa. The fashion of micro-credit led to a shock wave of funding in all developing countries; some cynics have argued that it is excessive funding that plagues the sector, because inefficient micro-lenders are not weeded out. Funding for micro-credit projects may be more competitive in countries with a larger number of functioning lenders. In much of Africa, where micro-credit is not as well established as in Latin America and Asia, donors are rather chasing projects than the other way round.[26]

One important factor that hinders group credit schemes in South Africa from reaching a large part of the poor is crime and violence, especially in urban areas. It is not possible, within this study, to evaluate the effect of crime on micro-lending, nor to compare it with other developing countries. However, several commentators have suggested that Africans are more individualistic than Asians (such comparisons often aim at Bangladesh, the mecca of group credit) and thus not as easily organised in formal credit groups with rules and penalties (Hyuha *et al*, 1990). Again, evidence is scarce and this study does not attempt to quantify any such cultural factors. Further, most commentators point to large differences of attitude within Asia and Africa, even within countries, and warn that vague cultural stereotypes should not be overemphasised.

There is one factor, however, that does set Africa apart especially from South and Southeast Asian countries with successful micro-credit institutions: delivery mechanisms for micro-credit services are more expensive in Africa. One reason for the difference is that the population density is much lower than in Asia, making communication more costly, which is also often aggravated by poor

[26] Notably, Aburgre (1993) and Buckley (1997) are critical about the role and success of micro-credit in Africa.

physical infrastructure.[27] Further, the costs of extension staff and loan officers are higher in Africa. Wages at the relevant educational level - credit officers need good numerical and writing skills - are noticeably lower in Asian countries. This factor is important for the analysis presented in chapter 5. However, it also means that most African countries share the problem of finding delivery mechanisms that promote low-cost production and are efficient in serving poor clients. In response to this problem, micro-lenders in Africa seek to co-operate with the commercial banking sector in order to benefit from its branch network, transmission systems and deposit facilities. South Africa is in a good position in this regard as the country is endowed with a comprehensive, modern and competitive banking system.

[27] For this reason, the explanations given by Yaron (1994) for the success of rural financial institutions in Asia have only limited relevance in Africa, and he emphasises that great caution is warranted when planning to transplant lending technologies to other social environments.

2. Micro-finance and micro-lenders

The previous chapter has outlined the development of the micro-credit movement and the role micro-credit could play in addressing the development needs of South Africa. Although the importance of small-scale entrepreneurs in Africa has been emphasised for decades (Katzin, 1964), Africa has been a laggard in the global development of micro-finance, and regional micro-credit institutions are neither as large nor as advanced as in Asia and Latin America (Morewagae *et al*, 1995; World Bank, 1996; Pal, 1997). Policy-makers and NGOs neither agree on a common understanding of the meaning of micro-credit, nor is there a common understanding of the technology choices for the production of micro-credit.

This chapter suggests that conflicting demands for financial rectitude and moral compassion lead donors and micro-lenders to adopt dual roles with conflicting objectives. While proclaiming their intention to achieve financial sustainability, many mainstream micro-lenders see themselves as agents of social change. Micro-credit technology, however, is inevitably conceived with either objective as the priority. In the first section of this chapter, various alternative micro-lending designs and structures are identified, giving rise, in the next section, to a broad categorisation of micro-lenders into compassionate agents of development and financially prudent market-makers. This categorisation is reflected in the choice of case studies in chapters 5 and 6. In the final section of this chapter, the roles of commercial banks as partners of micro-lenders are discussed; this not only highlights an important part in the development of micro-lending technology, but the form of linkage between micro-lenders and banks has a profound influence on the balance between sustainability and compassion.

2.1 Objectives and Characteristics of Micro-credit

Micro-credit describes seemingly very different forms of financial services offered by equally dissimilar organisations. However, micro-credit always refers to credit extended by formal institutions to individuals or informal groups. Such formal institutions have been set up by donor aid and usually continue to receive support for many years. Very few micro-credit institutions have been transformed into for-profit organisations, and none have been successfully set up as for-profit. Micro-credit concerns very small amounts; in South Africa initial loan amounts vary between R200 and R600. Although business development is often a major rationale behind micro-credit programmes, micro-credit is also used for construction, emergency consumption, education and social expenditure.

As an intertemporal financial transaction, micro-credit is subject to the problems of asymmetric information, bounded rationality and opportunism. However, micro-credit also faces the problem of delivery costs, which are usually neglected in models of financial intermediation in established financial markets. Micro-credit deals with small loan amounts, tiny, but frequent repayments, and rapid loan roll-over; therefore, the unit costs of making, receiving and recording payments are an important determinant of total lending costs, and cost-efficient delivery systems assume great importance. Because micro-credit is a developmental tool, the social dimension is sometimes seen as equally important, or even paramount, in decisions of programme design and technology development.

Selecting and benefiting a target group

Micro-lenders are not established merely through the need of poor people, but by the decision-making of donors who first identify a social or developmental objective. Such an objective usually makes reference to the need for credit amongst a specific group of people. In broad terms, the beneficiaries of micro-credit are thought of as 'the poor' or 'the disadvantaged'. However, there are important sub-divisions, and there may be problems in reaching the target group.

Some lenders specifically target micro-credit at women. Women are usually seen as economically less independent than men in the same social group, and benefits from their economic empowerment are argued to extend more directly to their children. Therefore, women are often seen as more desirable borrowers, from a social equity point of view, than men, and there is a large number of micro-lenders who explicitly aim at the empowerment of women. Another important group at which micro-credit is sometimes targeted is young people. With high youth unemployment and insufficient job creation by the formal sector, school-leavers face disillusion and an unemployed, impoverished youth may well be seen as a threat to the social fabric of society. Alternative target groups may comprise rural people, because they are seen as unable to benefit from development and employment creation in cities and towns. In fact, much of the debate about micro-credit takes place under the title of rural finance, although the two are not necessarily the same.[1] Finally, other social criteria for selecting a target group may be factors such as ethnic identity or nationality, or factors of social disadvantage like a physical disability.

Targeting specific sections of the population has not only social but also economic implications. There are two sides to it: first, different groups may be variably efficient in utilising micro-credit in creating viable enterprises, and second, different groups typically have different repayment patterns, thus affecting the sustainability of micro-lenders. Therefore, the social desirability of lending to a specific group of people does not imply the financial sustainability of lending to them.

In most credit schemes it is found that women are better repayers: they pay more punctually, and they default less often than men. Hence, the targeting of women appears not only socially desirable, but also furthers financial objectives. Lending to youth, though, is different. Young borrowers typically have lower repayment rates than older borrowers. So, while it may be seen as socially desirable to lend to

[1] The Ohio School economists, who were influential in preparing the ground for the micro-finance movement, addressed themselves to rural finance (Von Pischke *et al*, 1981). Still today, micro-finance is more often directed at rural than at urban people, although the latter are often easier to reach.

youth, there is a specific risk premium attached. And not only is it more expensive to lend to youth, they also appear to be less successful in using the loans for setting up viable enterprises. Reaching the rural poor is difficult: it is expensive to maintain outreach structures in rural settings with poor infrastructure and low population density. However, some research has argued that higher social stability in rural communities aids the reliability of financial relationships. Similar considerations must be applied to any other potential target group that may be identified: Why is it desirable to lend to them, and what are the social and economic effects of targeting them? How does a specific target group affect the sustainability of lending programmes?

Identifying a target group is only the first step in securing its access to credit. In many cases, targeted credit has missed its intended beneficiaries as it was abused by those in positions of power. Some micro-lenders restrict their services to women, or youth, or rural communities; such targeting can become the victim of fronting, the practice of presenting a loan application not through the intended loan user (Goetz and Gupta, 1996). Other lenders structure a programme so that it primarily appeals to their intended target group but does not explicitly exclude others. In this case, there is likely to be a leakage, an outflow of lending capital to non-target group borrowers, as non-members of the target group participate.

Some credit schemes do not seek to target their loans to any specific use, assuming that poor people themselves know best how to better themselves, and that some apparently consumptive expenditures may well have investment properties. Others allow borrowing only for income-generating purposes and seek to control loan use through strict follow-up procedures. The view and objectives of donors often determine the choice, but it is important to emphasise that follow-up procedures are costly. Therefore, verifying the supposedly socially desirable form of loan utilisation could potentially undermine the viability of micro-lending.

More controversial, generally, is the question whether specific sectors are more promising for the establishment of small enterprises, and whether loan availability should be made conditional on the sector identified in business proposals. Many new business ventures at the micro-level are in fact based on trading activities, either hawking or operating tuck shops. Arguably, the establishment of more trading enterprises in specific locations does not increase the purchasing power of their clientele and offers few developmental benefits. More traders thus imply reduced profits for those already in business, and potentially undermine the viability of all. Therefore, so the common argument goes, micro-credit should be directed away from trading activities. Opponents of this view hold that trading is often the start of a more creative enterprise; trading profits can be reinvested into manufacturing equipment. Empirical evidence suggests that such transformation does indeed take place.[2] Following such a decision about the desirability of

[2] Some micro-lenders start, however, from the explicit objective of furthering manufacturing or skills-based economic activity. While trading may be fully acceptable as a survivalist activity, it is less compatible with industrial policy motives that may underlie micro-lending. Therefore, the objective of the lender should inform the decision concerning the sectoral targeting of credit.

directing credit, it should be considered whether it is also feasible: especially in micro-lending to the very poor, it is difficult to vet business proposals and to follow up loan use. In these cases, targeting could be inefficient due to the practical problems of enforcing compliance.

In many micro-credit programmes, there is an intimate linkage between training and credit.[3] The benefits of linking credit with training are many; from the perspective of micro-lenders the most important effects are self-selection and capacity building. While many people will want to borrow, fewer are prepared to undergo training in order to become eligible for credit. Those who are, arguably, are those more determined to run their business, and to run it well. Further, most entrepreneurs are unaware of their skills deficiencies, and therefore they are unlikely to seek training voluntarily (Briscoe, 1995). When access to credit is conditional on undergoing training, many come to appreciate its value (see chapter 8). However, training is costly both for borrowers and lenders. In order to benefit poor people, training needs to be subsidised, which requires resources either from micro-lenders' donor or interest income, or direct support from government or international aid. The decisions on financial support for enterprise training are usually taken with the benefits of training in mind, not micro-credit. Further, training is costly for potential borrowers if they value their time. Especially

[3] Training can be offered basically in two forms: there is vocational training to equip entrepreneurs with the technical skills needed for running a service or manufacturing enterprise, and there is business training to help entrepreneurs to cope with the managerial aspect of running their own enterprise. Technical skills training requires more generous funding and typically takes much longer. Business skills training can be fruitful on a very basic level, and is often urgently needed prior to set-up.

business owners may find it difficult to allocate their time to not directly productive activities.[4] Training, on the other hand, makes it administratively easier to target and benefit a specific target group than credit as it does not involve fungible assets - human capital is not transferable and can neither be stolen nor appropriated.

Technical details: Loan size, interest rates and savings requirements

Many NGO officers tend to argue that loan size follows the decision of the target audience: if the very poor are aimed at, then loans should be very small. If the capital requirement of entrepreneurs is high, loans need to be large. This view defines loan size from the perceived loan needs of the borrowers. However, this misses one fact: many successful micro-credit institutions control access to future credit to enforce repayment. Access to future larger loans is made dependent on punctual and full repayment of small initial loans. Such staging requires that entrepreneurs are kept hungry for capital.[5]

Mainstream micro-lending literature agrees that charges and interest rates need to be set high enough to cover costs (Robinson, 1996). Theoretically, most micro-

[4] In response, some lenders have organised very short training courses, some taking as little as two hours. The benefit of very short training will be much reduced, both in terms of self-selection effects and learning. But it may still pass on basic business knowledge, especially when concepts such as interest, capital, credit and repayment need some explanation.

[5] Loan staging in micro-credit is similar to the assessment used by credit-card companies which base overdraft limits, partially, on repayment history. Generally, loan decisions in the micro-field are more similar to those in consumer lending than those in formal business finance. Lenders should not assess the debt - ie repayment - capacity of their clients through analysis of their loan application or their business; rather, debt should be made available according to repayment capability based on current income.

lenders agree, yet few follow this general rule. Obviously, inefficient lenders could experience problems if they tried to charge interest rates reflecting their true cost level. However, there is no efficient market yet in Southern Africa for the provision of credit to the poor. Hence price determination depends on a variety of factors, including concepts of 'fairness' (Dichter, 1996). Redistributional objectives sometimes influence the level of interest rates, or the range of services offered. Although even large and supposedly successful institutions subsidise their interest rates, the paradigm on cost-recovery persists. Finally, it should be noted that several countries legislate interest rate levels, or usury laws set a maximum interest rate that is legally chargeable. Financial liberalisation has removed such limits in most countries, or micro-credit has been exempted from such legislation.[6]

Charges, such as membership fees, can be used to disguise interest rates. However, most micro-credit programmes offer more than merely loans; typically, business advisory services are available free of charge, some schemes offer insurance or bonus payments, and some even more extensive support relating to social and economic issues (Fuglesang and Chandler, 1986; Von Pischke, 1991). Micro-lenders may then argue that charges and high nominal interest rates contain payment for these non-credit services and are not usurious. In any case, the determination of the 'real' interest rate, relating to the costs of credit only, is methodologically difficult. Also, micro-lenders may generate income from non-

[6] Loans below R6000 are exempted from the usury act in South Africa. In Mozambique, the central bank does not enforce regulation that could hinder micro-lenders, while in many other Southern African countries lending does not require administrative approval.

credit services, for example by selling business implements to their clientele. Some institutions have used such lines of business successfully to establish their viability.

Many micro-lenders require their clientele to accumulate savings both prior to borrowing, but also during borrowing. Savings can perform various functions: people who save may be more prudent, so arguably they make more reliable borrowers; savings behaviour helps to determine their debt capacity; and savings can be used as 'collateral'. Thus, self-selection, screening, and enforcement may be aided by savings accumulation. However, savings requirements have disadvantages: they exclude potential borrowers, they slow the expansion of credit extension, and they seem to contradict the very logic of micro-lending. One important question, fought over with vigour in South Africa, is whether savings should be used to 'hide' real interest rates. Especially when savings are pledged as collateral, the difference of deposit and lending interest rates provide arbitrage profits for the lender. There is an unresolved discussion whether such profits are a justified means for making micro-lending schemes viable.

Although many micro-lenders incorporate into their lending strategy a compulsory savings component, only few operate discretionary savings schemes; no major micro-lender in Southern Africa offers discretionary savings services. Such schemes can appear desirable as savings mobilisation and the development of full financial intermediaries are higher policy objectives than the formation of mere subsidised lenders (Frimpong-Ansah and Ingham, 1992). However, discretionary savings schemes are relatively expensive to run and may not be easily compatible with the demands on an efficient micro-lender, although micro-lenders may use their clients' deposits as loan funds. Besides regulatory implications, this is an important factor for the viability of a micro-lender (Chaves and Gonzales-Vega, 1994). Some institutions claim that their savings scheme provides a low-cost source of funds for their lending operation (Lepp, 1996). However, micro-finance schemes with substantial savings business tend to operate in densely settled parts of Asia, where low-cost educated labour is available for staffing branches or mobile savings collections (Scheepens, 1974; Winterhalder, 1992; Robinson, 1994). In Africa, micro-savings services are generally expensive to produce in the formal sector, and informal savings collectors continue to enjoy a comparative advantage (Hyuha, 1983; Seibel and Marx, 1987; Gurgand *et al*, 1996). Unless alternative funding is prohibitively expensive, it seems the economically preferable alternative to concentrate on lending. The costs of operating savings schemes, therefore, need to be justified within the context of savings policy, not micro-credit.

2.2 Groups, moneylenders, and the character of micro-lending NGOs

For many participants in the debate on sustainable lending to the poor, micro-credit and group credit have became almost synonymous. Especially sustainability, high repayment rate, and outreach became associated with terms such as solidarity and peer pressure. This association is arguably attributable to the well-publicised successes of the Grameen Bank in Bangladesh (Hossain, 1988). Individualistic credit is often neglected as compared with solidaristic models. However, international experience is more diverse; evidence suggests that sustainability and cost efficiency may be achieved without the so-called 'group methodology' (Chaves and Gonzales-Vega, 1996). In fact, the decision of adopting a group-based, Grameen-style lending method or lending to individuals is probably the most important factor in determining the lending technology of micro-lenders.

Group lenders have extensive relationships with their clientele. Often, they offer advice and support that is quite unrelated to enterprise development. Social empowerment, even health matters, are often discussed, and sometimes social gatherings - parties - are part of their working procedures. Frequent meetings are an important part of group lending schemes: they are crucial to the transparency and information sharing on which joint liability depends. Meetings are usually fortnightly, with an attendance of around six borrower groups, usually around thirty borrowers, and are attended by a credit officer. The function of meetings, and other forms of social interaction, in group credit schemes is not purely economic; while meetings are part of the credit operation, they also have a social role. Group credit schemes have, therefore, more functions than credit extension alone. Both their organisational form and their social function indicate the origin of group credit schemes in informal, communal institutions. Most important, ROSCAs are the model for the grassroots groups organised by Grameen-type lenders.

While group credit schemes tend to follow the Grameen Bank model, micro-lenders which offer credit to individual borrowers are more diverse. In the absence of group discipline, they seek to find sufficient security for repayments in other forms, including identifying collateral, requiring training, establishing a savings record, or formal third party repayment guarantees.[7] Individual lending emulates the lending strategies and the diversity of informal moneylenders. Platteau and Abraham (1987, p. 461) define this type of lender as a 'credit-giver [...] who aims at earning regular income from lending his money at profitable rates of interest'. Adams notes that "[m]ost moneylenders operate on a small scale, extend loans mainly out of their own funds, and restrict lending to less than a hundred or so individuals" (Adams, 1991, p. 31). Moneylenders, as opposed to informal self-help groups, are motivated by profits and thus subject to criticism about exploitation of power and dependence.

The observation of high interest rate has given rise to arguments of 'usury' and to the 'default hypothesis' (Bhaduri, 1977). Both claim that borrowers on

[7] Several credit schemes now exist that do lend to individuals with great success. The safeguards they apply range from training requirements to credit rationing; some require that borrowers pledge savings as security; others tap local knowledge by requesting 'character certificates' from local worthies who are compensated according to the performance of their flock. Through various mechanisms, these rules create an incentive structure that penalises default, forced withdrawal, from the scheme. Several studies show that micro-lenders that apply such safeguards for lending to individuals extend credit efficiently, taking into account both administrative costs and defaults (see chapter 6).

underdeveloped financial markets are exploited through monopolistic structures, and the class character of surrounding polities. In general, more recent authors tend to argue against the 'usury' allegation, pointing out that interest rates in small-scale, informal lending are high because lending costs are high (Bouman, 1980; Adams, 1980; World Bank, 1989). However, the argument points to the importance of the social environment in which financial markets operate, and on which peer banking depends. Harriss (1980) reports that competing moneylenders share information about 'bad risks' between them, but finds no further co-ordination or collusion. In fact, she encountered lively competition between various types of moneylenders based in villages and market towns, and between credit from full-time lenders and trade finance offered by merchants.[8] Such competition could benefit potential borrowers, if they are geographically and personally flexible to seek credit from the most competitive lender. Otherwise, the existence of multiple forms of moneylenders may not lead to effective competition, and 'usurious' interest rates could extract a monopoly rent from borrowers. A number of reports from South Africa support the notion that informal moneylenders are actively competing.[9] In other countries, though, rural communities are characterised by extensive patron-client relationships. This may

[8] On the other hand, Adams (1991) reports about moneylenders who never acquired new customers, had inherited old ones together with the business from their fathers, hence never had to evaluate new risks.

[9] Preston-Whyte (1991) writes about small-scale female traders with access to multiple financial arrangements, Khosa (1991) makes the point with regard to venture capital, including informal lending by whites, van Rooyen (1995) lists the many options of poor people in the Western Cape for borrowing both formal and informal sources.

limit the choice of poor people to select their lender, and thus position the borrower in a disadvantaged power situation.[10]

However, in an environment where efficient markets are absent, and information is available only through informal, personal channels, such patron-client relationships may have positive effects on credit availability. Credit in informal markets is sometimes extended as part of a wider bundle 'in which two or more interdependent exchanges are simultaneously agreed upon' (Basu 1984, p. 149), similar to trade credit in formal markets. The interlinking of different transactions has been analysed as a means of reducing both risk and real resource costs, as merchants, employers, and landlords may posses information and leverage about their clients. In the absence of such skewed power relationships, credit could be rationed rather than offered at 'usurious' terms. Arguably, the ability to borrow at 'usurious' rates is preferable to not being able to borrow at all.

The same rationale underlies the defence of high levels of interest rates of micro-credit. Micro-lenders are compassionate institutions, but at the same time the current paradigm holds that social objectives are best achieved with cost-covering

[10] Similar debates are taking place in South Africa around formalised types of moneylenders: loan-sharks. Although grouped in the 'Association of Micro-lenders', these firms offer small scale credit that would not normally be described as micro-credit. They typically lend to people in financial distress at very high interest rates, up to 30% per month. These micro-lenders only lend to formal sector employees who have bank accounts and ATM cards. When applying for credit, borrowers have to show their last three wage slips and have to surrender their ATM card and PIN number. On pay-day, the lender withdraws repayment directly from the accounts of borrowers. This form of lending is commercial loan sharking. This thesis does not pass a verdict on loan sharks and their benefit to society, but it is concerned with developmental lenders, who design their lending programme with a view to poverty eradication, not merely profit.

interest rates (Robinson, 1996). This view is supported by the argument that many small-scale entrepreneurs are more concerned about access to credit than about its costs. In addition, group lenders need to consider that social interaction is time-consuming, both for borrowers and for credit officers. Therefore, group credit is more expensive than nominal interest rates suggest if borrowers value their time. Also, and maybe even more important, the time-consuming nature of interaction between borrowers and credit officers limits the number of borrowers who can be served by a credit officer, but preserves a personal relationship between micro-lender and borrower.

While most recent literature is optimistic about solidaristic institutions, there are few reports about innovative, individualistic institutions.[11] For both types of micro-lenders alike, strategic choices relate to the level and kind of customer contact, the screening of credit applicants, the use of computers, automated teller machines (ATMs) and branch networks. The products can, for example, be tailor-made or standardised, they can be provided at the customer's doorstep in the local language or by telephone in English. Answers to these choices give rise to one of two concepts of poor people's banking; these concepts define two alternative technologies for the 'production' of micro-credit.

[11] One of the few is the excellent account of the 'Syndicate Bank' by Bhatt (1989). He correctly places this Indian 'poor people's bank' in the context of financial innovation. The Syndicate Bank does not rely on credit groups, but on the willingness of individual customers to build up a financial record, based on regular savings, prior to their first loan. Screening and enforcement was based on motivated locally based bank employees, thus altering the nature of the 'peer' relationship and incorporating it in the bank structure. Another important contribution reports about viable and efficient lenders in Indonesia (Chaves and Gonzales-Vega, 1996). Government owned banks there lend to poor people in the basis of savings record and local knowledge of staff at branches. They identify as important the incentive structure that rewards local loan officers for good performance.

- There are those who see 'banking for development' as a requirement for a full support structure that enables disadvantaged communities to gain confidence with financial matters. Their banking technology typically encompasses educational aspects, their approach would be personal, supportive, community oriented.
- The opposite strategy focuses on economic viability. It would seek to provide some crucial service at minimal costs and accepts the need for standardised procedures.

The division is one between a full-service, high-cost lender and a standard-service, low-cost lender. Ideologically, the difference is between proponents of a development service that poor people are entitled to, and providers of a market-making product that enhances the efficiency of the national economy (Cotter, 1996). Group credit schemes are, by the nature of their operation, caring organisations with a human touch. Lending to individuals can be designed in a 'Fordist' manner, because extensive personal contact and social relations between borrowers and lenders are not an intrinsic part of their technology.

In fact, some commentators have suggested differentiated roles for these two types of micro-finance models. According to this line of thought, group credit is better suited for poverty-oriented programmes while individual lending is for the less poor and the development of their enterprises. Kesterton argues that 'group methodology appears to be highly suitable for poverty alleviation, [but] it would appear to constrain the budding entrepreneur for whom individual lending becomes more appropriate' (1994, p. 37). Buckley, summarising the lessons from two Kenyan lenders, contends that 'it is necessary for micro-enterprise lenders to segment the market correctly for their loans and to determine their primary objective, which could be poverty alleviation or business growth' (1996a, p.327). Seibel finds, on the basis of Asian experiences, that '[b]y adopting group technologies, microfinance institutions may greatly increase their outreach, particular to low-income people' (1998, p. 1). In practice, the choice of lending technology is rarely determined by the focus on either poverty alleviation or micro-enterprise development. 'Many programmes assumed that in making credit available for income-generating activities they were both alleviating poverty and creating enterprise' (Kesterton, 1994, p. 33) and thus often fail to prioritise one with sufficient clarity.[12]

The differentiation between full-service and low-cost lenders has similarities to an earlier debate in development circles about the appropriate approach to credit for poor people, the integrated versus minimalist debate. Centred on the policy objectives around poverty alleviation and eradication, proponents of an integrated approach argue for the need to extend credit only as a component in a wider bundle of social services, and have sometimes used related arguments in favour of full-service micro-credit (Sharif, 1997). Sometimes, such a strategy is cast in a

[12] The most notable exception are those schemes that combine a group credit programme for their poorest clients with a individual lending programme for more mature borrowers. One such scheme, the Rural Finance Facility, is discussed in chapter 5.

class-oriented perspective, favouring the social mobilisation of the poor and the politicisation of credit (Sobhan, 1997).

To many in today's micro-finance movement such an approach sounds unfamiliar and sometimes even rebellious. However, there is historical precedence for the integrated, or 'radical', approach. Both the rural German co-operative movement in the 19th century as well as the credit union movement (both discussed in greater detail in chapter 3.2) had clear emancipatory objectives and emphasised social mobilisation as a means. However, neither had a class-oriented political agenda.

However, in modern development practice holistic institutions, or schemes, exist which combine mentoring, training, marketing and financing support to small enterprises. Because of the close contact of their staff with their beneficiaries, lending decisions are taken in a context jointly with other interaction. From the perspective of integrated organisations, group lending appears 'large-scale' credit delivery, because the close interaction between support staff and beneficiary is replaced by the weekly meeting and peer support. Hence group-lending, which I classified as 'full service', is being criticised for not including the support of the integrated package and for reducing support to 'optional extras' around credit delivery.

The weakness of the integrated approach lies mainly in its difficulty of defining its desirable form of credit extension. Criticising any institution that sees credit as its core contribution to poverty eradication, and reduces other functions to ancillary roles, proponents of the integrated approach find fault with 'full-service' institutions such as the Grameen Bank. Chiding its reliance on credit, and its objective of achieving financial sustainability, they would at the same time applaud its community development focus, and its participatory empowerment ethos. In fact, the diverse schools of thought representing the integrated approach appear, at times, uncertain whether group credit could be counted as integrated. Group credit institutions have sometimes invoked the integrated rhetoric to justify their persistent reliance on donor funding. Berenbach and Guzman write that 'some programs have used the minimalist debate as a veil to divert attention away from their own highly cumbersome and inefficient operations' (1994, p. 138).

All major institutions involved with micro-finance today - both internationally and in South Africa - fail to pass the strict integrated criteria.[13] Micro-finance institutions typically strive for financial sustainability and accept that their status as a donor-dependent NGO is temporary. They see themselves as financial institutions and expect their lending programmes to stand up to economic criteria, although non-economic benefits are to be achieved through their lending.

[13] One integrated organisation in South Africa, the Triple Trust Organisation, is discussed in chapter 5. It describes its activities as 'training and support for emerging enterprises' and sees its loan scheme as a subordinate function. It is insignificant as a micro-lender, but constitutes the 'old' model of development lender prior to the rise of micro-credit. Several critics of 'new' micro-finance approaches have argued that this old model represents a different, but still valid approach to enterprise development (Dichter, 1996).

Prominent micro-lenders have transformed themselves into banks or other types of private-sector, independent organisations (see section 2.3).

There are, though, a number of institutions which, mostly for historical reasons, focus on emergency relief or social mobilisation and which extend credit as one of their many functional objectives. These institutions do not see themselves as financial institutions, and they are not operating on the same logic. In consequence, welfare-oriented NGOs would be advised not to venture into credit without good reason (Dichter, 1996). The literature on micro-finance mostly agrees that credit extension and other financial services are best separated from other services (Robinson, 1996). As these organisations do not intend to become part of the financial system, nor have a significant impact on credit extension, they are better understood in the context of poverty alleviation and enterprise promotion than in comparison with aspiring financial firms.

The problems encountered in the micro-finance literature in locating group-credit micro-lenders decisively in either the integrated or the minimalist camp demonstrates one fact: micro-finance institutions have laid claim to the moral values of traditional NGOs and also to the financial rectitude of private sector financial institutions. All modern micro-finance institutions are trying to combine the seemingly incompatible. However, the demands and expectations of donors and policy-makers, who see micro-credit as both a development tool and a form of viable intermediary, leads to a clear distinction between two types of micro-lenders: those who provide a business service in an infant industry situation, and thus focus on financial viability, and those who see themselves as a comprehensive development and empowerment agency, and thus emphasise social change. With appropriate arguments, both approaches can be justified. However, many donors and micro-lenders hold on to unreasonably optimistic hopes of being able to combine the best of business mindedness with charity and compassion. Therefore, donors as well as lenders evade some hard choices; this may explain why many micro-credit schemes in Southern Africa promise to deliver on conflicting objectives.

2.3 Micro-credit and financial markets - linkages and technology

In the search for sustainable, market-oriented models for micro-enterprise credit, the traditional relationship of credit-giving NGOs with donors is increasingly supplemented, sometimes superseded, by another: linkage development with commercial banks. Linkage creation, so it is often argued, supports the integration of 'compassionate' lenders in mainstream financial markets, facilitates the market orientation of donor-financed organisations and thus enhances the effectiveness of intervention aimed at helping the 'unbankable' (McGuire and Conroy, 1997). While the desirability of linkage development is almost universally accepted, its meaning is usually not fully explored.

The discussion about linkage creation, and the role of non-profit organisations in profit-oriented financial markets, is often blurred by the more fundamental problem of defining the objective and social aim of such organisations. Can micro-lenders be turned into banks and is this desirable? How do charity and market forces interlink? Can an organisation that is exposed to competitive forces still deliver the social goods expected of it as a compassionate institution? It has been argued that there is an inherent contradiction in expecting NGOs to be market participants, and to perform well on commercial criteria (Otero, 1994; Dichter, 1997). While this view is certainly relevant, this section outlines forms of co-operation between commercial financial institutions and micro-lenders that are beneficial for both. Such co-operation brings micro-lenders closer to the commercial market, but does not necessarily relegate them to it. The form of co-operation, surely, is not merely one of technical convenience or financial compatibility; crucially, it depends on the character of the micro-lenders.

The forms of linkages that micro-lenders can form with established financial institutions vary widely, depending on financial regulation and development, demographic and economic conditions, and the 'mission' of micro-lenders. In many instances, linkages are seen as access to capital for making loans, gained from commercial banks. This 'traditional' view sees this as access to loans for micro-lenders, equipping them with the necessary funds for lending to their clientele. Also, credit or default insurance is a major venue where commercial financial institutions meet micro-finance. The choice between capitalisation and risk insurance is essentially determined by the nature of the micro-lender involved. Capitalisation can be used to subsidise a loss-making micro-lending scheme. Default insurance can, in the absence of additional subsidies, only be applied to sustainable lending ventures. Those micro-lenders who choose to seek indemnity for their loan portfolio typically are the more business-oriented. Both forms will be briefly surveyed, but not analysed in detail, because they are basically forms of funding micro-credit operations. However, non-capital linkages are arguably of greater immediate importance for designing appropriate lending technologies in Southern Africa.

Capitalisation for lending

Grants and subsidised loans delivered directly by donor agencies have been criticised as incompatible with modern, credit-granting NGOs. They allow no leverage and therefore quickly exhaust available resources. Except for new start-ups, direct donor capitalisation could be phased out for micro-lenders who seek and approach viability. Therefore, access to capital through commercial financial markets and institutions has occupied much of the discussion of linkage creation. In principle, there are two ways for attracting capital from financial markets: loans and equity. Loans are the better travelled route; attracting equity remains the rare exception. Both will be discussed in the following.

Wholesale credit denotes large-scale lending by established large financial institutions to micro-lenders for loan capital, ie to expand their loan portfolio. A typical lending model involves a commercial bank, usually in a donor country, and a development finance institution. The development finance institution, through its own reputation and capital base, attracts loan capital from financial institutions at a lower interest rate than micro-lenders could; but it then lends funds on to those micro-lenders. In its lending practice, the development finance institution mirrors market-oriented decision-making while promoting projects that are not adequately integrated into financial markets. In practice, development finance institutions are usually set up by governments in donor countries, and their share capital stems from public sources in these countries. Borrowing by development finance institutions constitutes, in effect, public borrowing of donor countries. Lending by development finance institutions is often equivalent to direct donor capitalisation. From the micro-lenders' perspective, the relationship with their source of funds differs little from the traditional donor relationship.

Alternatively, donors often facilitate a direct link between micro-lenders and the commercial banking sector in recipient countries. Donors give a credit guarantee for loans provided directly by commercial banks to micro-lenders for on-lending. Such guarantees cover the risk of lenders becoming unable to repay their loans; thus the interest rate would reflect a reduced risk premium, but would otherwise be market-oriented unless further subsidies are provided. This, in turn, requires micro-lenders to be able to achieve a market-related return; interest income less lending costs and defaults must be sufficient to cover the costs of borrowing funds from banks.[14]

In both models, the interest rate payable by micro-lenders is, in effect, subsidised as it rarely reflects the appropriate, market-determined risk premium. Further, when loans are provided directly by international development finance organisations, the interest rate is often set below market level. Such profits may then be used to cross-subsidise micro-lending operations. Hence, loans with low interest rates can be used to provide substantial subsidies, even where the core micro-lending activity is loss-making.

Capitalisation through subsidised loans or grants is usually chosen by institutions with high operational costs, or during the set-up period. Once lending approaches viability, a micro-lender may be able to afford market-related loans, as long as credit guarantees assume some of the risk associated with marginal lending. There are other factors, however, that may affect the choice between seeking loans or guarantees from donors. One is exchange rate risk: many donors lend only in their home currency. A credit guarantee allows access to credit denominated in the recipient's home currency, thereby removing the exchange rate risk. Another important advantage, from the recipient's view, is that sourcing credit from local

[14] One example of such a relationship is the credit guarantee provided by Appui au Develloppement Autonome (Luxembourg) to the Start-Up Fund in South Africa, which used it to borrow from a local bank. In some countries in Africa, commercial banks are hesitant to lend to micro-lenders, even with guarantees, unless substantial subsidies are offered as incentive.

commercial banks furthers the institutional development of the micro-lender and supports its innovation.[15]

The opportunities of equity capital, rather than loan capital, for financing micro-lenders are often neglected. Partially, this derives from the view of micro-lending as a social and developmental, rather than a commercial enterprise. As such, it is often held, micro-lending requires 'soft' sources of equity, usually donors or 'social responsibility funds' which do not expect a market-related return on their investment, or may provide grants. However, several micro-lenders have shown that a real return can be earned from loan funds in micro-credit. In such cases, attracting profit-oriented private equity investment becomes an alternative to the usually more restricted donor funding. Private sector equity investment is theoretically available in unlimited quantity; therefore, expansion of a micro-lender may then depend not on access to funds, but on the lender's ability to use funds adequately and profitably. If a lender attracts private investment capital, management also enjoys a higher level of autonomy in comparison to donor-funded organisations.[16]

[15] The point that involvement of banks with small enterprises furthers learning effects is also made by Levitsky (1997). Through credit guarantee schemes, he argues, banks may be induced to lend to small enterprises and thus learn about this sector. Over time, the implicit subsidy entailed in the credit guarantee scheme may become redundant. The same argument could be replicated for credit guarantees extended to micro-lenders.

[16] Several assumptions of capital markets, though, do not hold for micro-lenders as institutional investors dedicate a portion of their portfolio to 'socially responsible' investments. Other banks, such as the Co-operative Bank in the UK and Triodos Bank in the Netherlands, seek to invest all their assets in socially desirable projects. Finally, development finance companies such as the International Finance Company are able to provide equity to leverage the involvement of private investors.

There are very few examples of equity investment in micro-lenders. Some, like the Grameen Bank, have private shareholders, but these are not true commercial investors. Rather, their clients are required to acquire one share each. Share ownership is a vehicle for creating a stable, long-term relationship, not portfolio investment (Von Pischke, 1991, pp. 240-1). However, several micro-lenders have 'formalised' their operations and become licensed banks. One well-known example is the transformation of Prodem, a micro-finance NGO initiated by ACCION International, into BancoSol in Bolivia (Glosser, 1993; Mosley, 1996). Typically, former NGOs choose to vest a large part of their equity in their clients; a standard way may be to register as a mutual bank, such as Cash Bank in South Africa. Fewer former NGOs have targeted outside investors other than development finance institutions. However, the Start-Up Fund even plans to become a quoted company at the Johannesburg Stock Exchange. Formalisation as a for-profit organisation has, however, also adverse effects on net income because of tax liabilities. Some micro-lenders, such as ADEMI in the Dominican Republic, have chosen to remain non-profit organisations although they are highly profitable.

Risk management

Credit insurance is a common tool in micro-lending. In many cases, insurance is used to make marginal lending 'market-acceptable' by having the risk borne by 'soft', donor-supported funds. The bank guarantees discussed above are one form of credit insurance, made available to commercial banks, by donors, for the benefit of micro-lenders. For controlling the lending risks of micro-credit, however, forms of insurance are important which are made available to micro-lenders with the intention of insulating them against erosion of their loan portfolio through defaults. This form of insurance seeks to steady the income flow and avert the threat of insolvency of the micro-lender. Such insurance can be provided in three forms: several micro-lenders maintain very high cash reserves which serve as an informal insurance against cash-flow problems; other lenders established their own, dedicated, but separate indemnity trust to cover their own defaults; and finally, indemnity companies have been set up to offer portfolio insurance services to a wide range of lenders in the micro- and small enterprise field. Such indemnity schemes are usually donor-financed.

The strategy of maintaining high cash balances is not a form of insurance in the strict sense. However, it is important to note that reserves perform the role of insurance. Maintaining high cash balances is the preferred option mainly for credit-granting NGOs which have easy access to large amounts of funding at low cost. Funds which are kept as reserves cannot be used for loans, hence they reduce the lender's outreach.[17] Holding funds as reserves is only an option if their return, by investing them on short-term money markets, is above their cost. If cheap

[17] The role of holding large reserves as a means of insurance could be compared to the capital adequacy requirements that are imposed internationally on banks. However, the size is significantly different: under the Basle Agreement, commercial banks are required to have between 0 and 8 percent of capital for the loans they grant. Micro-lenders were reported to use between 50 and 500 percent of their micro-credit portfolio as 'reserve'; investing this amount on commercial money markets (Von Pischke, 1991).

donor finance can be profitably invested in domestic money markets, that income can become larger than that from the micro-credit portfolio. In this case, the institution acquires long-term sustainability while simultaneously insulating itself from the performance of its micro-lending activities. However, this strategy requires donors to provide capital far in excess of loanable micro-credit funds, and it has the implication of subsidising a micro-lender. Institutions which have used this approach include the Grameen Bank (Hossain, 1988), the Women's Finance House Botswana, and the Small Enterprise Foundation in South Africa, which will be analysed in chapter 5.

Micro-lenders have in some cases chosen to set up an indemnity fund as a separate corporate entity for their own portfolio insurance needs. Such a structure facilitates better accountability in combination with close linkage between lending and insurance activities. Insurance premiums, in such a model, are usually deducted from loan pay-outs. By separating lending and insurance functions, the potential viability of lending alone can more easily be established. As a separate entity, the lender could become viable or profitable, although as a joint operation the lending scheme is not. Establishing a form of partial viability offers easier and cheaper sources of finance, as was shown above, than one combined, loss-making operation. If defaults render the insurance side unprofitable, but the indemnity fund can cover its costs, then grant finance can be used for capitalising it. The lender may then seek commercial finance for expansion of the credit portfolio. Therefore, this option is attractive to micro-lenders without access to generous amounts of cheap funding. Credit insurance in this model can be provided for the full loan amount. The structure of insurance, including the timing and payment of premiums, can be incorporated into the lending structure, yielding a unified and consistent product.[18] However, if the default risks of the clients of one micro-lender are not independent, then the risk distribution in the portfolio is poor, reducing the value of insurance.

General indemnity funds that insure small-scale lending are often part of a national or donor-inspired policy framework for small enterprise development, sometimes including other, socially desirable lending such as housing finance. Credit insurance can then be targeted to specific groups of borrowers, but remain open to a wide variety of competing lenders, including both credit-granting NGOs and commercial banks (Levitsky and Prasad, 1987). However, such schemes rarely offer full default insurance as this would misalign the incentive structure for lenders; with full default insurance they would find proper screening of loan applications unnecessary. In fact, incentives structures are invariably biased by insurance and sub-optimal screening and monitoring are frequently occurring problems for credit insurance schemes. Although general insurers profit from better portfolio diversification, incentive and information problems lead to additional costs so that the capitalisation required may not be lower than for

[18] A typical example of this approach is the Group Indemnity Trust set up by the Start-Up Fund. From the Group Indemnity Trust, the Start-Up Fund recovers all its default losses. While the Group Indemnity Trust is structured to cover its costs - most of its surpluses in fact are paid out to good borrowers as incentives - the Start-Up Fund has achieved high profitability by eliminating the defaults from its loan portfolio. The credit and insurance scheme is analysed in chapter 6.

lender-specific insurers (Bautista, 1992; Levitsky, 1997). Khula Enterprise Finance is an example of a recently set-up general default insurer in South Africa. It offers credit insurance both to banks and NGOs for loans to specific small enterprise or housing projects (Kirsten, 1997). Its loan insurance activities are focusing on commercial banks; this leads to the proposition that donor-financed guarantees are only desirable if they lead to additionality in commercial banks' lending to a target group. Measurements for additionality still rely on anecdotal evidence.[19]

Institutional co-operation

On the level of general discussions, linkage creation is understood to involve capital flows between micro-lenders and commercial financial institutions. In practice, most co-operation involves no capital flows. The misconception stems from the view of the financial sector mainly as the provider of intermediation. However, operating transaction mechanisms is an equally important function of the financial sector. Two areas of co-operation between micro-lenders and commercial financial institutions are exceptionally important for developing micro-lending technology: deposit-taking and transfer systems. While the first assumes its importance from the role of financial regulation, the second depends on banks' size and technological strength. In practice, both forms of linkage development are interdependent.

[19] Additionality is a term widely used in the literature on credit guarantees. It describes that additional amount of lending that takes place with a credit guarantee which would not have taken place without one (see Levitsky, 1997).

Many forms of micro-lending involve a component of savings accumulation. In the micro-finance field, savings generation may in fact be a policy objective in its own right. Several highly successful micro-lenders offer savings facilities and often link them with their credit programmes. However, in almost all countries, deposit-taking institutions need to have a banking licence. Acquiring such a licence is in most cases not an option for micro-lenders; formal capital requirements and supervisory rigidities deter most micro-lenders (see Chaves and Gonzales-Vega, 1994).[20] Savings of a micro-lender's clientele cannot be held directly by the lender. However, acquiring a banking license may neither be desirable nor necessary. Where the existing infrastructure of banks can be used, there is little reason for a micro-lender to incur the costs of duplication. Most major established micro-lenders in South Africa have agreements with licensed banks to allow their clients the use of deposit facilities.

Co-operation with established financial institutions in the field of savings usually requires that every client of the micro-lender opens an account with a bank or savings bank. Although information about the account must be made available to the micro-lender, the deposits do not form part of its resources or liabilities and are regulated through the registered bank. The micro-lender therefore is not subject to the regulations concerning banks; the participating commercial bank

[20] While their are widely reported exceptions of micro-lenders turned into commercial banks, it remains generally true that this constitutes not a viable option for most micro-lenders in the foreseeable future.

may, at its own responsibility, grant an overdraft facility to the micro-lender relating to the deposits of the micro-savers. For many typical micro-borrowers the requirement to open accounts at a formal bank may look daunting, but several micro-lenders have negotiated framework agreements with banks on behalf of their clients who then stand to learn from their exposure to formal financial institutions.[21] An additional benefit of requiring clients to open accounts with a bank is that such accounts are then also used for transactions: banks operate cheque-clearing and electronic transfer systems for their account holders.

When micro-credit established itself, many practitioners thought of it as 'village banking'. At this time, the image dominated the minds of donors and aid officials of 'community bankers' living in villages and providing services in their neighbourhood. Such community bankers are cash-carrying agents, working on behalf of larger, formal micro-finance institutions. However, since then, a wide variety of methods has been developed and successfully applied. Cash-carrying credit officers are now the exception rather than the rule. Many modern micro-lenders use electronic transfer systems to move funds between clients and lender in co-operation with commercial banks with sophisticated infrastructure.

The use of commercial banks' transaction mechanisms obviously depends on the availability of appropriate systems in a specific country. In many developing

[21] The managing director of one South African micro-lender remarked that it was 'a good problem' for his clients to be forced to open an account, as it helped them to gain confidence.

countries, transaction systems are slow, unreliable and often expensive. Sometimes, transactions depend on cheque-clearing systems which may be labour-intensive and thus have high unit costs. However, modern and efficient transfer facilities are available in more and more developing countries.[22]

A well-designed transfer system does not only send money, but is designed so that all electronic transfers of money also forward relevant information. This enables a micro-lender to concentrate all book-keeping and data-processing. Typically, the scale economies of data-processing are large. However, the most important benefit of impersonal transfer systems is that they allow the movement of funds without corresponding travel requirements for credit officers. This is often argued to contribute to financial prudence and a more efficient flow of information to headquarters (Meyer, 1997).

Linkages - the relationship of micro-lenders with commercial financial markets - are an important factor for developing micro-finance technology. Linkages may remove the 'soup-kitchen' aura from NGOs, presenting them as calculating, but compassionate organisations. However, it does not necessarily require micro-

[22] In South Africa, all major micro-lenders use electronic transfers for loan disbursals and repayments. In the Dominican Republic, ADEMI was not only successful in using general transaction mechanisms for loan disbursals and repayments, but about 3000 of its clients now use a MasterCard, which vastly reduces transaction costs for them in all their financial transactions. At a more moderate level, postal savings banks exist in most developing countries, including rural, underbanked areas in South Africa and Botswana. Their transaction systems, although typically not as fast and with slightly higher marginal costs, can handle small and frequent payments, to and from every post office.

lenders to be transformed into commercial enterprises.[23] The promotion of linkages does not require profit-orientation, and linkages are not synonymous with capital flows.

This chapter has sought to give an overview of micro-credit arrangements. Chapters 5 and 6 will present two case studies which represent diametrically opposed approaches to 'banking the unbankable'. While these do not capture all different lending technologies, they lie at two opposing ends of the menu of lending technologies, and they will thus illustrate the relationship between technology choice, sustainability and developmental thinking.

[23] Some may wish to transform themselves into commercial banks. Others may choose to become for-profit organisations without banking license. Yet others may choose to retain a charitable character and explicit redistributional objectives, which are not compatible with profit-orientation. For them, too, linkage development offers the opportunity to achieve their objectives more efficiently.

3. Solidaristic Finance - the formalisation of credit clubs

This chapter will discuss the merits of the group credit vogue in recent development theory and policy. Group credit institutions are conceptually based on rotating savings and credit associations (ROSCAs). Therefore, section 3.1 outlines three standard types of ROSCAs and surveys the body of literature analysing them in various fashions. All early work was carried out by sociologists and anthropologists, and only recently have economists discovered the topic. The work tends to be descriptive, and remains fairly thin. I will show that the literature has failed, as yet, to produce an adequate analysis of ROSCAs that would encompass both economic and social facets of this institution. Distinctively different strands of analysis remain; sociological and economic research are isolated and unsatisfactory.

Section 3.2 summarises the literature on group credit schemes, ie group-based institutionalised credit schemes. Since the inception and apparent success of the Grameen Bank in Bangladesh, group credit schemes have attracted attention and continue to influence policy-making circles. Group credit schemes operate on principles which are similar to those underlying ROSCAs. Apart from descriptive (and often biased) work there is little of analytical substance relating to group credit schemes. Economic models on this subject are argued to suffer from the *a priori* exclusion of social relations. Finally, section 3.3 will briefly outline South

African experience with formal group credit models. These support reservations about the efficiency of group credit schemes.

3.1 Role and function of ROSCAs

ROSCAs are the most basic solidaristic financial institution. They offer simple intermediation based on a small group of participants and their inside savings capacity. ROSCAs exist in endless variations; no fixed rules are necessary as prospective participants can adopt rules to their liking *ad hoc* and have to obey them for only one rotation, ie usually not longer than a year. From all the diversity which is found in descriptive literature, some common principles can be deduced and summarised in three standard models:

Basic ROSCAs

The basic model (Type 1) is the prototype for all successive developments and still widely found. It comprises a number (N) of members who agree to save a specified amount (A) of money (or, theoretically, other storable and exchangeable value such as grain) regularly and contribute it to the association at regular, eg monthly, meetings. At these meetings, all members' contributions - the 'prize' - are given to one member - the 'winner' - as a loan, ie this member receives the amount of NxA. The full rotation is completed after N meetings, after which each member has received the prize once. The order of rotation may be determined randomly, through gambling or chance, or systematically by financial need, status, or age of members.

In this model there is no headperson; responsibility is shared equally in egalitarian fashion. No tangible transaction costs are incurred by organisational structures. There are no interest rates either. Hence the first winner within the rotation remains a borrower until the last meeting, while the last winner is a pure depositor. In the presence of positive inflation and/or opportunity costs for capital (including 'normal' time preference), this type of credit association distributes the benefits of membership extremely unevenly. Some members - at least the last winner - would be better off ex-post if they simply hoarded cash.

However, this and similar models are still widely found and always strongly associated with a social superstructure. The regular meetings assume the role of parties, or the loan given to the winner is required to be 'invested' - fully or in part - on entertainment or feast for the members. Financial motives may be in the background. Arguably, the financial intermediation function of such basic ROSCAs is often doubtful. They appear more comparable to 'kitties' held at clubs or workplaces in developed countries which finance occasional social expenditure like Christmas or birthday parties.

Discount ROSCAs

The introduction of a discount constitutes the next stage in ROSCAs' development. It improves on the intertemporal indifference of the previous model by allowing for discounts. Through this mechanism it is organised that the 'prize' increases as the rotation continues, hence late winners are compensated for their opportunity costs. The operation of this mechanism, and the amounts of discount involved, are tantamount to the imposition of an internal interest rate on credit/saving transactions within the associations.

Under the strong assumptions of a (hypothetical) perfect environment, excess liquidity can be employed or deposited at a rate of return equal to the opportunity costs, excess borrowing can take place at the same rate, and there are no transaction costs. If we further assume that the internal interest rate equals the opportunity costs, which are the same for all participants, then in this case participants are neutral with regard to their allocation of the prize within the rotation. On the other hand, there appears to be no economic reason for the existence of the association as no benefits are derived which could not easily be had from the alternative deposit or borrowing facilities.

Assuming that the external financial market is less than perfect, the above assumptions would not hold. The opportunity costs of capital (ie the deposit/lending rates available) differ between the participants of the rotating credit associations, and the internal interest rate as given by the discount mechanism lies somewhere between the highest and lowest opportunity cost faced by individual members.

In this case members with high opportunity costs would prefer to be allocated early prize slots within the rotation, ie they prefer to borrow. Their opportunity costs could be rationalised as high returns to alternative investment projects, or high alternative borrowing costs, or actual exclusion from alternative borrowing sources. Members with low opportunity costs prefer to lend by seeking late allocation slots. Their relatively low opportunity costs may stem from better credit ratings at local money lenders, or access to cheap institutional credit. In this case both early and late winners benefit from the existence of the associations: the former find access to credit at costs below those of alternatives, the latter realise returns to their capital higher than they otherwise had been able to. In so far as different opportunity costs are an expression of financial fragmentation, this form of rotating credit association helps to lower the barrier between its 'fragments' by facilitating capital flows between them.

However, the internal interest rates are fixed as are the amounts of money contributed and loaned. There is no built-in guarantee that the internal interest rate allows for an equilibrium between would-be borrowers and lenders. Because the contributions of each member are equal, equilibrium requires that N/2 members have opportunity costs below the internal interest rate and the other half of members above. Also, given that the interest is fixed in nominal terms, and that one rotation may last several months or even years, changes in the general or individual opportunity costs are likely to occur. These cannot be adjusted for.

Bidding ROSCAs

The introduction of bidding captures the final stage of traditional ROSCAs' sophistication. It improves on some of the earlier models' inflexibility and allows for a somewhat flexible internal interest rate. Again, N members commit themselves to meet regularly and contribute amount A to the fund at each of these meetings. However, the fund of NxA then is not given in full to any of the members, but auctioned between the members. The one who offers the highest discount D receives the amount of NxA-D. The discount may either be distributed equally between the members - so that their contribution at any meeting amounts only to A-(D/N) - or it may be accumulated in a common pool and used for outside lending purposes, social expenditure or any common good. Having received the prize once - ie having outbid the other members once - the winner is excluded from bidding in further meetings.

The procedure of bidding for the prize incorporates market elements: members know their own intertemporal preference, and they know the costs of alternative lending/investing. Hence they know their own opportunity costs. Bidding on the prize reduces the pay-out the winner gets. The stream of instalments is fixed, therefore bidding increases the interest rate calculated by discounting the instalments. Assuming rational decision-making, each individual member will bid to receive the prize as long as the discount on offer carries a discounted interest rate below his/her own opportunity costs, and stops bidding when the interest rate exceeds his/her own. The real interest rate that each member pays then reflects the relative scarcity of capital within the rotating credit association under consideration of members expectations. The most 'desperate' members will outbid the others early during the rotation, while the ones with low opportunity costs may well wait towards the end of the rotation where competition for the prize is lower, and so is the discount. The last winner will receive the full amount NxA without discount as he/she is the only member allowed to 'bid'. However, this market element is confined to the funds available within the association. The flexibility applies to group members only, and their personal access to outside finance. Also the turnover of the ROSCA is fixed for the period of rotation. As groups tend to be small and knowledgeable about each other, there is also scope for 'strategic' bidding. This raises the question whether the bidding process does actually guarantee an internal equilibrium.

In the form I have described the three 'standard type' ROSCAs their members represent equals within the group. However, the more elaborate the institutional arrangements are, and the larger the associations are, the more likely it is to find a 'headman', and sometimes more 'officials' involved in running the association, organising paperwork and securing members' contributions. For these services the headman frequently receives some remuneration: a certain share of the prize on each meeting, the first prize without any 'discount', or he may be in power to determine the order of rotation, enabling him to ask for fees or 'bribes' for the allocation of the prize from members. These possibilities illuminate the fact that organising and running an informal 'mutual bank' may pay handsome returns independently of the benefit generated for the rank and file members. More complex and sophisticated schemes are occasionally run by commercial banks, local businessmen or are embedded in a pre-existing patron-client relationship.[1] However, the function and structure of these organisations have changed profoundly, and they do not properly fit the understanding of solidaristic ROSCAs.

The body of literature reports that defaults are not a major problem for ROSCAs. A notable exemption is the report by Hyuha *et al* (1990) who find that widespread defaults have led to virtual eradication of ROSCAs in rural Tanzania. The reasons for the failure and disappearance of ROSCAs appear under-researched in comparison to reports about their widespread existence. Still, there are a number of reasons which account for the unusually high stability of ROSCAs, the relative security of funds within the association and the commitment of its members:

ROSCAs are characterised by entry restrictions. Membership is exclusive for a group of 'insiders' who may be friends, colleagues, neighbours or any other

[1] See Nayar (1990) on examples from India and Thomas (1991) on South Africa. Such institutionalised schemes could vary in character from philanthropic projects run by the 'community responsibility' departments of concerned commercial banks to profit-oriented, legitimate schemes to embodiments of rogue genius. In the latter case, comparisons with Mafia-style enrichment or with fraudulent pyramid schemes are seem plausible.

socially related group. 'Outsiders' are in some cases considered, provided they are introduced and their payments initially guaranteed by an 'insider'. Social rather than economic criteria dominate the evaluation process of potential new members, although both may be correlated. The 'collateral' provided is the social status, the individual's standing within the group, the mutual dependence of the 'community'. The permanent screening during the period of rotation uses the same device. Some societies may actually have access to legal procedures through which they can enforce the payment of arrears. This possibility, however, is rather the exception and found only with relatively large associations which keep accurate records of their payments. However, both Nayar (1990) and Thomas (1991) report the use of the legal system for enforcing repayment to informal financial institutions. Such liabilities were, however, masked as debt to private individuals or non-financial firms.

The use of social collateral is more characteristic of ROSCAs. The type of social 'enforcement' they use varies significantly. For some small, closely-knit clubs - characterised by the emphasis on their social function - the loss of friendship, company and trust may suffice to make members comply. It should not be forgotten that in many localities where ROSCAs operate, economic transactions in general are highly personalised. Hence the loss of friendship may entail severe economic loss, making economic exchange more cumbersome and endangering the network of mutual solidarity.

Other types of ROSCAs, ie more economically oriented ones like the third model, use legal or illegal methods of appropriation, or repossession and personal threats to substantiate the demand for paying up arrears. This may take the form of having members 'roughed up somewhat' (Thomas 1991, p296). The prerequisite, however, remains the existence of direct social relationships between members, ie lenders and borrowers. Obviously, the 'micro-threats' available to micro-intermediaries are unthinkable for commercial banks.

Defaults do still occur and are sometimes forgiven. These cases are often associated with extreme financial distress of a member, in which case the ROSCA members may agree to let the defaulter off, though this creates an obligation for reciprocity should need arise. Alternatively, the departure of a member from the social environment in which the association was arranged may free him/her from further obligation.[2]

Early attempts to understand ROSCAs

ROSCAs first attracted the attention of academic research in the 1960s. Geertz (1962) and Ardener (1964) were occupied with documenting the existence of ROSCAs over a wide spectrum of societies and countries, and with working out the similarities between the institutions they found. Naturally, questions of appropriately defining ROSCAs were on their agenda, as was the attempt to conceptualise the phenomenon in the context of contemporary social science.

[2] One might consider a member of a ROSCA organised at the workplace who shifts employment, or an entrepreneur whose commercial success brings about new opportunities for access to credit.

Though they make some way towards locating ROSCAs in society and its developmental processes, they do not provide an analysis of the institutions itself. Their preoccupation with the credit groups remains largely descriptive, they take the view of the intrigued outsider who tries to make sense of the impenetrable object he or she observes.

Geertz (1962) describes in detail the different forms of ROSCAs in Asia and Africa. Only the last few pages are devoted to an assessment of this institution. He starts with a comparison between cultural change on one side and Israeli immigration on the other: immigrants from Yemen, Iran and North Africa are characterised by the 'customary family and kinship ties, authority relations, and religious views' (p. 259). Still they succeeded in adapting to the 'rational' Israeli society 'through the mediation of the agri-cultural cooperative' (ibid.). This institution 'may thus be seen as an "intermediate" institution which links traditional motivations to modern functions, serving at the same time to transform those motivations toward a more rationalistic basis' (p. 259-60). The ROSCA is argued to be a similar Trojan horse: it is able 'to organise traditional relationships in such a way that they are slowly but steadily transformed into non-traditional ones, as an institution whose functional significance is primarily to facilitate social and cultural change in respect to economic problems and processes' (p. 260-1).

He concluded that ROSCAs are an institution belonging to the 'middle rung' of development, in both economic and anthropological terms. Hence, ROSCAs are involved with the 'shift from traditionalistic agrarian society to an increasingly fluid commercial one' while, at the same time, they also provide an 'educational mechanism in terms of which peasants learn to be traders, not merely in the narrow occupational sense, but in the broad cultural sense' (p.260). Eventually, he predicts, ROSCAs will be replaced 'by banks, cooperatives and other economically more rational types of credit institutions' (p.263).

Ardener (1964) attacks Geertz on two fronts. First, she refutes his definition of ROSCAs, and second, she criticises his concept of ROSCAs as a 'middle rung' institution. Having supplanted Geertz's definition of the ROSCA, Ardener's is still accepted as the standard in relevant literature (Thomas 1991). She defines ROSCAs as 'an association formed upon a core of participants who agree to make regular contributions to a fund which is given, in whole or in part, to each contributor in rotation' (p. 201). Around the basic concept of fixed contribution and rotation, she agrees that another attribute is common to all these institutions: they combine social and economic functions which are valued by their members. The mix of these functions varies, and may change over time, but these functions are always mutually dependent. Further, she acknowledges that there are group organisations which exist to furnish their members with mutual credit, yet they do not show a strict pattern of rotation.

Responding to the 'middle rung', Ardener finds Geertz's analysis misguided in that it argued that ROSCAs appeared as a consequence of the shift from 'traditionalistic agrarian society' to a commercial one. Instead she describes ROSCAs as a reason for, not the result of, such a shift. She strongly argues this point, but cannot avert the impression that she misunderstood Geertz: he found a shift between developmental stages and ROSCAs to be mutually supportive, not mono-causally related. Hence he might not contradict Ardener's understanding, that ROSCAs are one of the reasons why societies do develop and transform. However, she does make a valid point in posing the question about the non-existence of ROSCAs in some monetarised, underdeveloped societies (ie middle rung societies). Apparently, some societies do produce ROSCAs at a specific stage in their development while others do not. She correctly points out that a mono-causal relationship between certain stages in development and ROSCAs can not be accepted. While the middle rung could possibly be a necessary condition for the formation of ROSCAs, it certainly is not a sufficient one.

Bouman (1976, 1977, 1990), Adams (1984, 1985), Braverman and Guasch (1986), Nayar 1973), Seibel and Shrestha (1988) are ardent advocates of informal finance, including ROSCAs. These and others deny vehemently that ROSCAs are a backward 'middle rung', a mere episode in the succession of stages in the development of economic structures and cultural values. They point out that informal finance is fully compatible with rational, modern decision-making and has an important role to play in economic development. Unfortunately, their work offers much anecdote and little detailed analysis. Nayar (1986) outlines the history and development of ROSCAs in India, called chit funds there. In opposition to the description of Geertz and Ardener, he covers ROSCAs which are not located in deprived, underdeveloped communities, which do not conform to the 'middle rung' status. He offers a more detailed analysis of costs and efficiency than in previous reports. Nayar also includes modernised versions of ROSCAs which could not properly be counted as informal finance. Broadly, his categorisation of ROSCAs mirrors the three standard types developed above.

The South African anthropologist Thomas (1991) shows that all three types of ROSCAs exist in South Africa. He traces the earliest references of ROSCAs to the early 1930 when stokvels - the term used in South Africa for solidaristic savings and credit institutions - were reported in 'slumyards' in Johannesburg. Other reports followed in the 1940s, but little work has been done since. Thomas asserts that 'apart from the early publications of Ardener (1964) and Geertz (1962), relatively little information can be found on [ROSCAs], even in the international literature' (p. 290).

His work, concentrating on the wider Cape Peninsula, illustrates that ROSCAs, and notably the more complex ones, exist for reasons other than institutional underdevelopment. The social component is shown to be strong, if not dominant. One of his respondents felt strong enough about it to state that a 'stokvel is like religion - it takes commitment and cooperation' (p. 295). In South Africa, stokvels are strongly associated with opportunities for a 'party'. Stokvels may, indeed, have originated from tea-party groups which assumed a financial functions as a clear subordinate to the partying rationale of the group. 'Social reasons for membership of a [ROSCA] abound, and are clearly intertwined with pecuniary interest. Not only does membership help establish friendship and neighbourhood ties, but it often brings with it the prospect of regular parties (Thomas, 1991, p. 302). Thomas also points to the 'importance of mutual trustworthiness and personal friendship as membership qualifications' (p. 293).

Thomas does not describe exactly how 'social reasons' and pecuniary interest' are intertwined. Though he informs his readers about the doubling of the ROSCA's functions, his short survey does not convey an inside understanding of the rationale of ROSCAs, nor of the conditions for their existence and stability. His colleague Preston-Whyte (1991) goes some way to fill that gap. Her account of petty trading in Natal illustrates the social environment and economic motivation of female craft traders who, among other things, participate in ROSCAs. She finds ROSCAs constitute only one of many ways through which informal traders establish and maintain social links, networks and a degree of stability and security in an otherwise volatile environment. Though it remains important to facilitate savings and credit channels, the financial function could be described as subordinate to the cartel-building one. Unfortunately, Preston-Whyte's research notes ROSCAs only on the sidelines, and remains more narrowly focused on other questions.

Modelling ROSCAs and not avoiding the pitfall

Rigorous economic analysis of ROSCAs remains the exemption. I have given an overview of the discovery and exploration of ROSCAs by social scientists, and their subsequent categorisation by economists. The work by economists on ROSCAs is dominantly descriptive, and sometimes carried by an explicit desire to introduce informal finance to the acceptable society of developmental financial institutions. ROSCAs themselves remained, unfortunately, the great unknown at the centre of this argument: repelled or admired, treated with respect or curiosity, located geographically, demographically and socially, subsequently uprooted and redefined, yet never understood.

An article by Callier (1990) constitutes the starting point of the more rigorous approach in the economic analysis of ROSCAs. He provides a rather short exposition of ROSCAs, pointing to the benefit they generate over autarky. The waiting time - time an individual saves for some specified amount before he or she can buy a 'lumpy expenditure'-good - is greatly reduced. The main thrust of Callier's argument is, however, that financial fragmentation is the very reason why ROSCAs exist, hence financial liberalisation is a more efficient remedy than pooling savings and loans. He finds that the ROSCA 'loses its raison d'être when capital market segmentation vanishes as a result of market integration: access to credit at the prevailing market rate solves the problem of lumpy expenditures' (p. 275). If the 'collective action' nature of the ROSCA stretched beyond the provision of saving and credit facilitates, as Callier has also argued, one is led to conclude that they cannot be as penetrable by a market rationale as the last quote implies.

Furthermore, the view that ROSCAs lose their raison d'être with market integration implies a somewhat optimistic view of liberalised financial institutions' ability to serve all those who are presently members of ROSCAs. It has been shown that credit rationing may occur not only in fragmented financial markets like those of developing countries but also in integrated ones (Duca and Rosenthal, 1993).

Besley *et al* (1993) provide the most comprehensive economic analysis of ROSCAs to date. They develop a formal model of ROSCAs for examining the potential private gain from participation and compare different types of ROSCAs with differing 'rules' for the allocation of the rotating credit 'pot'.[3] However, they also assume a world without uncertainty, reducing the meaningfulness of their model. In reality, the solidaristic nature of ROSCAs and other informal credit arrangements provides a network through which members manage risk, and this is one of the most important motivations for operating informal financial institutions (Platteau and Abraham, 1987; Salas *et al*, 1991). This function cannot be

[3] ROSCAs are perhaps too diverse to capture all structures in few formal models. However, Besley *et al* follow a categorisation adopted elsewhere (Nayar, 1986). In random ROSCAs the receipt of the 'pot' is determined by chance. In discount ROSCAs, there is an explicit discount for early distributions. In a bidding ROSCAs, members bid for the receipt of the pot, offering cuts on the net pay-out. Typically, discounts are accumulated in a kitty for communal use.

understood in a model where a priori there is no uncertainty, no individual risk and hence no demand for insurance.

Examining random ROSCAs, Besley *et al* argue that "risk aversion is not an issue here, since from each individual's *ex ante* viewpoint, the random ROSCA does as well as autarky in every state of the world, and strictly better in all but one" (p. 796). However, they conclude this point by stating that "the individual receiving the pot at the final meeting date has been made strictly worse off (*ex post*) by joining the random ROSCA" (p. 797). Risk aversion seems an issue here, as it is always a measure of the divergence between the expected outcome and an individual's disutility derived from the likelihood of adverse *ex post* outcomes. Hence, Besley *et al* err when they dismiss risk aversion on the basis of *ex ante*, and faulty, statements. The individual receiving the pot at the final meeting, if risk averse, would have had a good reason not to join the ROSCA in the first place. If we accept the proposition that a ROSCA has to be neutral, if not attractive to all members (i.e. in all their allocational positions) from an *ex post* viewpoint, these findings can safely be ruled out as unrealistic - a longer rotation deters potential members and has been found to be counterproductive in fieldwork with solidaristic institutions (Thomas, 1991).

The attempt of Besley *et al* to outline the nature of the bidding ROSCA further illustrates the conceptual weakness of placing the model in a risk-free environment: in the absence of uncertainty individuals know their own future preferences perfectly well, including their inter-temporal preference as represented by the interest rate. Bidding, therefore, is meaningless, and can be organized at the beginning of the rotation. 'ROSCA members determine the order of receipt for the pot when the ROSCA is initially organized at time zero' (Besley *et al*, 1993, p. 797). In effect, Besley at al describe a discount, not a bidding ROSCA. While such a simplification may be necessary for modeling a complex institution like the ROSCA, it nonetheless inhibits the meaningful analysis of the economic rationale behind solidaristic intermediation.[4]

The insurance resulting from the solidaristic nature of ROSCAs is difficult to endogenize, due to the implicit nature of the contract. Neither are the obligations of the insurer (i.e. other ROSCA members) fixed nor the conditions under which they should apply, hence no fair premium can be calculated. Because insurance rests on the mutual obligation of ROSCA members, no insurance premium is actually paid, and value attached to insurance is not observable as a market rate. However, assuming risk-averse individuals, the implicit insurance contract embodied in the ROSCA is a valuable asset. Because of the obligations entailed when entering a mutual insurance arrangement, the implicit insurance contract is also costly. Similarly, the value of reputation which serves to enhance one's creditworthiness constitutes an economic asset. Its actual evaluation depends on

[4] Considering the insurance element that is an important part of almost all informal financial institutions, these assumptions are reminiscent of an attempt to model insurance in a world without risk.

the individuals' expectations, i.e. the perceived likelihood to seek future loans, and on personal values attached to social prestige.

Solidarity, which is the basis of the ROSCA, entails the acceptance of long-term commitments and entitlements. The net present value of these cannot be exactly determined, as their evaluation relies on private information and social relationships. However, solidarity incorporates social respectability, insurance, and some form of long-term investment; none of these is represented in the model developed by Besley *et al.* Platteau and Abraham (1987) provide an excellent account of insurance in the context of small group-based credit agreements. Although their survey data does not include groups that would fit the definition of a ROSCA as there is no fixed rotation, their analysis sheds light on the underpinnings of reciprocal credit. Their analysis is based on their survey of fishing communities in Kerala. Fishers participate in groups who guarantee mutual credit lines in case the daily catch falls short of requirements. As the catch is stochastic and unrelated, even relatively small groups may constitute sufficiently good insurers. They find that credit is essentially an insurance instrument, while 'the repayment of the loans is uncertain, and the repayment may even be conditional upon the decision of the debtor to stick or to break out of the broader relationship he has entered' (p.483). Commercial capital market evaluations are inappropriate as 'the price of credit is either formally zero, or is blurred in a way that renders its assessment especially difficult. The interest forsaken by the credit giver [...] can be construed as risk premia he is willing to incur to reduce risk ...' (ibid.).

Further, Besley *et al* assume implicitly that the exchange of resources and commitments between ROSCA members does not incur transactions costs. In many economic models, such costs are plausibly omitted as they may be negligible. While this view largely applies to cash transactions, those transactions involving credit are typically more complex and costly (Diaz-Alejandro, 1985). ROSCAs are time-intensive as most empirical accounts attest; members have to bear transaction costs in the form of regular meetings and other, social interaction necessitated by their financial interdependence (Hyuha *et al*, 1990). Arguably, the approach that views ROSCAs as a market where credit-constrained individuals trade financial services misses important elements of solidaristic institutions.

Summary: weaknesses in mainstream analysis of ROSCAs

In early research ROSCAs were treated as somewhat exotic institutions that existed in the (former) colonies as an expression of not then fully developed financial markets. Since the 1980s there is a strand in the literature which has set its aim at defending the ROSCA (and other informal financial institutions) as progressive and advantageous to credit-constrained individuals. Notably, the latter view was enforced by the fact that ROSCAs continue to contribute prominently to the financial markets in countries that have since made great progress in modernisation.[5] In spite of this swing of the pendulum, some of the mysterium found in the exotic, 'weird' institution remains.

Recent research oriented towards the analysis of ROSCAs as economic rather than social institutions tends to ask different questions. These questions relate to ROSCA members as economic agents, their benefit, ie utility from attending such institutions, the incentive structure and the institutions' sustainability. However, the attempts to model the ROSCA amputate the social, 'solidarity' function that ROSCAs were found to possess in earlier research. Besley *et al* are aware that their analysis falls short of incorporating the insurance element. However, insurance is an important factor in ROSCAs, but it also entails that every member 'underwrites' a policy for others. Insurance is intrinsically connected with solidarity, and ROSCAs cannot be properly understood without considering both. Similarly, personal connectedness can be enjoyed or loathed, the attendance of group meetings can be work or pleasure, but in any case social obligations affect the incentive structure and stability of ROSCAs.

Excluding any interpretation of connectedness, ie the core social characteristic of ROSCAs, the economic models must remain unsatisfactory as explanatory tools for economic agents' behaviour and institutions' development. They can hardly produce necessary conditions for ROSCAs' existence, but never sufficient ones.

[5] ROSCAs exist in urban Taiwan, where they play a role in maintaining social relations which are the basis for a range of informal transactions, including credit. There is also a report of ROSCAs run by IMF employees in Washington (Bouman, 1990, p. 164).

Crucially, the causes of ROSCAs failures remain uncovered insofar as they relate not to an inefficient incentive structure but to the breakdown of solidarity or the inconvenience of connectedness. Based on a large survey in rural Tanzania, Hyuha *et al* (1990) find that 'lending in the informal markets overstresses interpersonal relationships' and a 'decline in moral values has led to increased defaults on loans' (p. 24-5). They report that ROSCAs had declined to insignificance in rural financial markets. Current theory appears unable to handle these conclusions.

In the foregoing survey of research on ROSCAs it was found that social connectedness made it a type of organisation that is not easily understood by economic analysis. Though there is a pronounced overlap with the problems of defining the firm within the parameters of economic theory (Coase, 1937), informal groups have received much less attention. ROSCAs are not merely economic units with the function of securing future income streams, but they are a form of social organisation which promotes a wider range of goals related to the personal connections of its members. Personal connections may at times have tangible economic returns, but just as likely they may be deemed desirable without possessing economic value. Solidarity has been construed as insurance, yet such simplification is doomed to remain incomplete. Solidarity does indeed provide insurance, but is a more complex system of obligations than could reasonably be founded on enforceable and specific contracts. Solidarity is always more far-reaching than a formal contractual arrangement can reasonably be, and it takes into consideration more circumstantial information than formal insurance would. While it is thus right that solidarity entails a measure of insurance, the reversal is not necessarily true.

The reasons for creating and running ROSCAs are therefore not identical with those that create demand for credit and insurance, which are purely economic. The wider-ranging powers of solidarity and personal relationships may be most valuable in underdeveloped economic circumstances with underdeveloped access to functioning markets. Some functions which are more traditionally associated with ROSCAs also have clearly social connotations and have to be considered. Members value friendship, togetherness and social functions - the ROSCA meetings have been cited by members as first-rate pretext for parties - independently of their tangible economic value.

There are therefore several separate possible raison d'être for ROSCAs: Credit, insurance, solidarity and company are all reasons for the existence of ROSCAs, and often intermingle in one group. Yet, comparing different groups, their prime goal may well differ, but the prominence of ROSCAs in some parts of the literature, and the attractiveness of some of their characteristics to many micro-credit proponents, may have diverted the attention away from the fact that all different components - credit, insurance, and company - must be incorporated in their analysis.

3.2 History and Nature of Solidarity in Formal Credit Schemes

The group credit model has a strong appeal for policy-makers, aid officials and NGO volunteers because its proponents promise that it will make credit available on a self-financing basis to poor people who are normally beyond the reach of banking institutions. This claim rests on the assumption that transaction costs - as the sum of administrative costs and defaults - can be reduced. This is supposedly achieved by making borrowers perform screening and monitoring functions through their social connectedness, and overall defaults are lower because groups can select their members and enforce commitments more effectively than 'standard' lenders owing to their informal environment.

Co-operatives and Village Banks - earlier forms of solidarity credit

Group credit schemes are not as innovative as some participants may believe. Financial institutions aimed at poverty alleviation and empowerment, based on grassroots action and social cohesion, were invented by Friedrich Raiffeisen in Germany in the middle of last century. Early this century, the model gained popularity in North America and India under the term 'credit union'. In several developed countries, including Germany and Canada, the credit unions established then are still part of the financial system (Von Pischke, 1991). However, credit unions are part of the co-operative movement; early credit unions in Germany not only provided savings and credit facilities, but traded in agricultural produce and farming implements. While the Raiffeisen Banken in Germany are now modern banks, many co-operatives in developing countries continue to combine financial and non-financial activities.

Co-operatives are a form of solidaristic economic organisation which is not only much older than joint liability credit schemes, but has also been researched much earlier than ROSCAs. All co-operatives are employee owned and managed enterprises; some are aimed at producing financial services for their members - credit unions - while others are involved in producing marketable products, offering employment and income to their members. Co-operatives rely on solidarity binding their members and are, in this regard, crucially different from employee-owned commercial firms. Co-operatives are also associated with self-help, grassroots community actions. The literature on co-operatives, and especially credit unions, can therefore provide some insights into the problem of solidarity in economic analysis.

'The critical factors for the success of co-operatives and other group enterprises' are discussed in an article by the same title by Harper (1992). The article is based on survey data covering 150 co-operative managers, staff of support organisations and others. The respondents were asked to answer questions relating to the desirable organisational structure of a co-op, diversity versus homogeneity of its members, similarity of their skills, diversity of the coop's functions, political affiliation, self-reliance and leadership structure. In a second part, they were asked to assign relative importance to these different questions.

The most striking result is that these co-op experts hold similar views on only a few questions, but they also judge those questions less important to the co-op's success. On the other hand, the respondents' opinions differ widely on those issues which they have judged to be of higher importance. Notably, the questions related to the solidarity in the group are judged important, but the survey does not produce coherent answers as to what the most successful course of action would be. There is a narrow majority for the statement that group members should be homogeneous, on another question a rather stronger majority favours that group members should possess different skills. Harper finds these demands 'at least to an extent incompatible' (p. 17). On the question of leadership, a majority of 47% favours stronger leadership with 36% for an emphasis on participation. There is also a majority of 58% for the argument that a 'group's objectives must go beyond income, and include social and community goals' (p. 18), and more than a third of all respondents consider this question most or second-most important. The results from this survey seem to convey the argument that solidarity plays an important part in promoting a group's enterprise, but that the measures for the promotion of solidarity are judged very differently. Harper suggests that the diverging answers and indecisive results in his survey illustrate that individual circumstances differ and require varied responses (p. 20), but it also demonstrates the point that connectedness and solidarity are neither easily defined or integrated into institutional design.

Bogaert (1992) summarises the experience of rural co-operatives in India. He gives a positive evaluation of the developmental impact of group entrepreneurship, but stresses that 'maximization of profit is not the primary objective, rather, security, in the form of strengthened social bonds' (p. 38). Entrepreneurship, if suitable to a co-operative enterprise, is not 'elitist and selective' but 'a set of functions, roles and characteristics that can be and are shared [...] amongst individuals' (p. 38).

Guinnane *et al* (1993) emphasise in their analysis of German credit-co-operatives that the extent of group commitment is correlated to the income level of group members. Credit co-operatives with unlimited liability, where members commit all their wealth to the solidarity group, are dominant in rural and poor areas, while more affluent urban groups have introduced some form of liability limitation. Their data suggest that the costs of solidarity, especially those related to joint liability, are positively related to income and wealth.

More recently, village banks have entered the debate following the successes of FINCA in Costa Rica. In the village bank model, a lender delivers credit to large groups which are based on local 'communities'. Confusingly, a 'village bank' is one local group of borrowers and not their lender. Hence, NGOs lending according to the village bank model will establish a larger number of village banks, each located in different villages or localities, and will have separate lending relationships with each of them (Hatch, 1989).

Village banks are based on larger solidarity groups, comprising between 20 and 30 borrowers. As in group credit schemes, the village bank members select each other for membership and guarantee each others' repayment. In this model, members set out rules stating entitlements and commitments in a more formal manner than smaller solidarity groups. Credit disbursals are made to all members of a specific village bank at once: hence all 20 to 30 members receive their loan on the same day and all are required to make repayments following the same schedule, keeping administration relatively simple. Typically, both disbursals and repayments are made on a cash basis.

The village bank concept is most prominent in Latin America and has not yet found many followers in Africa (Holt, 1994; Nelson *et al*, 1996). However, the concept was adapted by World Relief, an American NGO, for its rural lending programmes in Mozambique. There, it seems to operate with encouraging success although viability is still a distant goal. The relatively simple administrative structure of village banks, and the simplicity of credit disbursal and repayments in bulk, has led to significantly lower lending costs than experienced by comparable Grameen-type schemes. While the repayment experience is generally encouraging, natural disaster adversely affected it. During floods in early 1996, the on-time repayment rate fell from previous 100% to 62%, but recovered to 88% within a few months (de Vletter, 1996). However, it could be argued that the village bank model tends to be at greater risk from default than Grameen-type institutions as larger groups lead to looser solidarity and simultaneous loan disbursal removes the incentive of those who wait for their loan to heckle the others to repay.

The village bank model is flexible; many NGOs implementing such schemes allow their different village banks to define their own rules for repayment, credit utilisation, penalties for late payment and other regulated activities. The internal democracy is, more or less rigidly, circumscribed by the minimal requirements of the implementing NGO and its request for disciplinary procedures and a level of uniformity between its various village banks. One development, however, is particularly notable: some NGOs have, influenced by the example of Grameen Bank, introduced a subdivision of their village banks into smaller groups of five to seven borrowers, who guarantee their loans mutually. In this case, liability is transferred from the village bank to the group. However, in difference to the group credit model, the village bank remains liable should an entire credit group default. However, with the subdivision of liability, the differences to the group credit model are gradually eroded.

Group Credit Schemes - in the footsteps of Grameen Bank

Above I have mentioned the current vogue for formal, mostly developmental, financial institutions to provide credit with joint liability. Arguably, the Grameen Bank in Bangladesh was the trend setter; recent analysis finds that it 'stands out as the most significant peer group lending programme in the world' (Berenbach and Guzman, 1994, p.127). Because of the importance of this type of institution as a role model for ‘banking with the poor’, this study will concentrate on the group credit approach and not on credit unions or the village bank model.

The Grameen Bank grew out of a local lending project that was started in 1976 by Muhammad Yunus, an economist at Chittagong University. In 1983, Grameen was registered as an independent bank. Originally, 60% of the capital was held by the government and the remainder by the borrowers who have since acquired the majority. Yearly disbursals of loans approach US$100 million and more than US$25 million has been saved by members in deposits and shares. There are now over 800.000 borrowers and loan size averages about US$70.

Grameen lending technology centres on groups of five borrowers who are jointly responsible for the repayment. Before they are eligible for a loan, all five members must undergo training to become familiar with the working regulation of Grameen Bank. The first disbursement provides loans for the two poorest members of each group. Only when those loans have been fully repaid does Grameen release the next disbursement for two other members of this group, and so on. Ten groups are then assembled in a ‘centre’ in order to allow the visiting loan officer to address 50 members at once. Meetings of each group are held weekly. The social element in group activities is strong: members are required to learn the Grameen song and sing it together and they are lectured about a range of support-worthy causes and rules of conduct, the sixteen promises (Chandler and Fuglesang, 1986).

The target group of the Grameen Bank is poor rural people, with an emphasis on women. No collateral other than group participation is required. In order to qualify as a member - one could also say participant, client or shareholder - each individual has to acquire one share of Grameen. In the process of expansion, Grameen became a customer-owned bank. Most members are female, and many are virtually landless (Grameen Dialogue, various issues). Credit is given almost exclusively for income-generating purposes, and the highest legally achievable nominal interest rate is charged. It is an inherent part of the loan programme that members are required to accumulate savings which are automatically deducted from their loans. In effect, this raises the real interest charge. Repayment rates are high, default lies at 2% as opposed to 90% in the commercial banking sector in Bangladesh (Braverman and Guasch, 1989). Grameen has been argued to be the least subsidised bank in Bangladesh (Manuel, 1993). Although it is widely argued to be one of the most successful institutions providing credit to poor people in the world, the level of subsidisation is difficult to compare as Grameen has access to concessional lending from foreign sources.

BancoSol (Solidarity Bank) in Bolivia is probably the most established imitation of the Grameen Bank model. It employs a similar strategy, using credit groups with between four and ten members. As in Bangladesh, loans are meant for starting an income-generating enterprise, and the institution has been hailed for helping poor hawkers and urban unemployed to withstand the pressure of recent structural adjustment and accompanying reductions in state expenditure.

BancoSol's history leads back to the establishment of Prodem - a micro-lending NGO - in Bolivia in 1986 as a joint venture between ACCION International (an American NGO) and the Bolivian private sector. Following initial successes, it was quickly felt that prospective expansion was restricted by the regulation governing non-bank entities in Bolivia. Only banks are licensed to accept deposits which are seen not only as a service to customers but also as cheap and reliable source of funds. Hence Prodem was transformed into a commercial bank; BancoSol opened for business in 1992. It was projected to become profitable within the first few years of operation (Glosser 1994), but in fact experienced problems due to cost overruns.

The group lending model developed and practised by the Grameen Bank has become the subject of policy-makers' envy and academics' debate. Yunus promotes the idea in various developing countries, including South Africa, and has found numerous imitators. In South Africa, one of the targeted institutions was the National Stokvel Association of South Africa, the umbrella organisation of local ROSCAs. It was hoped that the Association may build on the strength of local stokvels (ROSCAs), unlike the Grameen Bank and BancoSol, who had chosen to develop their grassroots groups from scratch. The experience with stokvels was disappointing. There are, however, still several organisations in South Africa running Grameen-type group credit schemes. Two of them - the Get Ahead Foundation and the Small Enterprise Foundation - are analysed in greater detail below.

ROSCAs and solidarity credit groups in formal lending schemes

Group credit schemes are based on groups which are conceptually related to ROSCAs. Nayar (1986) demonstrates the continuum from informal ROSCAs to formal joint liability credit institutions. He follows up the development of Chit Funds from ROSCAs in their most basic form to more elaborate institutions which are run by a headman. Some chitties are rather large with up to 3500 members, and the operation assumes a formalised character. However, a further stage of development saw the proliferation of institutional foremen, often commercial banks. Specialised chit fund companies are the dominant force since the 1970s and form part of the financial system in India. The Chit Funds Act (1982) passed by the Indian Parliament guarantees their position as a non-bank financial company and regulates their business. Chit funds are, unlike most joint liability schemes, profit-oriented private sector enterprises. They are characterised by rotation and time-bound operation. The character of solidarity has changed profoundly and Nayar stresses the subsequent commercialisation, though no detailed social study is available on the subject.

While the literature is generally positive about the possibility that group lending may make credit available to 'unbankable' people, it is rarely mentioned that borrowers are faced with real costs when acquiring financial services through membership in a group. In a typical way, de Aghion (1995) finds that 'contracts under joint responsibility can induce peer monitoring among participant borrowers. These contracts can potentially dominate standard (bilateral) contracts to the extent that they allow the bank to take advantage of both lower monitoring costs and social sanction (among peer borrowers) in order to elicit higher debt-repayments from each group member' (p. 12). However, running groups, monitoring each other and imposing sanctions in case of default are costly, and there is time-consuming 'solidarity business'. The shift of transaction costs from lender to borrower could be Pareto efficient[6] and equitable if the savings of lenders are greater than the extra costs of borrowers, and if the savings of lenders are shared with borrowers so as to compensate them for their effort. This compensation is usually understood as the welfare effect stemming from the provision of credit in the presence of credit rationing.

It is also generally assumed that monitoring and screening by mutually liable borrowers reduces total transaction costs incurred by the lenders, but that lending to groups would not create costs that did not exist when lending to individuals. However, a group lender has to perform functions that are not generally found with standard bilateral contracts: groups have to be identified or formed, criteria have to be developed for the identification of credit-worthy groups, and appropriate support structures have to be established. The accompanying costs may well be outweighed by the savings group credit schemes can achieve in other fields (eg significant reductions of defaults), but the problem of costs which are

[6] Pareto efficiency seeks to measure the efficiency of resource allocation in welfare terms. '[A] situation is said to be Pareto optimal if there is no feasible alternative that makes everybody better off' (Feldman, 1991, p. 715).

specific to joint liability lending has not yet been addressed by the appropriate literature.

Policy-makers and institutional lenders need to know, for example, whether these costs are likely to change during the rotation of credit (ie before all members have repaid), whether peer monitoring is stable and how it develops over time. Joint liability credit is, from the perspective of the institutional lender, enforced by linking the repayment of present loans to access to future credit. It remains an open question whether this linkage provides an active threat, and whether future access to credit is an active incentive. The credibility of the threat is important to determine the effectiveness of linking repayment to future access. The higher the costs of alternative sources of credit, and the higher the dependence on credit, the stronger appears the threat of 'red-lining' defaulters.

Despite the similarity, group credit schemes are different from ROSCAs. Social interaction within the group is likely to be different, as the agenda is determined by the lender. Meetings take place not merely by chance, or through everyday interaction, but times are agreed and a formal discipline established. In fact, many group lenders penalise group members who arrive late for meetings; such practices owe more to the discipline of banking institutions than to rural communities.

Solidarity Groups and Economic Analysis

Following the critique of mainstream analysis of ROSCAs, I have argued that the theory available on institutional credit with joint liability does not understand why groups are superior to rational individuals. Why are creditworthy groups more reliable than their individuals? What difference is there between a random grouping of unrelated people and a credit-worthy group? Institutional lenders need not only find the answer theoretically but each time a group applies for credit. Screening for 'group solidarity' may not be less costly than screening in a bilateral context. Mainstream economic texts typically evade the problem by assuming that 'connectedness' exists, and that a group lender knows this.

However, most institutional lenders do not find ready-made, credit-worthy groups in their chosen area of operation, hence they do not face the problem of selecting the best borrowers. In fact, they are usually involved in setting up groups for the purpose of lending to them, and possibly achieving other developmental goals through them. This involves the institution in a timely process during which it will seek to create, artificially, the connectedness that ROSCAs possess. Arguably, the provision of access to credit could be enough for poor people to take this task onto themselves. In practice, this is rarely observed, and the lender usually gets involved in 'grassroots' work with the aim of promoting credit groups. Institutions with the intention to lend to grassroots-groups find a productive asset missing that is crucial to the working of their lending model.

These costs can most easily be understood with the concept of 'social capital' that describes trust and connectedness as a productive asset. 'Physical capital is wholly tangible, being embodied in observable form; human capital is less tangible, being embodied in the skills and knowledge acquired by an individual; social capital is even less tangible, for it is embodied in the relations among persons' (Coleman, 1990, p. 304). Like other forms of capital, social capital is found to 'facilitate productive activity' (ibid.). Those who own social capital usually refer to it by other names, such as friendship, trust, expectation.

With regard to ROSCAs and credit groups, social capital encompasses internal rules of conduct, a set of obligations and expectations among group members, all of which facilitate the production of valuable services, both credit and insurance. These obligations and expectations are built up over time at some positive cost. A credit group is an intentional organisation and as such it is 'the direct result of investment by actors who have the aim of receiving a return on their investment' (Coleman, 1990, p. 313). Obligations are not always fungible, so in a group members may have obligations outstanding to each other which do not cancel out. Social capital, unlike physical but similar to human capital, is not easily transferable or marketable. It relies on the persons in whose relationships it is vested and on the stability of their social relation.

Social capital can promote Pareto efficient exchange. One agent can create an obligation by giving a service to some other person when the costs are perceived to be low, and the benefit large to the other person. The favour can be repaid when relative 'prices' have changed, due to personal reasons. The insurance against distress built into solidarity structures in poor communities demonstrates this mechanism.

Solidarity and connectedness can amply be described as social capital. As with any form of capital, it needs to be accumulated with sacrifices in present consumption. Creating social capital is costly with tangible economic expenses. Social capital, in turn, is expected to yield returns. It is this complex which is conspicuously absent from the literature on ROSCAs and group credit schemes. The real resource costs of group connectedness - of creating it, identifying it and maintaining it - are excluded from the consideration of its usefulness, and also from the data that the literature mostly presents: loan repayment rates may be high, but little is told about the operating costs of highly subsidised institutions like the Grameen Bank. In the absence of collateral and applicable, sufficiently efficient normal banking technology, social capital is among the necessary conditions for the success of group-based lending.

In a modern world, relationships play little role in the procurement of goods and services. People may prefer to use credit without the necessity to socialise with their peers and impress their lender about their social attitudes. Friendship, social life and economic functions would be relegated to different institutions, such as banks, employers, friends, family and so on. In a less than fully ideal world, relationships are important, as they are a requirement in an environment characterised by weak or lacking institutions and markets. Solidarity is not a virtue more easily enjoyed by poor people.

The conditions for successful joint liability schemes may well be met in appropriate circumstances. Yet the sufficient conditions are more stringent than the necessary ones which are borne out by the literature. The necessity to build social capital and to provide a subjective return on it indicates the gap that exists between necessary and sufficient conditions.

Economists who only recently developed a taste for research into solidaristic institutions have focused on the internal incentive structures and returns for groups' members. They have done so from a strictly individualistic perspective. Trust and solidarity - characteristics that earlier research had found so important to ROSCAs - were essentially assumed away, or presumably covered in such assumptions as monitoring costs and asymmetric information. An independent understanding of the role of solidarity was, however, ruled out by this course of action.

In the following section, a broad survey of group credit institutions of various designs in South Africa will give evidence on the problem of maintaining solidarity while controlling costs. In chapter 4 I will develop fully the critique of solidarity, arguing that solidarity is in fact a jointly produced asset and not a by-product. I will argue that there is a possible solution, leading to a hypothesis: Connectedness of borrowers is not a pre-existing feature of quaint rural settings, but an asset that needs to be created and maintained for successful solidarity lending. To this end, borrowers and lenders face non-tangible contributions which are substantial, and decisive for success. Further, credit is always more expensive in groups than it would be were markets accessible.

3.3 Group Credit in South Africa

The current paradigm has conveyed the argument that innovative financial institutions can transcend the frontier of conventional banking if they build their lending technology around solidaristic groups; and a closer inspection found this claim to be doubtful. The empirical evidence from South Africa substantiates these reservations. Recent experience from South Africa generally confirms that a gap exists between the conclusion of recent literature and the results of NGOs' involvement in the micro-loan sector.

Micro-enterprise lenders in South Africa show that group credit is no panacea for entrepreneurial credit. The accumulation of discouraging experience is no coincidence; in all cases, group credit did not work as prescribed in the literature for a number of reasons. The implicit assumptions of the group credit literature do not generally hold for the urban poor, for semi-industrial entrepreneurs, in South Africa's townships:[7]

1 - communitarian solidarity

In South African townships, people are geographically mobile but have generally a low attachment to specific neighbourhoods. Movements between townships, homelands and other areas are frequent. Some of the anonymity of cities is present. These neighbourhoods do not facilitate solidarity, trust and long-term relationships in the same way as do rural communities. Even in rural areas, geographical mobility is often high. Labour policy of the last decades has enforced a migrant labour system, and both male labourers and dependants often have a foothold in both village and city. 'Disruptions of social organisation and of social relations can be highly destructive to social capital' (Coleman, 1990, p. 320), an effect that climaxes under violence as experienced frequently in South African townships. Dependence from the joint good - credit provision, acceptability in the group or community - is weak and unpredictable as individuals pursue multiple opportunities, both in terms of income-generating opportunities and geographical location. Entrepreneurial activity often constitutes a survivalist strategy that is abandoned as soon as more attractive opportunities arise; survivalists often engage

[7] This information draws on interviews with Gunda Bernhard of the Informal Business Training Trust, Christine Clover of the Group Credit Foundation, Hilmar Thomas, an anthropologist working on a health project in the Cape Flats, Don Shay of the Triple Trust Organisation, Kwedie Mkalipi of the Credit Union League of South Africa and informal business people, mainly taxi-drivers and hawkers, in Johannesburg and Cape Town during 1994 and 1995.

in petty trading (Preston-Whyte, 1991). The frequent breakdown of solidarity groups seems unavoidable in these circumstances

2 - short term finance needs

Authors often assume that informal sector firms 'commonly require small amounts of short-term funds' (World Bank, 1989, p. 113). South African urban entrepreneurs do not agree. In townships, the nature of business differs dramatically from the countryside. Entrepreneurial loans are often given for the purchase of a capital good, such as a sewing machine, or welding equipment. The life span of these goods is long, and the entrepreneur may need long to repay a loan on them. Generally, neither ROSCAs nor group credit schemes rotate for longer than a year; and practitioners found their stability compromised by rotation times exceeding six months in urban South Africa.[8] Hence the purchase of crucial capital equipment requires loan arrangements for which a ROSCA/stokvel or group credit scheme is quite inappropriate. On the other hand, there is an adverse selection problem. Small, short-term loans are mostly appropriate for petty traders (hawkers); their initial stock could be purchased with the meagre proceeds of the first credit round of a group credit scheme.[9] Yet, borrowers whose main investment is in stock are highly mobile and may find alternative sources of funding, especially supplier credit. They are therefore less committed to a long-

[8] This information was volunteered during interviews with managing directors of the Group Credit Company and Rural Finance Facility.

[9] Information on the appropriateness of loan sizes and repayment terms for various kinds of entrepreneurial activities was collected during a series of interviews in townships and in informal conversation with fruit, clothing, and cosmetics hawkers in Cape Town and Johannesburg city centres.

term relationship with a lender than those entrepreneurs who invest in productive assets.

3 - co-operation as stable equilibrium

Stable peer groups in urban areas are often comprised of work colleagues in formal sector employment. Especially peer groups among teachers and support staff at formal sector institutions are known to have implemented many stokvels and credit unions. Unlike entrepreneurs, members of these groups are not in economic competition with each other. They also have secure income and basic social security, so that they can more easily predict their regular savings and repayment capacity. Entrepreneurial peer groups are formed by the colleagues who are also competitors, eg taxi-drivers, hawkers. Yet, in an environment characterised by rough competition and a survivalist attitude, there appears to be little incentive for co-operative help. Rather, the formation of 'gangs' could be the outcome as has happened to the taxi industry (Bank, 1991).

'Peer pressure' in South Africa has a real risk of translating into physical, and criminal, violence. Numerous social workers testify their experience on this point. Violence, unlike solidarity, does not aid the functioning of financial intermediation, or entrepreneurial activities. On the contrary, violence is often cited as one of the major obstacles to economic development of the townships. Any policy that enhances the potential for violence, therefore, has to be judged counter-productive.

The experience of two group lenders illustrates the structural dilemma between the need to establish solidarity and the pressure on costs. These institutions that have taken diametrically opposed strategies are compared; neither has successfully implemented a group lending scheme. The viable Credit Unions are then argued to have steered clear of trouble by avoiding, by and large, involvement with unemployed borrowers. Finally, a supposedly successful lender - the Get Ahead Foundation - is then analysed and found to be much less efficient than is claimed.

The Group Credit Company[10]

On the initiative of the Urban Foundation, the Group Credit Company was set up in 1988 in Cape Town to provide loans to low-income groups. In accordance with its name, a Grameen-type lending technology was applied. Activities concentrated on the urban and semi-urban communities on the Cape Peninsula. After a year or so of satisfactory performance during which all original funding had been 'utilised', 'the Group Credit Company decided during 1990 on a growth strategy with the objective to increase its lending capability to R20 million' (Development Bank of Southern Africa 1991, p. 1). However, the Group Credit Company soon experienced severe problems with the loan groups. First, the administration of group credit worked out to be much more costly than was originally budgeted, and the Group Credit Company received consultative help from the Development

[10] Much of this information was provided by the managing director of the Group Credit Company, Christine Clover, during an interview in September 1994. Additional insights stem from informal discussions with staff of the Development Bank of Southern Africa at various times between 1994 and 1997.

Bank of Southern Africa. Its report argued that specific attention needs to be given to 'the ratio of loan officers to loan groups taking into consideration the cost associated with loan officers' income generated through loans' (Development Bank of Southern Africa 1991, p. 3). Simultaneously, the recovery of loans worsened. Apparently, the credibility of the Group Credit Company's promise of future loans diminished. Groups found it more advantageous to default than to maintain a good credit record in the hope of future credit that may never materialise. In this situation, the simultaneous increase in costs and decrease in loan recoveries brought the Group Credit Company close to failure.

At this time it was decided to change the emphasis from group to individual credit. The Group Credit Company provides savings and credit facilities for low-income individuals and seeks to disassociates itself from group credit though it continues to run those credit groups which were established before the policy shift. Current emphasis is on prudence and financial control, and the Group Credit Company claims to have achieved a successful turn-around. In late 1994, the company registered as a mutual bank and changed its name to 'Cash Bank'. The association of group credit and near-disaster remains strong within the organisation.

Reasons for the break-down of group credit, that originally appeared successful, were stated as follows: First, the costs of travelling credit officers were prohibitive. More contact with credit groups was required than anticipated, especially when 'things go bad' which means that arrears also affect operating costs adversely. Further, contact with groups is made more difficult by the settlement patterns in the area of operation where townships are sprawling, locations are difficult to find (especially in squatter areas) and political insecurity took its toll at the time, too. Second, repayment rates were adversely affected by the lack of group solidarity. Rotation times of credit groups were too long and the stability of groups could not be guaranteed over periods required for economic reasons. Frequent movement of people into and out of townships means that the connectedness of groups is less than desirable. As claimed by the Group Credit Company, individual banking products could be designed to avoid these pitfalls.

The Group Credit Company illustrates that the need to further group solidarity is an important yet expensive component in the group credit technology. The process of building solidarity was found to involve credit officers extensively with local borrower groups, associated communication and travelling expenses were not compatible with the cost projections and could not be supported by the revenue generated from the loans. When the Group Credit Company started its lending programme, it fell prey to optimistic predictions and calculated that it would be possible to apply group solidarity technology without significant implications for administrative costs. After the inception, and following substantial loan disbursements, these effects became known. As the Development Bank of Southern Africa has argued, the costs of loan officers could not be justified by the number of loan groups, hence the costs of group maintenance threatened the viability of the Group Credit Company. Subsequent cost reductions led to defaults and the costs-revenue relationship quickly deteriorated. In conclusion, the Group Credit Company shows that cost-consciousness does not mix well with solidarity-based lending. In order to maintain sufficient social cohesion, a group credit scheme must be prepared to spend generously on extension staff and relationship-building activities.

National Stokvel Association of South Africa

The National Stokvel Association of South Africa (NASASA) is an umbrella organisation for stokvels in South Africa. Its membership of 11500 stokvel groups is concentrated in the Northern Province and constitutes probably only a minority of all national stokvels. NASASA is a lose organisation, yet there is some regionally biased animosity to 'being bossed from Joburg'.[11]

Andrew Lukhele, NASASA's charismatic founder and president, emphasises the social aspect of stokvels which is important to further the solidarity and cohesion of groups.[12] He summarises stokvels' aim as 'have fun while channel people's savings to proper investment'. Since the inception of NASASA it was its policy to develop a partnership with a formal financial intermediary. Presently, NASASA makes institutional credit and saving facilities available to its member stokvels

[11] This opinion was sampled during interviews with stokvel members in Cape Town. See also Thomas (1991) for similar reports about regionally biased perceptions of NASASA.

[12] This opinion and the following quotes were the fruits of an interview with Lukhele in August 1994; similar views are expressed in Lukhele (1992).

through the People's Benefit Scheme which it runs in conjunction with the First National Bank of South Africa. The People's Benefit Scheme encourages stokvel groups to save with First National Bank offering unit trust and fixed deposit instruments. Groups with a savings record can borrow against their savings. The maximum loan amount is 150% of the deposits. Deposits cannot be accessed as long as loans are outstanding as they are held as collateral. An Indemnity Fund, capitalised by the Development Bank of Southern Africa, guarantees the amount not covered by groups' savings.

Solidaristic credit institutions like stokvels save and provide credit in cases of distress. Insurance is one of their functions. The People's Benefit Scheme requires them to save in illiquid assets which cannot be accessed on short notice. The credit scheme requires stokvels to use savings as collateral, leaving only 1/3 of the nominal loan amount as net credit. Interest spread is used to hide the high real interest rate. The People's Benefit Scheme seems inappropriate for the needs of ROSCA-type institutions. Less than 10 percent of NASASA's member groups have decided to use the scheme. Critics have pointed out that the Peoples' Benefit Scheme is inappropriate for the needs of stokvel members.

NASASA appears insecure about its role. Lukhele describes it as 'financial facilitator', not intermediary, saying that 'we don't want to handle money, we only deliver people to the bank'. The ambitions are cast more widely in the field of community development. NASASA is involved in a school feeding system and contemplates supporting township hydroculture vegetable growing. On the social side, a stokvel football league is organised for the development of team spirit amongst its members. Valuable income is generated by the promotion programme: companies are invited to promote their products to stokvel members through the network of NASASA. According to its own information, NASASA can provide visibility in a wide audience of township consumers. In conclusion, the NASASA is far from becoming a lean, well-focused lender. It may yet be a successful NGO catalysing social change on a number of fronts, but it is not the financial intermediary that some see in it.

However, NASASA has succeeded where the Group Credit Company has failed: it is a large organisation with a loyal membership base, its members are not merely customers. Multiple activities are designed to enfranchise diverse stokvel members, and NASASA explicitly concerns itself with members' well-being beyond credit. However, this success comes at a cost: NASASA has not been successful in turning itself into a serious financial institution but rather incorporates elements of a welfare organisation and lobbying group. Financial services are now only one of many services, and they are dominant neither for their members' nor for NASASA's income. Commercialisation, especially the township promotion schemes, provides a larger share of NASASA's budget, the remainder coming from membership fees and donations of foreign donors and local corporations. Hence, NASASA has shown that group solidarity is crucial for stability, and has proven that it is possible to achieve a high level of cohesion. Yet, concentration on a narrow set of objectives and activities had to be sacrificed. Somewhat ironically, the success in creating a strong institution with a loyal membership basis means that the prospect of turning NASASA into a viable small enterprise lender is further removed than at the Group Credit Company.

The Credit Union League of South Africa

Proponents of solidaristic credit claim that viability and solidaristic structures are not conflicting objectives. Yet this claim can only be upheld by institutions which avoid high risk members and engage in loan markets that are easier to navigate than the entrepreneurial credit sector. The Credit Union League of South Africa is, arguably, the only solidaristic lender in South Africa with a chance of succeeding with financial viability. Despite a lack of tradition with credit unions, there exists now a strong and noticeable movement that consists of local credit unions and the umbrella organisation, the Credit Union League of South Africa. The promotion of credit unions was seen as a conscious act in the direction of black empowerment. Linkages with the international credit union movement are strong, and the Credit Union League receives financial help from American credit unions and USAID.

Local credit unions are designed to be self-sufficient. The League accumulates additional funds to which donors have contributed and which local unions may borrow, and acts as an information and consultancy centre. Previously, credit unions were organised in close collaboration with religious communities, usually around township churches. The communal emphasis was strong. The credit unions experienced problems with defaults and the depletion of their funds. Policy was re-oriented in order to make the credit unions more business-oriented and financially accountable. The performance is now more satisfactory.

Credit unions maintain a measure of stability by avoiding high-risk borrowers. Most of their members are employed in the formal sector. Although they are 'unbankable', they have a high degree of income security and usually borrow for items such as housing, consumer durables and schooling, not for entrepreneurial activities. In contrast to credit groups within a group credit scheme, credit unions form as a self-help savings and credit mechanism. Net savings are often high, and members are not expected to be net borrowers for some time after entering the club. Members select each other for loan eligibility which is not automatically linked to membership. Secure income, preferably from formal sector employment, is a usual way of showing 'social collateral'. External finance (ie the net indebtedness of the credit union) is only an exceptional occurrence, savings being the main emphasis for raising funds. Credit unions occupy a ground somewhere between a communal savings club and a small-time building society.

Credit unions are justifiably proud to contribute to socially desirable expenditure, but they are not strictly comparable to Grameen-type lending or small business loan schemes because they largely avoid the more demanding and more risky entrepreneurial market. Hence, their likely success is partly due to avoidance of the market segment that this study identifies as its main interest.

The Get Ahead Foundation

In 1988, the Get Ahead Foundation started disbursing loans to micro-enterprise owners in South African townships. Its agenda was a political one: to contribute to the correction of the effects of Apartheid. During the first few years of operation, the rapid expansion of the loan portfolio and the client base was seen as vindication for the Foundation's success as a social agent. During 1991, the client base tripled. In the quest for size, loan officers necessarily adopted a hand-outs attitude which they passed on to their clients. Also, staff were selected on empowerment criteria too, and many lacked the qualifications for prudent loan administration.

As a result, the group liability was often ignored. Groups were allowed to re-organise, including members from previous defaulters. Repeat loans were disbursed while repayments were still outstanding, and repayment rates sacked (Christen *et al*, 1992). In 1993, '70 percent of the portfolio was in arrears and they needed to make a provision for 50 percent of the portfolio' (Calvin, 1997, p. 3). When the crisis became fully known in 1993, reforms were implemented with the support of the key donor, USAID, that sought to strengthen the staff capabilities and to raise their morale, as well as to build discipline in the group lending principle. These reforms led to a weeding out of clients, reducing the client base by about 60% until it started growing again in the first half of 1994. Both the reorganisation as well as the improved group nurturing have increased the administrative costs, but defaults were down to 5% at the end of 1995 from around 25% in early 1994.

According to Churchill (1997), data from 1994 and 1995 show that the reforms have had the desired effects. However, he cautions that '[a]lthough portfolio quality has been restored, achieving efficiency, self-sufficiency and financial stability are still major challenges (p. 40). In fact, another study shows that the Get Ahead Foundation incurs costs of R1.4 for each Rand of credit disbursed (Strauss Commission, 1996).

The Small Enterprise Foundation

The Small Enterprise Foundation is a NGO located at Tzaneen, Northern Province. It describes its aim as the 'alleviation of unemployment and poverty in the black population of the rural areas of South Africa' (Small Enterprise Foundation 1994, p. 1). Imitating the Grameen Bank, the Small Enterprise Foundation is often referred to as one of the more successful lenders in the unsecured loan market in South Africa and enjoys a level of admiration from competitors and local policy-makers (Christodoulou *et al*, 1993, pp. 13-14), and according to the Strauss Commission (1996), it is more efficient in lending than the better-known Get Ahead Foundation. The Small Enterprise Foundation will be analysed in greater detail in chapter 6.

4. Group Credit: Contractual Exchange or Joint Production?

Recent interest in micro-credit coincides with a long-held belief in participatory development. Not only are previous policies such as subsidised rural credit perceived as having failed, but solidaristic institutions also fit into the current paradigm that prescribes 'grassroots participation' as the key to successful development policy, aid implementation and poverty alleviation. Consequently, solidaristic financial institutions have become the vogue of development thinking during the last decade.

Rigorous economic analysis of solidaristic financial institutions remains the exception. Discovered in the 1960s, rotating savings and credit associations (ROSCAs) were explored and discussed by sociologists and anthropologists (Geertz, 1962; Ardener, 1964), and subsequently categorised by economists (Nayar, 1986; Smets, 1996). Many contributions were predominantly descriptive, and sometimes carried by an explicit desire to introduce informal finance to the acceptable society of developmental financial institutions (Bouman 1979, 1990; Nayar 1986; Lukhele, 1990). The ROSCA itself remained, unfortunately, the mysterious black box at the centre of this discussion: repelled or admired, treated with respect or curiosity, located geographically, demographically and socially, subsequently uprooted and redefined, yet never understood.

The second major form of solidaristic financial institutions is group credit schemes modelled on the pioneering Grameen Bank (Yunus, 1982; Hossain, 1988). Many similar institutions exist now in various countries of the developing world (Berenbach and Guzman, 1994). Because group credit schemes are formal organisations, documentation is more easily available than on informal ROSCAs. Unfortunately, academic literature is again dominated by enthusiastic but hardly rigorous contributions (Fuglesang and Chandler 1986; Glosser 1994). Conceptually, ROSCAs are the origin of solidaristic financial institutions and still constitute their 'pure form'. Group credit schemes are more relevant for policy formulation; indeed, major institutions presently favour the continued establishment of group credit schemes.[1]

In section 4.1, three research papers that have as yet made the most rigorous contributions to the understanding of group credit schemes - Besley *et al* (1995), Stiglitz (1993), and Armendariz de Aghion (1995) - are examined. All three represent substantial progress in the analysis of solidaristic financial institutions, as they illustrate the benefit of co-operation, but do not provide an adequate understanding of the nature of groups. Section 4.2 argues that their approaches do not help us to understand the crucial characteristics of solidarity because they systematically underestimate the private costs of participation. Section 4.3

[1] For example, see *Financial Times*, 2 February 1996, reporting on the World Bank and other institutions holding very optimistic views about the repayment capabilities of borrower groups. On 24 December 1996, the *Financial Times* reported again about the Grameen Bank as a model for replication. Wright (1997) reports about the International Finance Corporation's 'micro-finance debut' which is, apparently, equivalent with its planned support programme for Grameen-type lenders.

proceeds to develop an alternative understanding of solidaristic financial institutions that views solidarity as a productive asset for making available joint goods. This approach applies the concept of 'social capital' and the theory of 'group solidarity', leading to the new, critical perspective of solidaristic financial institutions outlined in section 4.4. Section 4.5 concludes this chapter.

4.1 Solidaristic Financial Institutions as Contractual Clubs

Traditional economic analysis views solidaristic financial institutions as groups of individuals who enter into mutual contracts of exchange. However, this view leads many authors to formulate assumptions and develop models that misrepresent solidaristic financial institutions in some important aspects. Callier (1990) points out the central conceptual problem that bedevils this approach:

> "The traditional approach, which analyses the ROSCAs in the framework of financial intermediation, is logically valid. However, it does not highlight the economic logic underlying the emergence of this institution and fails to account for the specific features of the ROSCAs. To its participants, the ROSCA is more like a pooling of resources needed to gain the benefits of some kind of collective action [...]: the logic of the ROSCAs is the logic of collective action, not the logic of the market" (p. 274).[2]

[2] Here Callier refers to the traditional approach to ROSCAs, but the same criticism is valid directed at the analysis of group credit schemes in mainstream literature.

In the view of this 'traditional approach' individuals trade savings and monitoring effort with each other, receiving credit in return. Other important aspects of solidaristic financial institutions, notably risk, insurance and participation costs, are then omitted from their models. Such inappropriate assumptions led economists to impractical conclusions and policy advice.

Most economic analysis of group credit schemes focuses on either the informational advantage that socially connected individuals have within their communities, or on superior penalties that connected individuals can impose on each other. Besley *et al* (1995) focus on 'social sanctions' which are possible due to the social connectedness of borrowers in a group and formulate a 'repayment game' in a model with a two-member joint liability group. They conclude that group lending has both positive and negative effects on repayment behaviour, the outcome of those contradictionary effects depends on the 'social penalty function', ie on the severity of social penalties.

As with other economists writing on group credit scheme, Besley *et al* assume that repayment decisions depend primarily on the success of the investment projects that the borrowers undertake individually with their share of the loan. Hence, they view low return on investment as the principal reason behind default. Therefore, they interpret the positive effect of group lending on repayment rates as 'the possibility that successful borrowers may repay the loans of partners who obtain sufficiently poor returns to make repayment profitable' (p. 16). The concentration on investment projects distracts from the importance of opportunism and bounded rationality in determining repayment behaviour. In solidaristic financial institutions, members screen each other for character, not only for business acumen.

Besley *et al* discuss institutions that cannot be explained within the parameters of their analysis. They conclude that 'group lending may allow a bank to harness "social collateral"' (p. 16), but they offer no logically consistent explanation for its emergence. While asserting that 'participation in village life typically involves restraining self-interest' (p. 9), Besley *et al* do not explain which institutions regulate individuals behaviour in such ways. They observe that 'a variety of enforcement mechanisms, formal and informal, are harnessed to ensure this' (p. 9). However, such 'mechanisms' are themselves participatory institutions.[3] It is logically flawed, therefore, to assume that such institutions provide costless enforcement services on the basis of social participation, and to proceed with the analysis on the basis of a framework that views participating villagers as rational, maximising individuals. Two avenues for imposing a penalty are suggested by the authors: admonition and exclusion from other forms of exchange that normally take place between partners.

[3] Besley *et al* only mention 'mechanisms' at work in village communities; this term implies that it functions automatically. These mechanisms should more appropriately seen as institutions.

Collateral is an asset, whether 'social' or otherwise.[4] Institutions such as 'village control mechanisms' provide the environment for the creation of such assets; such mechanisms could be compared with the judicial system that enforces contracts in mainstream societies. Penalty mechanisms, whether vested in village connectedness or in courts of law, require real resources both for their establishment as institutions and their operation. Neither collateral nor contract enforcement are free.

Besley *et al* provide a caveat, though; they state that they are 'seeking implications of social phenomena rather than explaining them' (p. 10). However, such an approach would be valid only if the 'phenomenon' is independent of its 'implication'; it is not logically sound when social institutions are, *inter alia*, shaped by their roles in society. Besley *et al* assume that connectedness is a given feature in village societies and that contract enforcement and social collateral evolve automatically from it. However, it seems more appropriate to assume that both connectedness and the formation of social collateral depend on the intensity of economic exchange between villagers, including the availability of group loans. To ensure that their model is an adequate approximation of group credit schemes Besley *et al* would need to consider social institutions; notably, the costs of establishing and maintaining 'social collateral' are missing from their analysis.

[4] If collateral was not an asset, the threat of losing it could not be a deterrent for potential defaulters.

In contrast to Besley *et al*, Stiglitz (1993) looks at the informational gains that group lending achieves by tapping 'local knowledge'. Stiglitz discusses the meaning of solidarity in his introduction, but then develops a model without any reference to it, although he intends to capture informal contractual obligations and returns. He assumes that information is costless because the borrowers are neighbours and know each other well. However, he also reports that "the interdependence among the members of the group is artificially created" (p. 72). His model allows no insight into the process of peer monitoring. Increased risk is the only cost of joint liability that he states explicitly. However, even if information were free, monitoring (i.e., the analysis as opposed to the gathering of information) and enforcement must be costly. Also an overemphasis on monitoring distracts from the process of group formation: Stiglitz mentions the selection effect of group formation in a footnote (note 5), but excludes any consideration within his model.

The riskiness of borrowers is described as given ex-ante, although not observable by the lender without costly monitoring. In the model, as in Besley's, it is only represented as the respective riskiness of the chosen investment project.[5] However, contrary to the assumption underlying this specification, evidence shows that riskiness of repayment is largely influenced by members' commitment to the group, and the group's ability to apply social pressure (Thomas, 1991;

[5] This implicit definition of lending risk captures the insolvency of micro-business only. However, opportunism and free-riding are also potentially important reasons for non-payment in credit markets without collateral.

Albee and Reid, 1992). It is the interaction of group members, therefore, that has a large influence both on the repayment behaviour (i.e. actual risk) and the costs of group participation. Neither is adequately addressed by Stiglitz. A group as such does not exist in his model; he dispenses with the object of investigation and replaces it with borrowers who act as agents for the lender to monitor their peers.

Following the approach established by Stiglitz (1993), Armendariz de Aghion (1995) develops a more complex model of credit with peer monitoring. Her aim is not only to prove potential superiority of peer monitoring over 'standard bilateral credit contracts', but also to consider specific variables for efficiently designing such a credit contract, such as group size and monitoring structure. On the diversification of group members according to their economic activities, she assumes that peer monitoring depends crucially on the knowledge of a group member about peers' return to a specific investment project. This knowledge, she argues, is easily acquired as all projects are stochastically dependent. In reality, peer monitoring depends little on the peers' knowledge about specific investments, and strongly on peers' knowledge about each others' overall financial position, including personal and familial affairs, and 'character'. "Group credit schemes induce borrowers to engage in assortive mating wherein local knowledge about each others' assets, capabilities, and character traits is used to sort and self-select" (Wenner, 1995, p. 265). The advantage of peer monitoring over traditional practices lies in their social connectedness, not merely private information about specific investment projects.[6]

Armendariz de Aghion's discussion of the structure of monitoring finds pyramidal monitoring superior to mutual. This conclusion is based on the assertion that mutual monitoring agreements duplicate efforts as each member gets monitored several times if the group size exceeds two. The quality and reliability of monitoring does not enter the argument, while, in fact, the benefit of peer monitoring lies exactly in the pulling together of all local information.[7] Peer monitoring is a group effort that relies on the members' connectedness and cannot, therefore, be delegated.

The body of literature presented here constitutes a major leap forward as, for the first time, informal, 'joint-liability' groups are shown to be potentially creditworthy in a rigorous economic model. Unfortunately, economic theory still models solidaristic groups without making explicit reference to solidarity. 'Connectedness' is assumed to be in existence and to be objectively - and sometimes costlessly - observable from the outside by the potential lender. Only under these conditions can the potential lender be able to treat a number of individuals as a group that can present 'solidarity', i.e. mutual liability, as

[6] If all group members ran businesses of the same type in the same village, overtrading in this sector could well undermine the viability of their projects.

[7] This 'pulling together' is exactly how reputation is created: a group arrives at some consensus, agreed by informed members, to evaluate character and credit worthiness of individuals.

collateral, rather than the sum of their individual wealth. It is only on the basis of these, arguably implausible, assumptions that economic literature can conclude that joint liability 'contracts can potentially dominate standard (bilateral) contracts to the extent that they allow the bank to take advantage of both lower monitoring costs and social sanctions (among peer borrowers) in order to elicit higher debt-repayments form each group member' (Armendariz de Aghion, 1995, p. 12) and can assert that group credit is preferable 'in less developed countries [...] especially in rural areas where a large majority of individuals do not have enough collateral to secure a loan' (Armendariz de Aghion, 1995, p. 1).

4.2 Solidarity and Capital Accumulation

All three papers discussed above share one weakness. Their authors all stress that certain social relations - 'connectedness' - are the key to solidaristic financial institutions. Yet, they do not incorporate into their analysis the difference between a solidaristic group and contracting individuals. This means that all three authors acknowledge that solidaristic financial institutions are based on specific, non-standard decision-making patterns; yet they proceed to model these institutions assuming general, standard decision-making. Solidaristic groups are also generally characterized by a relatively high level of egalitarianism, compared with non-solidaristic groups such as firms. As a result, all three authors focus on monitoring costs - which are really only one part of total 'solidarity costs' - or payment streams and assume various free goods: free information, free trust and connectedness. While group-oriented behaviour is clearly a precondition for peer monitoring, solidarity is supposedly in abundant supply.[8] This approach can be criticised for presenting an atavistic picture of villagers enjoying cosy and trustful relationships.

In contrast to recent economic analysis, early work on solidaristic financial institutions was almost exclusively done by sociologists and social anthropologists. While the insights of both sociologists and economists are valuable for the understanding of solidaristic institutions, their approaches and results often appear incompatible.[9] Sociologists are primarily concerned with the behaviour of groups and within groups. Solidarity - that is the binding 'glue' of groups - is assumed to exist, as without it no social order would be explicable. Normativists, who argue that group-oriented behaviour stems from socialisation processes, have tended to argue that the reasons why solidarity groups exist are to be found in the characteristics of the specific communities in which they are embedded. These norms, supposedly characteristics of rural, more communally

[8] The failure becomes apparent through a simple mind-game: Imagine a development manager who is to set up a group credit scheme in some area where no such scheme exists. Once you are supplied with all you need by the donor - funds, offices, support staff - the question is: where are the solidarity groups? How do you recognize them? After you advertise your lending strategy in the local population, groups may approach you for loans - how do you know that they do, in fact, constitute a solidaristic group and not a bunch of free riders? Finding answers to these question will involve your organization in spending time and money to get to know the applicants, to learn about their relationships with each other, to foster relationships in the way required for your purposes, and, thus, become a member of their group yourself.

[9] Two distinct strands of knowledge, therefore, exist simultaneously, apparently without much chance for mutual enlightenment, but obviously in contradiction to each other. This unfruitful friction is not limited to the research into solidaristic credit groups; rather it is embedded in the foundations of sociology and economics respectively and afflicts many areas of shared interest.

oriented societies, guarantee individuals' willingness to behave to the group's benefit at the expense of private gain. Such a view is implicit in Lukhele (1990) and Fuglesang and Chandler (1986). According to this approach, group formation and solidarity are aided in rural and poor communities by the normative influence of closely-knit societies. Structuralist interpretations of solidaristic financial institutions emphasise that their members are all credit-constrained and thus share specific vested interests. According to the structuralist view, solidarity groups form because their members all experience credit rationing and aim at bettering themselves through co-operation (Callier, 1990; Moodley, 1995).

Both sociological schools give plausible and important explanations for the emergence of solidarity, yet both remain unsatisfactory. Most important for this study, they fail to account more fully for the critical conditions under which solidarity arises and flourishes. Why, for example, is solidarity such a rare occurrence in public life - and misconduct a common threat - if normative behaviour is so persuasive? Why do so few, but not all (or even most) individuals with shared interests, form solidaristic groups - a question raised by Ardener (1964) in response to Geertz's (1962) structuralist interpretation of ROSCAs? Why do group members not free-ride?

Solidarity denotes a pattern of behaviour where a group acts in ways which are in the long-term interest of its members. Yet there are no visible incentive mechanisms that entice members to behave in the group's rather than their own individual interest, no immediate or tangible return as in a contracting situation. Therefore, many authors found it difficult to reconcile solidaristic behaviour - and institutions relying on it - with the assumption of rational choice decision-making which underlies modern economics (Hechter, 1987, pp. 30-31). It is this gap which the above authors failed to address, and where therefore their models deviate from the reality of solidaristic financial institutions.

However, solidarity does produce returns. Individuals may be better off if they position themselves within a network of social relations so that they can borrow (Besley, 1993; Stiglitz, 1993) because credit availability is a valuable asset. Within the context of solidaristic institutions, the availability of credit is dependent on developing - and being able to demonstrate the success in developing - specific social relations. Economists refer to productive assets as capital, but social relations are not yet widely accepted as constituting productive assets.[10] Social groups better themselves by setting long-term objectives, committing private resources to each other and adhering to rules and norms with the aim of preventing shirking and free-riding. Being able to lend credibility to their commitments, they pareto-improve above the Nash-equilibrium that individualistic actors would choose.[11] Social capital has been accumulated when

[10] Generally, social capital is more accepted in economic research with a multi-disciplinary flavour. Notably, work in the fields of development and management are willing to apply the concept to issues from business networks in Asia to reputation and the value of the firm.

[11] Nash equilibria are outcomes of games, with two or more players, based on mutual expectations of their respective decisions. Credible cooperation may improve the pay-off for all players (and therefore improve welfare in the distribution-neutral meaning of pareto-optimality): In the case of the prisoners' dilemma, if the two prisoners constituted a solidaristic group, neither would confess,

two parties are prepared to commit their own resources to a specific, intertemporal transaction that two individual rational choice agents would not engage in without safeguards, such as collateral or enforceable contracts, to prevent opportunism and bounded rationality. Social capital thus plays the role of such safeguards, although it is not necessarily established by - nor subject to - formal rules.

Social capital shares certain properties with human capital - the productive value of knowledge and skills of persons - as it is also embedded in persons and personal relationships. Like human capital, it cannot be transferred. As a non-marketable asset, its value cannot be determined by market-based 'price'. Finally, its production process can rarely be precisely described as many incidents of social exchange, experience and cultural formation imprint on the production process of both forms of capital. "Like human capital and physical capital, social capital depreciates if it is not renewed. Social relationships die out if not maintained; expectations and obligations wither over time; norms depend on regular communication" (Coleman, 1990, p. 321). While these facts are intuitively known to solidaristic financiers, they still have to be addressed explicitly in theory covering solidaristic financial institutions.

knowing that the other is bound to cooperate. In fact, crime syndicates heavily rely on group formation and credible commitment, enforced by 'peer pressure' (see also footnote 13).

4.3 Joint Production and Group Lending

So far it has been argued that a solidaristic group is not merely a network of individuals conducting contractual exchange of private resources. Rather, it constitutes "a collection of individuals who are engaged in a specific type of mutually oriented activity" (Hechter, 1987, p. 16) with the aim of engaging in risky, intertemporal transactions that would, normally, invite opportunistic behaviour. This mutually oriented activity, made possible by social capital binding together the group's members, aims at providing credit, insurance and company as a 'jointly produced good'.[12] Joint production requires that group members enter into obligations to provide private resources for the production process within the group. Members are obliged to contribute for membership in the group, but not for the consumption of a specific quantity of the joint goods. Therefore, the obligation can adequately be seen as a membership fee or tax. The products of participatory activity are also not distributed according to the rules of the market, but according to exogenous decisions made by consenting group members. Rules have to be agreed which govern the extent of obligatory contributions of effort and money, the organisation of production and the

[12] This type of good possesses similarities with a free good, but it differs because its supply can be restricted to those who participate in its production. Gaining access to this 'collective good' is the motivation for joining a group. The necessity to produce a good jointly rather than individually may arise from the costs of production or the nature of the good. Hence, either private resources are insufficient and pooling is warranted, or private production is impossible regardless of individual endowment. The latter case is more likely to be true with non-tangible goods; Hechter mentions the examples of churches which produce 'salvation' and 'the pleasure to be gained by playing chamber music' which necessitates membership in an appropriate group (Hechter 1987, p. 54).

distribution of the good. The group also needs to control its members and enforce the obligations. If it is unable to do so, members will free ride, i.e. enjoy the good but avoid contribution (Olson, 1971).

Control has two elements, monitoring and sanctioning; the latter entailing a credible threat, including expulsion from the group and from the enjoyment of the joint good. Members of groups are subject to a degree of dependence on the group. They desire the joint good, for this is the reason to form a group. Entry occurs only if the benefit from consuming the joint good exceeds the disutility of the contribution. Dependence is created by the disutility incurred from leaving the group and taking the next best alternative. It is greater the fewer alternatives exist, the more difficult alternative sourcing is, and the more important the joint good is for individuals' survival.

Personal relations and commitments which accumulate over a period of time through repeated interaction within the group are sunk costs in the group constituting non-transferable social capital. Social capital thus entails that rules and practices are established which structure the production process and determine individuals' entitlements to the group product. As social capital increases, members also become more dependent because larger shares of their private wealth is embedded in non-fungible social relations, thus their exit costs increase.

Contributions have to be large enough to cover the costs of production for the joint good; if they are not, production will not be forthcoming and the group will disintegrate. While the contributions of members can comprise any type of scarce resource - time, effort, money, reputation - the level of contribution may well differ between members within the group, depending on the internal social structure. The maximum achievable contribution is determined by the level of dependence of group members. Were contributions greater than the dependence, that is the costs of leaving the group, membership would hold no net benefit. Groups may also produce more than one good. Often groups can be found providing some more tangible good but also company, friendship and social fulfilment. Many reports on solidaristic financial institutions have pointed out that social meetings, which are part of the production process, are enjoyed by their members and are an important incentive for participation (Ardener, 1964; Fuglesang and Chandler, 1986).

Why are jointly-produced goods produced by groups and not by freely contracting individuals, as is implicitly assumed by Besley *et al* (1993; 1995), Stiglitz (1993) and others? Supposedly, free contracting would provide immediate rewards for individuals and would be more efficient than group production. Obligations to forego control over private resources were unnecessary and, socially, the costs of establishing and controlling group rules could be channelled to more directly productive ends. Several answers are possible. Firstly, complex contracting arrangements are expensive, and an obligatory rather than a contractual system may be found to be the more efficient solution. This argument lies at the foundation of the theory of the firm and has been well documented (Coase, 1937; Williamson, 1985). Firms, like solidaristic groups, rely on some form of obligation and control rather than immediate contracting. Further, contracting is spontaneous and offers returns to individual effort, yet the rate of return is frequently beyond the individual's control. Contracting relegates the individual to the volatility of markets; risk-averse individuals may prefer group production because allocation is exogenous. Thus, groups offer implicit insurance (Platteau and Abraham, 1987).

Why are group members not compensated for their efforts, effectively paid wages or commissions, as Armendariz de Aghion (1995) suggests, describing group members as agents on behalf of the lender? Hechter argues that there are 'groups' (such as firms and co-operatives) paying wages. These 'groups' are characterised by the fact that their products are marketable. The sale of their products, therefore, enables them to acquire the means for compensating their members. Solidaristic groups, in comparison, produce goods which can only be consumed by their members, i.e. immanent goods. Creditworthiness, attained by creating group characteristics, is such an immanent good. Therefore, it is also misleading to construe solidaristic credit as a commercial service.

Hechter (1987) argues that the conditions for solidarity are dependence, contribution and control. Dependence exists because a group is the only, or the least costly provider of some valued good. Contribution is the cost of membership which entitles members to some, exogenously agreed share in the production. Control is necessary to ensure that they honour their promise of contribution, and to sanction their behaviour.[13] "The greater the average proportion of each member's private resources contributed to collective ends, the greater the solidarity of the group" (Hechter 1987, p. 18).

Dependence has been argued to be a function of various variables, one being the lack of viable institutional alternatives. Solidaristic financial institutions are more frequently found in poor, underdeveloped communities where access to numerous goods, notably insurance and credit, is dependent on social networks (Basu, 1984; Platteau and Abraham, 1987; Hyuha *et al*, 1990). Efficient markets are less readily available there than in developed countries and sectors.

Contributions are the condition for membership which entitles members to the receipt of the joint good.[14] Yet the value of the contribution exceeds the price of the good if it was available on a reasonably efficient market because production in a group necessitates the accumulation of social capital. The costs of accumulation

[13] The creation of these three properties (dependence, obligation, and control), and the accumulation of social capital within a fiercely exclusive group, are the foundation of organized crime. Gambetta (1993) describes the interplay of ritual, physical threat and social and economic incentives through which solidarity is enforced in the Italian Mafia. Obviously, social relations embedded in a Mafia 'family' give rise to economic exchange which are not available to free contractors, and which benefit the members of the solidaristic group.

[14] Contributions for ROSCA membership commonly comprise household resources: time, work food, and, obviously, money. However, the non-tangible costs are often substantial.

include the resource need for the establishment of organisation, i.e. rules and control. Therefore, contributions have to exceed the costs of production and assume a level closer to dependence. The group must be seen to be appropriating a share of the consumer surplus.[15] Intuitively, this appropriation can be understood as the costs of providing a safe environment for joint production; social capital has to be 'overinvested'. As risk-sharing is one of the attributes of solidaristic groups, overinvestment is a necessary safeguard to ensure the survival of the group in a volatile environment.[16] Brett (1996) refers to the 'costs of consent' which arise from the establishment of the group's 'superstructure', notably time-consuming decision-making procedures. In any case, joint production costs exceed physical production requirements - such as the monitoring costs captured by Armendariz de Aghion's (1995) model - due to the requirements of regular communication, meetings, and social bonding (Coleman 1990). Therefore, when a market develops, groups will cease to be the provider of a joint good at the lowest realisable price. Bankable people do not normally form credit groups. Callier (1990) finds that the ROSCA "loses its raison d'être when capital market segmentation vanishes as a result of market integration: access to credit at the prevailing market rate solves the problem of lumpy expenditures" (p. 275).

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[15] For a more detailed argument see Hechter (1987) p. 169-71.

[16] As groups offer a more constant income stream than immediate contracting - ie predictable access to their joint good - the costs of overinvestment in the establishment of the group could be viewed as an insurance premium.

Control in solidaristic financial institutions is often exercised in a rather informal way, and through more than one mechanism. Monitoring extends not only to reliable payments, but also to other aspects of an individual's economic and personal situation, and his or her character (Wenner, 1995). Sanctioning involves both the exclusion from the group, and also exclusion from a wider range of communal activities. Sanctions are most efficient if they can rely on co-operation of third parties. To this effect, group defaulters may be ostracised socially not only by their group members, but by other authorities playing a role in the life and economy of a village or community. The consequent loss of social capital may be a more severe threat than exclusion from the solidaristic financial institution per se. Hence group members may go to great lengths to honour their promises for contribution to the group, thus avoiding exclusion from economic exchange (Bouman, 1979; Thomas, 1991).

This approach derives solidarity from the assumption of rational choice agents; and it needs to be emphasised that this form of solidarity "differs from others that refer not to potentially observable behaviour of group members but to the strength of the sentiments binding them together" (Hechter 1987, pp. 18-19). While not denying the existence of sentiments, the concentration on observable behaviour aids the deduction of falsifiable statements and the application to solidaristic financial institutions. Solidarity, therefore, is not identical with altruism. Solidarity specifies a set of social relations that requires surrendering control of private resources, but that is also compatible with a long-term private maximisation strategy. It is based on reciprocity, not free giving, and therefore involves a rational choice calculus.

4.4 Solidarity and Group Credit Schemes

I have argued that group solidarity is a costly asset, a second order collective good that is produced by groups for their own productive use. The costs involved in its production, therefore, are part of the total production costs of the final product, credit. However, group credit schemes are promoted on the basis of their alleged efficiency in providing micro- loans. The costs of social capital, an integral part of their production function, are frequently neglected. In the following section, I will show that group lenders are also solidaristic partners to their clientele, although, as formal institutions, the relationship is asymmetric. In fact, much of the success of group credit schemes stems from their ability to present themselves as solidaristic partners of poor people. The lenders' burden in the 'costs of consent' are, unfortunately, financial obligations which are in conflict with the objective of financial efficiency of group credit. In contrast to ROSCAs, group credit schemes are lender-driven, and the lender is a formal institution with a level of authority. However, solidaristic groups constitute the organisational basis for this formal institution; these groups are formed in order to jointly provide access to external sources of capital. Thus the joint good has been created when a group comes into existence with characteristics which signal creditworthiness to the lender. This solidarity can be described as primary solidarity since it comes into existence only by power of another relationship with solidaristic characteristics. The connection between the group and the lender constitutes the secondary level of solidarity.

For this second level of solidarity, the credit officers are the crucial focus. The relationship between credit officer and borrower groups has two important functions: First, trust and connectedness between credit officer and borrowers create the social capital that binds solidarity credit scheme and members together. Second, only in this relationship can the solidarity credit scheme, through its agent, observe the nature of intra-group relationships. The credit officer thus has to verify that borrower groups are adequately equipped with social capital.

The solidaristic nature of the lender-borrower relationship is most visible in their 'bonding'. The lender induces the borrowers to internalise 'rules of conduct'.[17] Internalisation not only seeks to lower monitoring costs, it also represents a non-fungible investment by the borrowers and thus increases their exit costs. The Grameen Bank and other group lenders promise to provide contact and advice in financial matters and have an 'open ear' for the problems of the borrowers. This amounts to presenting the lender as a personalised, caring partner who takes interest in the well-being of the borrowers beyond its institutional self-interest. Thus, the Grameen Bank, like other lenders, commits itself to specific obligations vis-à-vis its borrowers. Having established its reputation with a specific

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[17] Fuglesang and Chandler (1986) detail 'The Sixteen Decisions' which relate, *inter alia*, rules for the use of pit latrines and food practices) and sing the Grameen-song together during meetings. For detailed descriptions of the daily group work see also Von Pischke (1991).

community, Grameen has also sunk costs into this relationship and increased its exit costs.

On the other hand, members are also required to engage in costly bonding. Grameen requires its borrowers to purchase its shares during the loan program, so that the majority of the Grameen Bank's capital is now owned by its borrowers; other group lenders use obligatory savings. It would be misleading to construe this as a portfolio investment by saving groups.[18] Rather, it is part of the contribution to the solidarity relationship between lender and borrower, and is meant to cement the stake borrowers have in maintaining a long-term, stable relationship (Von Pischke, 1991, pp. 238-242). Other group lenders require non-tangible start-up contributions such as taking 'entry exams'. Grameen further "encourages members to form schools and it sells textbooks, while centres have set up child welfare funds", it further "produces construction plans for houses" and "has a seed distribution program featuring very small packets to encourage gardening" (Von Pischke, 1991, p. 240). The lender assumes functions of a welfare organisation, borrowers become clients, or members; those borrowing from a commercial bank are mere customers. There are specific, costly obligations arising for both sides from the nature of this relationship.[19]

[18] As Grameen shares cannot be sold on a commercial basis, and may only be owned by members, they represent a sunk cost in the borrower's relationship to the lender.

[19] While the borrowers face contributions similar to those of ROSCA members, i.e. household resources, a group credit scheme-lender supplies corporate resources: staff and management time, contributions in kind like stationary, transport costs, and obviously capital for lending. Solidarity costs are therefore, from a lender perspective, tangible, real costs.

Following from the understanding of group credit schemes as social order based on a form of specific capital accumulation, it is possible to formulate several conditions for successful implementation of a group credit scheme:

- Groups are possible only where dependence exists. The joint product - credit, insurance and company - has to be valued highly enough, and there must not be any viable alternative to group credit. Group credit was often seen as a way to avoid exploitation by moneylenders. Whether the allegation of exploitation is true or not, once they provide an alternative source of credit, the dependence on credit groups is diminished and their stability is not assured.
- Obligations must be set by agreed rules. The value of obligations is not to exceed the 'consumer benefit' from credit; due consideration is to be given to transaction costs. From the borrowers' perspective, contribution includes not only the time spent on sitting in meetings but also, for example, the time involved in getting to meetings, preparing for meetings and in the management of the group, involving activities such as keeping accounts and communication outside meetings.
- Control must be feasible. If control costs are high the viability of groups will be reduced or undermined. Monitoring requires extensive personal contact between group members. Effective sanctioning is possible only where social and geographical mobility is low and economic interdependence strong. Finally, the costs of control must not be so high as to render joint production unattractive.

For an institutional lender involved with credit groups, control entails the management of groups and group characteristics, not only of their members as individuals. Monitoring could be almost costless if it was restricted to checking payment streams. But in practice, monitoring requires personal interaction and an orientation towards social relationships; the overt screening of repayments is sometimes discouraged. Sanctioning is practically restricted to the denial of future credit for the group. Should a group collude to default, effective sanctioning is virtually impossible, unless the wrath of local communities can be invoked. Therefore, group lenders find it important to establish a good image with the wider community, and they are frequently prepared to incur real costs for this purpose.

Natural (and free) 'connectedness' of borrowers is not the only condition for the successful application of group credit technology, as was implied by recent literature. Solidarity is a second order collective good that is required in the production of the joint good, credit. Borrowers and lenders face non-tangible contributions which are substantial, over and above the costs of 'pure' production of credit. Because group credit schemes are not natural persons but institutions, these contributions are measurable as the effect on general, operational costs or staff costs. Reliance on inadequate theory has led lenders to structurally and systematically underestimate their costs. This result illustrates a missing link in existing economic theory on solidaristic institutions: the contributions - both from lender and borrower - to the solidaristic network are substantial and crucial to the stability of groups. Although group credit schemes have generally encouraging repayment records worldwide, the cost factor could result in prolonged reliance on subsidies. The costs are a potential obstacle to the successful implementation of group credit schemes: the case study in chapter 5 indicates that 'costs of consent' can easily surpass the interest costs of credit for the borrower, while the costs of establishing and maintaining group networks exceed the default costs of comparable individualistic lenders.

4.5 Conclusion

In this chapter I have argued that group solidarity is a costly asset. The costs associated with accumulating it can be substantial, and may in fact outweigh the benefits of solidaristic intermediation. This conclusion is supported by the fact that many group credit schemes are much more costly than existing theory would imply. While social relations can reduce default rates, it is crucially important to consider the costs of creating such a social environment. This result suggests that non-solidaristic, non-participatory institutions should be considered as serious alternatives. Elsewhere it was argued that innovative non-group micro-lenders can be viable (Chaves and Gonzales-Vega, 1996), and could contribute to micro-enterprise development (Mauri, 1985; Grosh and Somolekae, 1996). Others have argued that innovation and 'good governance' are more important factors for success than control through groups (Jain, 1996).

Evidence from South Africa and elsewhere shows that the costs of producing an enabling environment for solidaristic lending vary considerably. Factors influencing the costs of social capital accumulation include pre-existing social structures and relationships but also other factors that have an impact on communication costs, such as population density and settlement structures (Hossain, 1988). However, to my knowledge there is not one solidaristic lender in developing countries who achieved viability of the lending operation without substantial cross-subsidisation from other activities. Individualistic lending in similar circumstances could arguably be more economical, even including generally higher default rates. This fact would suggest that accumulation costs of social capital are indeed substantial.

The costs of accumulating social capital - of establishing, monitoring and enforcing group rules - may explain why so little investment in poor communities is financed by solidaristic institutions. It is not the fragility of legal systems, as Stiglitz speculated, but the production function of solidaristic institutions that impedes the blossoming of ROSCAs and group credit schemes alike. Finally, the participatory principle in development theory is still prevalent, although it appears that its fundamentals have not been critically tested; recent research finds them fragile (Brett, 1996).

5. South African Micro-finance in Context

Following the abstract arguments developed in the previous chapters, this chapter provides an overview of the economic and political background to the operation of micro-finance institutions in South Africa in the mid-1990s. This discussion will then provide the setting for the analysis of two micro-finance institutions, representing two different approaches, in the following chapters. I start by setting out the policies of racial discrimination during the Apartheid era and their effect to black entrepreneurial activities in section 5.1. Here, I discuss discrimination in the labour market, poverty, and the housing crisis. The chapter then moves on to explore the changes of economic policy during political transition in section 5.2. This section includes a discussion of changes in financing NGOs during changing donor and government objectives. Section 5.3 provides an overview over the financial system in South Africa. It starts with brief comments on the central bank and the commercial banking sector, moves on to the non-institutional lenders and finally provides a summary of development finance institutions. This section detects the absence of a coherent policy towards the integration of the financial sector, especially between institutions serving different parts of the population. Section 5.4 provides an overview of the micro-finance sector. In particular, it points out that the sector is young, underdeveloped and comprises only four institutions of significant size.

5.1 The Apartheid Era and its Legacy

The segregation of people by race has a long history in South Africa. From early this century, segregation became increasingly enshrined in law, thus formalising and enforcing the *status quo* at the time. While this is mirrored by developments in other African countries, then colonies, South Africa became notorious for its ideology of Apartheid. Although racial segregation reaches back much further, the Apartheid system refers mainly to the legal, social and economic system established in South Africa under the rule of the National Party from 1948 until 1994. The establishment of the Apartheid system, and its peak under president Vorster, coincided with movements towards and attainment of national independence in most African colonies, and the start of civil wars in South Africa's neighbouring countries, which all resulted in their eventual independence. Therefore, South Africa was the country where black economic development remained suppressed by white supremacist aspirations longer than anywhere else on the continent.

Regulation and business development under Apartheid

Apartheid planners acted within the constraints of an ideology that ruled that black people were in white areas only on a temporary basis, as they were citizens and residents of their respective homelands. However, their temporary residence status in white areas, including all major towns and cities as well as the most valuable farm land, was deemed necessary as black labour was important in white industry, mining, farming and as 'domestic help'. The ideology of temporary presence of black people in most of the country denied black entrepreneurs the opportunity to establish businesses in economically more important parts of the country. The Land Act of 1913 prohibited black people from owning land outside designated 'native' areas. This meant that black entrepreneurs were automatically excluded from financial markets since they could not offer collateral in the form of property ownership.[1]

On the basis of this notion of temporary residence, a comprehensive control apparatus was established to monitor movements and resident status of black people in white areas. Implicitly, this apparatus served the interest of white business owners. Urban townships for black people were designed as temporary living quarters for black people while working for the white urban economy. Townships were not meant for families, and the original planning contained few of the social amenities that would induce voluntary long-term settlement. The Natives (Urban Areas) Act No. 21 of 1923 restricted the permitted economic activities within townships to the most basic necessities, mostly selling food. More up-market retail or service activities, such as bars or repair shops, were not licensed as 'businesses satisfying more than the barest daily necessities remained

[1] However, the geographical separation under Apartheid also created business opportunities for black entrepreneurs as white-owned businesses were banned from black areas. Especially after the gradual easing of business licensing requirements in the 1970s, several black business accumulated substantial wealth in retailing. Their success was partially attributable to the absence of white-owned retail chains in black areas.

the defended preserve of white entrepreneurs and were located in white urban areas' (Riley, 1993, p. 5).

In 1948, the National Party came to power and ventured to implement its vision of Apartheid. Most important, it passed the notorious Group Areas Act in 1950 that enforced race-related zoning retrospectively. This forced black entrepreneurs in white-designated areas to sell their businesses, and also affected residential ownership. Hence, property that could have served as collateral was often sold significantly below its market value. This policy affected a large number of Cape coloured people who had lived in mixed areas in Cape Town, but who were forced to sell or even saw their houses demolished.[2]

The stricter segregation regime and harsher implementation could be explained by the interests represented by governments following the election in 1948. Generally, the National Party governments that ruled South Africa from 1948 to 1994 were more sensitive to the demands of diversified white business interests than their predecessors.[3] This could be explained by the sections of society most directly represented by government: the National Party represented the accession of Afrikaner interests (Schrire, 1991), many of whom were farmers, traders or

[2] Most famously, the formerly coloured District Six in Cape Town was 'cleared', ie demolished, by authorities, its residents resettled to designated coloured areas and the land, adjoining the central business district of Cape Town, was opened to white development. However, because of the stigma attached to the forced relocation of its previous residents, the land of the former District Six remained mostly undeveloped during the Apartheid years and its use is debated even today.

[3] However, it should be noted that Apartheid-related regulations were softened, or increasingly ignored, from the early 1980s onwards, accelerating under the de Klerk presidency from 1989 until 1994.

small and medium business people. Previous governments were more easily identified with the large scale mining and finance interests of the English-originating white population, who felt their position less threatened by black entrepreneurs. While both major ethnic white groups relied on exploiting black labour (and on appropriating black-owned land), the large-scale mining empires controlled black labour through ownership and market power, while Afrikaner interests were better served by direct legislation.[4] 'The National Party, dominated by Afrikaners and in power continuously since 1948, had used its power of patronage to create an administrative machine in its own image' (Schrire, 1991, p. 40).

In 1963, legislation was further tightened to the detriment of black entrepreneurs. First, the 'one man-one business' policy, based on an informally circulated policy document, sought to limit black business expansion. This prevented the emergence of a professional, business-oriented middle class. The effect of this and additional legislation was 'to persuade black entrepreneurs to move their activities away from urban townships and to establish business ventures in the homelands instead' (Riley, 1993, p. 6) where they were deemed to be permanently resident.[5]

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[4] H.F. Verwoerd is often seen as the 'architect' of Apartheid, and as its most eminent theorist. He was Minister of Native Affairs from 1951 to 1958 and then Prime Minister until his assassination in 1966. 'Verwoerd's policy resulted in a crop of legislation' (Davenport, 1991, p. 338).

[5] Homelands are the semi-autonomous tribal lands created by the Apartheid governments for creating the notion of separateness between the ethnic groups in South Africa. They were all equipped with their own government and administrative machines and heavily subsidised by the Pretoria government. Eventually, four of them acquired 'independence', but were never internationally recognised.

Until 1976, black entrepreneurs were permitted to be active in only twenty-five trades and professions; this number was increased to fifty-two until such restrictions were removed during the 1980s (Riley, 1993). In addition, separate and inferior education systems for the non-white population disadvantaged young non-white job seekers,[6] while the job reservation system reserved access to apprenticeships and skilled jobs to white applicants. This policy not only disadvantaged black people in the search for formal sector employment and income, but it also served to limit their opportunities to acquire relevant skills for setting up their own businesses. The 1960s and 1970s were probably the peak of Apartheid oppression (Schrire, 1991). During the 1980s, the legal framework making up the Apartheid regulatory superstructure was slowly dismantled, although crucial provisions remained in force until after the official transition to non-racial democracy in the early 1990s. Most importantly, the structural distortions caused by Apartheid survive the abolition of relevant legislation, and constitute the main challenge for current policy.

Apartheid and SME development

During the last decades of Apartheid government, two distinct trends were observable: first, the labour absorption capacity of the formal, and mostly white, business sector declined, and second, the hostile stance on black self-employment

[6] The expenditure gap between school education for black and white pupils was rather staggering. 'Between 1969 and 1991 the government made significant strides in reducing the gap in per capita expenditure between African and white pupils' (South African Institute of Race Relations, 1993, p. 588), from 18:1 in 1969 to 3:1 in 1991.

and small-scale entrepreneurship eased. The declining labour absorption is illustrated by the fact that 81 percent of new entrants to the labour market were matched with job opportunities during the 1960-5 period, while expanded employment accounted for only eight percent of new entrants in the period from 1985 to 1990 (Riley, 1993, p. 8). The resulting increase in unemployment was borne mostly by black people. By one account, African unemployment increased from 28 percent in 1960 to 50 percent in 1990, while white unemployment increased only to 19 percent, up from 15 percent, during the same period (Fallon, 1992). Since 1990, total formal sector employment has further decreased and black unemployment is estimated at 60 percent (see below). Declining labour absorption in the formal sector was accompanied by increased informal sector employment. The annual rate of employment growth was 24 percent in the informal sector between 1983 and 1993 (South African Institute of Race Relations, 1996, p. 189).[7] This development led policy-makers and planning authorities to accept, often reluctantly, that independent black entrepreneurship was becoming an economic necessity. This acceptance related not only to homelands, but also, albeit in a more limited way, to urban areas. Therefore, government policy moved to de-regulate the small enterprise field.

As a result, the Small Business Development Corporation (SBDC) was established in 1980. This was a government-private sector joint venture to provide support to small enterprises. Loans to existing businesses were one of its most

[7] Almost half (48 percent) of all informal sector jobs are in trade (*ibid.*). Hawking is the most widespread trading activity.

sought-after services, although it operated more like a development bank than a micro-lender: lending was to established businesses with traceable financial data only, collateral was required, and application procedures were similar to those of commercial banks. Also, it remains doubtful how important black entrepreneurship was on SBDC's agenda. One of its ex-managers claimed during an interview that the emerging black business sector had always been their target group, but admitted that almost all lending had gone to small and medium-sized white-owned businesses.[8] The SBDC was completely restructured and its role partially taken over by other institutions in the mid-1990s, as I discuss below. Otherwise, the government was committed to de-regulation during the 1980s in order to remove the bias against black entrepreneurs, but did little to actively promote black entrepreneurship.

The legacy: unemployment, poverty, and the informal economy

Since the end of Apartheid in 1994, the employment situation has further deteriorated. The most important reasons for this are that trade liberalisation has led to some, limited, re-organisation in the manufacturing sector, leading to a loss of low-skilled jobs, that the gold mining sector is facing a crisis and has shed labour, and that political uncertainty and (expected as well as actual) labour militancy around the election period led to delayed investment, whose employment effect is felt with some time-lag.

[8] This comment stems from Wolfgang Thomas, now the chief economist of Wesgro, the regional economic promotion agency of the Western Cape. Prior to the 1994 elections, he was the Western Cape manager of SBDC.

From the end of 1989 to the end of September 1997, total formal non-agricultural employment fell by 9.0 percent. This implies that the number of formal non-agricultural jobs declined by 509,000. In the private sector, the fall was even steeper, and total private sector non-agricultural employment declined by 14.9 percent over the same time period (South African Reserve Bank, 1998, p. S-124). Since the end of 1989, the total number of registered unemployed rose by 159 percent to 301,214 in September 1997 (South African Reserve Bank, 1998, p. S-125). The number of registered unemployed, though, significantly underestimates actual unemployment. This is obvious, as the rise in unemployment of just under 185,000 is smaller than the fall in employment, during a time when the potential labour force expanded significantly.

Nattrass and Seeking (1998) report attempts to estimate 'real' unemployment. As a first step, such an attempt requires an estimate of the size of the potential labour force. While the data presented by the South African Reserve Bank captures only those who are either formally employed or registered unemployed, an 'expanded' measure based on survey data seeks to include those who are actively looking for work and those who would accept suitable work if available, referred to as the 'discouraged workseekers' (Nattrass and Seeking, 1998, p. 47).

On the basis of these 'expanded' estimates of the workforce and industrial surveys of the formal labour force, calculation can be made of the total labour absorption into formal wage employment. Such a measure expresses the percentage of the labour force which is in formal wage employment; its reversal is the unemployment rate referring to those unemployed by the formal wage sector, excluding informal employment. Based on this measure, Nattrass and Seeking detect 'a steady decline [of labour absorption] over the past two decades' (1998, p. 49). They survey studies showing a decline of labour absorption rates from 60.2 percent in 1975 to 39.3 percent in 1994. Nattrass and Seeking also point out that unemployment is correlated not only with racial group but also by gender. Especially in the non-white groups, women earn less than men and are more likely to be unemployed (Nattrass and Seeking, 1998, p. 46). Hall argues that '[e]stimates of unemployment, which are notoriously inaccurate, range from 30 to 60 percent of the economically active population' (1997, p. 395). The decline of labour absorption in the formal economy is mirrored by the rise of informal employment, often driven by necessity.

Several authors relate the problems of conceptually defining the informal sector and therefore of measuring its size (Kirsten, 1991; Rogerson, 1996). However, Rogerson surveys several studies which find that more than 4 million people work in informal sector employment. One study by Wolfgang Thomas, a former manager at the Small Enterprise Development Corporation, estimates that 4.3 million people were working in the informal economy in 1993, constituting 28 percent of the total labour force (Rogerson, 1996, pp. 6-7). Rogerson also shows that all surveys find that most informal sector workings are self-employed.

While large-scale unemployment is a main contributor to poverty, other but often related factors contributed to worsening living conditions especially of urban black people. 'Apartheid urban planning and residential settlement patterns concentrated the black population in peripheral residential areas, where the highest concentrations of unemployment are now found' (Hall, 1997, p. 396). Further, 'the spatial dislocation of the urban working class from the main centres of social, cultural and economic life causes huge spatial inefficiencies' (*ibid.*) which find expression in the huge cost (both financial and non-financial) of commuting.[9] Harrison *et al* (1997) find that townships are 'dormitory residential areas' where 'unemployment rates are high, and access to employment for residents is often problematic because of the long distances to work' (p. 44) because of the scarcity of local enterprises. They therefore identify 'local economic development [...] as a dominant development strategy for South Africa's towns and cities' (*ibid*, p. 58). The formerly imposed limits on entrepreneurial activity also severely constrained the availability of goods and services in townships. Such restrictions served to bid up the costs of goods and services, especially spaza shops and shebeens,[10] while

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[9] 'White areas have established agglomeration economies that will enhance returns on investment in infrastructure and economic development' while 'these positive contextual factors are few or absent in the townships' (Coetzee and Naude, 1997, p. 907). Therefore, 'many external constraints (for instance, on black enterprises) were created by the "apartheid city"' (*ibid.*) on the economic development in black communities.

[10] Spaza shops and shebeens are informal, and under Apartheid illegal small service enterprises. Spazas are small shops mainly selling food and a limited variety of daily-need items (Robertson, 1991). Many spazas are operated from residential homes, while others are set up in streets, in tin shacks or disused caravans. Shebeens are bars and are almost always operated from residential homes (de Haas, 1991).

potential returns of operating illegal enterprises were depressed by harassment, the frequent confiscation of goods, and deportation. The unsecured tenure of businesses in townships led, though, also to a popular culture of opposition, in which the culture of shebeens plays a pivotal role (de Haas, 1991).

Mass migration to urban centres and the ensuing shortage of housing in townships created extremely crammed living conditions, especially towards the end of the Apartheid years (Sithole, 1991).[11] When authorities increasingly chose to ignore the Group Areas Act, from about 1986, migration of black people to previously white areas reduced the pressure on housing somewhat. But those able to move to white areas were invariably the better-off, middle class blacks (Kotze and Donaldson, 1996). Hence, the urban housing shortage became worse as influx control weakened. The growth rate of the black urban population was estimated as 4.3 percent from 1990 onwards, and forecast to remain at the same level until 2010 (South African Institute of Race Relations, 1993, p. 206) According to the South African Housing Trust, a housing NGO, there was a housing backlog in urban areas of 1.8 million housing units in mid-1992, and almost 2.0 million houses needed to be built until the year 2000 in order to accommodate a growing urban population (*ibid.*, pp. 211-2).

As officially 'temporary' residents in white South Africa, most township residents did not own property, but rented from local government agencies. Decaying urban

[11] Previously, influx control and frequent deportation had kept the number of urban blacks relatively low, while obviously making life in townships even less predictable.

living conditions, as well as politically motivated opposition, led to rent and service charge boycotts. These, in turn, prompted local authorities to refuse responsibility for the up-keep of boycott-inflicted houses and areas. At the same time, property owners with mortgages - or bonds, as they are called in South Africa - boycotted their repayments, primarily because of a feeling of discrimination by banks and mortgage lenders. It was estimated that '30 percent of the estimated 170,000 African families with housing mortgage bonds had stopped paying instalments on their bonds' (South African Institute of Race Relations, 1993, p. 435) by mid-1992.

At the same time, organised, but informal community action made repossession of houses impossible. Repossessed houses were vandalised and potential buyers intimidated, effectively making houses in townships worthless as collateral. The Association of Mortgage Lenders stated in 1992 that mere 'threats of bond boycotts had made investors and construction companies reluctant to become involved in the lower end of the housing market despite funds being available' (*ibid.*). This led to a downward spiral: while some black organisations called for a complete bond boycott in 1992, lenders became cautious, raising the temperature of the conflict again because of alleged 'red-lining' and racial discrimination. As a result, housing finance was increasingly unobtainable for low income groups in townships, and the housing backlog increased accordingly. There were renewed calls for a bond boycott in 1996, but in mid-1997 only about 10 percent of outstanding housing loans in previously black areas were problematic (South African Institute of Race Relations, 1997, p. 752).

The developments outlined in this section explain to a large extent the factors which inhibit the development of stable communities, conducive to the accumulation of social capital (as outlined in section 3.3). Forced removal and land appropriation destroyed village communities and urban neighbourhoods and disrupted the social relationships embedded in them. The often illegal presence of blacks in urban areas, combined with the shortage of housing and other facilities, contributed to an atmosphere of insecurity and mistrust. Lack of income earning opportunities contributed to a charged competitive spirit and a hitherto unseen level of economic aggression. However, the popular dissatisfaction with authorities was conducive to other forms of social capital. Mass action, including the rent and bond boycotts outlined above, are dependent on social organisation and contribute to the formation of relationships which replace those that were previously lost. The organisation of hawkers' associations in many cities and of competing taxi associations are also manifestations of 'non-traditional' forms of social capital accumulation. But these forms do not easily fit into the models of solidaristic finance.

5.2 Political and Economic Transition in South Africa

The year in which the research for this thesis started, 1994, marks a watershed in South Africa because the Apartheid regime finally gave way to the Government of National Unity, led by the ANC. While the first democratic elections occupy an important position in the minds of most observers, it is important to note that political transition spanned many years (Schrire, 1991). Apartheid policies were softened, and gradually erased, from the 1980s, but the transitional period cannot be said to be completed even today.

Since the days of the struggle, the ANC has consistently emphasised its intention to address and correct the distortions of the Apartheid economic framework and to address the inequality resulting from it. The ANC remained faithful to its stated policy objectives, but the economic policy framework through which it seeks to achieve them has changed substantially. Before 1990, the ANC did not have an economic policy specific and detailed enough to be considered as policy documents for a future ANC-led government. During exile, the ANC's public policy statements relied on the 'Freedom Charter', a document containing 'vague and contradictory formulations of economic strategy' (Lundahl, 1998, p. 27). However, it was committed to 'the nationalisation of the mines, banks and monopoly industries and for a transfer of land from whites to Africans' (*ibid.*, p. 28). This document, and two workshops held jointly with the Congress of South African Trade Unions (COSATU) in Harare in 1990, scared conservatives prior to transition, and was used by some quarters to create a scare of a 'communist take-over'. However, these old pre-transition positions never translated into actual economic policy once the ANC geared up to taking over government. In the early 1990s, following its legalisation, a shift took place that de-emphasised redistribution of income and wealth as a source of economic growth and placed much greater faith in the private sector economy (Nattrass, 1994). The transformation of the ANC's position before its government inauguration culminated in the report of the Macroeconomic Research Group (MERG) in 1993. MERG brought together economists of varying ideological background, and its 'blueprint' for the ANC economic policy in government was accordingly incoherent (Nattrass, 1994).

MERG's members were all politically close to the broad objectives of the ANC, but opening the debate to a wide range of economic ideologies reduced the influence of those in favour of nationalisation and state planning and shifted the balance to towards market-oriented advice (MERG, 1993). This change of direction was characterised by most economists as pragmatic (Lundahl, 1998, pp. 28-9), while some saw in it an unwarranted sacrifice of development objectives, and therefore a bad compromise between acknowledging macro-economic constraints and political prerogatives (Fourie, 1996).[12]

[12] Fourie (1996) in fact addresses his research to the question 'Macroeconomic balance or development?', implying that strict fiscal prudence is incompatible with the developmental objectives of post-Apartheid macro-economic management. Predictably, he concludes that the ANC-led government should emphasise redistributive objectives. Dollery (1994) argues that the effect of redistribution on growth is more complex than most contributors to the policy debate in South Africa assume. In particular, '[w]ealth redistribution may enhance economic growth in the

Shortly after the assumption of power by the ANC-led government in 1994, the ANC's new economic policy was outlined in the Reconstruction and Development Programme (ANC, 1994). This was in some ways similar the MERG report, but also emphasised additional government provision to the poor in areas such as low-cost housing, education, electrification, provision of safe water and health services, and credible efforts towards the redistribution of land towards the rural poor. These were, however, accompanied by promises to stay within strict spending limits, to follow prudent conservative fiscal policies and to leave much of the financial superstructure of the last government intact. In combination with the financial obligations inherited from the former government (especially in the form of inflated government apparatuses in the both the Republic of South Africa as well its nominally autonomous or independent homelands, and the entrenched rights of their employees), these commitments limited the budgetary independence of the new government.

The RDP programme was to be funded from its own, separate budget. However, its responsibilities overlapped with those of traditional government departments through which much of its actual work had to be directed. Limited implementation capacity resulted in underspending of RDP funds. Implementation problems were confounded by allegations of non-cooperative, hostile old staff and counter-

short term by transforming some of the stock of wealth into income, and depress economic growth in the longer term because of the reduction of capital stock' (*ibid.*, p. 203).

allegations of inexperienced and under-qualified new staff. Finally, despite actual underspending, it became clear that the RDP's promises, including one million new low-cost houses within five years, could not realistically be financed under the strict fiscal constraint the government had promised to follow (Lundahl, 1998, p. 30; Gibson and van Seventer, 1996).

In the face of mounting obstacles and public criticism, the RDP office was closed in 1995 and the control of strategic economic policy shifted to the Department of Finance. During the phase of perceived failure of the RDP in 1995, the public debate crystallised around the large vested interest groups, and employers' organisations and trade unions put forward arguments and policy suggestions in direct competition. The ANC began tilting to the fiscally conservative side, and differences with COSATU became public. This situation of policy impasse - the RDP perceived as having failed but not yet formally superseded by another strategy - may have contributed to the rapid reversal of capital flows in early 1996, leading to a crisis of the Rand. From the end of January to the end of April 1996, the nominal effective exchange rate of the Rand fell by 16.7 percent, pushing inflation up to a height in mid-1996 and causing two increases of the Bank rate, rising by 2 percent, in 1996 (South African Reserve Bank, 1998, p. S-26). During the crisis, the government sought to assuage the fears on international capital markets by presenting itself as reliable, fiscally conservative and single-mindedly favouring external stability over internal political pressures.

In June 1996, the government then presented its document on Growth, Employment, and Redistribution (GEAR). This sets out a framework, based on an econometric model, for achieving real annual GDP growth of six percent by the year 2000 and significant employment creation as a result. Government's role, though, is limited; its most important input lies in its commitment to reducing the fiscal deficit and maintaining external stability while 'activist' policies in areas such as housing and education were to unfold within such constraints (Donaldson, 1997). Growth, according to the model, relies on private sector investment and foreign capital inflows. The GEAR document presented a further move, prompted by the crisis as well as the thinking of the Department of Finance, towards conservative conception of the government's role in economic development. Despite its politically appeasing name, it 'puts growth ahead of employment and redistribution' (Lundahl, 1998, p. 33). Immediately, criticism centred on the appropriateness of the econometric model that was used, over-optimistic data and the lack of a credible causal explanation of the private sector response - in terms of investment activity and job creation - on which its predictions rely (Nattrass, 1996).

Economic policy and the poor

The development of the economic policy of the ANC and the ANC-led government shows that the emphasis has changed from favouring direct intervention to reliance on market dynamics. While the end of Apartheid has resulted in a reduction of inequality - mainly because of a less distorted formal labour market (Nattrass and Seeking, 1998) - economic opportunities for the poor have not improved as much as they had hoped in 1994. Even the advocates of liberal economic strategies point out that the 'trickle down' process, by which macro-economic growth translates into employment growth and welfare gains for the poor, is part of a long-term strategy (Donaldson, 1997).[13] Independent from the perceived theoretical merits of this approach, recent economic performance lacks the vigour on which enhanced employment and redistribution depend. Real GDP growth in 1997 was only 1.7 percent, following marginally higher rates of growth in preceding years (South African Reserve Bank, 1998, p. S-137), implying a marginal drop on a per capital basis of 0.4 percent in 1997. Personal disposable income fell by 1.3 percent in real terms during 1997. Consecutive years of negative per capita growth in the early 1990s mean that its level in 1997 is 8.5 percent below its level in 1989 (South African Reserve Bank, 1998, p. S-138).

Due to the limitations implied in a conservative financial policy, critics have argued that the objective of redistribution towards the poor has been compromised by financial constraints and the perceived demands of 'international investors'. In fact, while early programmes sought to address the Apartheid legacy through large-scale macro-economic intervention, including nationalisation, current policy lacks a 'grand design'. This, it is important to point out, is seen by many as a

[13] Donaldson also argues that '[t]he GEAR framework provides for a marked acceleration in government investment spending' (1997, p. 456) in order to reduce the investment backlog of R170 billion in social infrastructure, 'including education and health facilities and basic residential services' (*ibid.*). However, this provision under the GEAR framework depends on its assumptions about accelerated economic growth.

strength and a sign of the maturity of the ANC's policy, while others see it as a sell-out of an organisation started as a liberation movement.

Macro-economic, fiscal prudence still leaves the possibility of micro-level intervention in favour of asset and income redistribution. Such attempts have sometimes been disappointing, mainly because of implementation delays, often due to institutional constraints. Kotze and Basson show that in the early 1990s the ANC was committed to land redistribution 'subject to payment of "just" compensation determined by a court of law' and that 'the state must take responsibility for redistribution' (1994, p. 186). Following its accession to government, the ANC set 'a goal of redistributing 30 percent of agricultural land from whites to blacks within five years and restoration of land forcibly appropriated after 1913' (Cousins, 1995, p. 481). A Land Restitution Commission and a Land Claims Court were set up to address legal claims resulting from forced evictions under Apartheid. However, land reform policy followed the example of other areas of economic policy in increasingly opting for market-orientation rather than for direct intervention. Since the mid-1990s, 'the government intends to accelerate private market transactions by restructuring financial services in rural areas', which implied the government's 'acceptance of voluntary market transfers [which] was welcomed by champions of the free market in South Africa (Lyne and Darroch, 1997, p. 562). Although current data on redistributed land are hard to come by, some estimates put the amount of land acquired by disadvantaged entrants at below 1 percent of all arable land (*ibid.*, p. 564). Restoration of land ownership through the Land Restitution Commission and the Land Claims Court encountered numerous delays due to the legalistic nature of the process, especially as the rights of existing owners and the public interest in uninterrupted production are given substantial weight. The prospect of land reform is now viewed more critically than a few years ago (de Wet, 1997).

Commitments to accelerated building programmes, including low-cost housing, drinking water and sanitation (Eberhard and Quick, 1995), and electrification (White *et al*, 1997), were to be financed within the budget constraints from the RDP allocation (van Horen, 1996). As outlined above, RDP implementation proved arduous and lags behind schedule (Friedman, 1997). The responsibility for delivering the goods originally promised under the RDP now lies with respective ministries and government departments, and only electrification seems to proceed satisfactory (Eskom, 1998, pp. 42-3). In health and education, where government provision was highly skewed in favour of rich and white people under Apartheid, the government sways expenditure towards the poor. This includes an emphasis on primary health provision and the offer of free health care for children. However, the slow, compromise-seeking process of change leaves many disappointed.

Despite the limitations to direct intervention implied in the macro-economic policy pursued by the ANC-led government, the end of Apartheid as a political event brought about noticeable effects. While domestic economic policy was more continuous than many South Africans had expected, the attitudes of foreign decision-makers affecting the South African economy changed considerably. International sanctions were lifted, diplomatic ties were established with many developing countries and followed by increased trade links.[14] South Africa is now a considerably more open society, and has a more open economy. The effects are felt at various levels: South African manufacturers complain about stiffer competition, stemming both from legal imports as well as increased contraband; tourism has boomed since 1995, as has international drug trafficking. Foreign direct investment, however, has not reach the levels expected by policy-makers, with detrimental effects on employment creation.

Financing non-governmental development expenditure

One economic sector specifically affected by the changed attitudes of foreign decision-makers is the voluntary sector as the political context of aid flows to South Africa was substantially changed. Here, two distinct effects are visible: compared with the preceding decades, the focus of government policy shifted towards those who were deemed the victims of Apartheid, and the focus of donor policy shifted from political liberation towards economic and social upliftment. At

[14] The direction of trade flows does not, obviously, always depend on diplomatic developments. It is interesting to note that the improved and heightened profile of South Africa led to rather rapid expansion of exports. A worthwhile case is wine: arguably, western consumers buy wine not only on the basis of a quality/price evaluation, but also on the basis of the perceived attractions of its originating country. Following the transition to democracy in 1994, South Africa's wine exports shot up, increasing by over 100 percent per annum to some markets (especially the Nordic countries). Although wine constitutes only a small part of South Africa's exports, anecdotal evidence points to noticeably improved employment conditions for unskilled, black labour in the Western Cape, where all of South Africa's export-destined wine is produced. More recently, black empowerment deals led to the first black-owned and operated wine producers in South Africa.

least nominally, therefore, government and donors found themselves working towards shared goals.

Despite the more laudable government objective, several NGOs felt threatened as benevolent government planners sought to limit their independence. It was argued that 'consideration needs to be given to establishing a national forum of government and NGOs through which all foreign donor assistance is channelled to nationally determined priorities, regions and sectors' (Jinubhai, 1995, p. 110). This line of thinking exercised a strong pull of resources towards the RDP and of subsuming the work of NGOs to centrally determined plans and delivery measurements. NGOs steeped in the tradition of defiance during the Apartheid era seemed to loose their justification and their access to overseas donor funds. Especially smaller NGOs felt vulnerable; their anxiety was amplified by the fact that social development - the field of their experience, which they still thought of great importance despite political liberation - was to be dominated by measurable delivery in sectors such as housing, with little regard for the needs of their specific constituents. For some time, NGOs became cautious.[15] Micro-finance institutions, too, were uptight with providing information on their financial performance, although they were never seriously endangered by the general funding upheaval because of the simultaneous boom in donor funding for micro-credit. Although

[15] This impaired my fieldwork in 1994-5 because many NGOs were unwilling to share information about their activities, or even finances. Anecdotal evidence suggests that in some cases even donors were denied adequate access to vital information. Not only NGOs, but also their employees, vied each other suspiciously while the fortunate ones won contracts under RDP programmes.

this was maybe not quite visible yet in 1994, micro-credit gained so much importance in the following years that there is excess funding capacity in Southern Africa.[16]

5.3 The Financial Sector in South Africa

South Africa has, for the half-century spent under Apartheid ideology, striven to develop a modern, European-style society for the white members of its society while excluding the majority from this development and banishing them to tribal, pseudo-traditional lands and lifestyles. The enforced 'invisibility' of black people, from a white perspective - except for rendering services - was mirrored in the structure and working logic of its banks, and the mentality of its management. While that legacy cannot quickly be overcome, rapid changes have taken place since the mid-1980s.

Banking was thought, by assumption, to be the prerogative of the affluent, and by implication, white. The invisibility of the majority is best illustrated by informal remarks made by bankers. In 1993, bankers at their Johannesburg headquarters claimed that 85 percent of the country's population were 'unbankable', while a

[16] During fieldwork, this view was confirmed by Pinky Mashigo, representative of the European Commission and by Ellen Brown, Southern Africa representative of the Ford Foundation. During 1996-7, when I undertook research on micro-finance for the Bank of Botswana, similar views were expressed by Marcia Musisi-Nkambwe, representing USAID, James Hochschwender, consultant to USAID, Aniceto Bila, NGO liaison officer of the World Bank, Kerstin Kiehl of the Friedrich Ebert Foundation, and Jan Vossen, regional representative of the Dutch donor Hivos. The sources of funding and the possible reasons for excess funding are discussed in the last section of this chapter.

regional manager (Grahamstown branch) claimed that his branch was serving black people adequately, only that there were very few, and therefore only few required loans.

The South African financial system is the most highly developed and most sophisticated in Africa. Despite its size and complexity, I will summarise it only briefly. Its most important institutions, including the central bank and the major commercial banks, have no significant contact with the part of the population that is most attracted to micro-finance services. The changes affecting development finance institutions, and their emerging new structure, will be discussed more prominently towards the end of this section.

The formal financial system - some key institutions

The South African Reserve Bank (SARB) is responsible for banking supervision, foreign exchange reserves, and monitoring foreign exchange transactions and enforcing capital controls. Liberalisation of the foreign account since 1995 reduced its role in maintaining external stability. It further plays a role in advising government and implementing government policies related to its field of responsibility, while enjoying a status of semi-independence.

Following the election in 1994, the new government saw it in its interest to calm fears of instability on international financial markets and decided to retain high-level personnel inherited from the previous government. Therefore, the finance minister at the time, Derek Keys, stayed in his post until he was succeeded by Chris Liebenberg, another conservative banker. Only in 1996 did the ANC-led government appoint a finance minister from its own ranks, Trevor Manuel, following Chris Liebenberg's resignation in the middle of a severe currency crisis.

While the continuity at the Finance Ministry related mainly to its head, the Reserve Bank is probably the only major public institution that has not significantly changed the composition of its staff. Not only the governor, Chris Stals, but almost all senior staff stem from the Apartheid-era. Generally, the Reserve Bank has little contact with micro-finance institutions. Some minor questions concerning financial regulation and micro-finance arose in the early 1990s, and the Reserve Bank has generally taken a sensible, liberal course of action.[17]

The commercial banking sector is dominated by four large banking groups. All four groups comprise several institutions, including banks, insurance companies and mortgage or leasing firms. The diversity of institutions and financial products offered by each group is very wide (Jones, 1992). Besides functional sub-division into merchant banks, retail banks, insurance, vehicle finance and other specialised

[17] These issues related to items such as portfolio quality in a case where micro-lenders borrowed from commercial banks and re-lent without collateral. Another major case was the establishment of a supervisory framework for mutual banks. However, there remains some doubt that its staff fully understand the nature of micro-finance. Two seminars that it held on the topic of micro-finance in 1996 and 1997 were dominated not by enterprise-oriented micro-lenders, but by consumption-oriented lenders. Although calling themselves 'micro-credit institutions', they require collateral and lend only to employed people. These firms are owned and managed by Afrikaners, and research on them was carried out at the Afrikaans-language University of Stellenbosch.

service providers, the four national groups own also regional banks. All banking groups are historically linked to mining interests and mining finance houses. Three of them, the bank groups led by the Standard Bank of South Africa, Nedbank, and First National Bank of South Africa, are related to the traditionally English-speaking urban white professional class, while the fourth group, led by ABSA (Amalgamated Banks of South Africa) is comprised of institutions which were mostly the product of Afrikaner advancement into mining, finance and the professions from the 1920s onwards. The banking groups have been instrumental in recent years in financing leveraged buy-outs of large white-owned firms by black interests, usually pension funds of black trade unions. The firms sold to black investors, often insurance companies, were usually carved out of the mining and banking groups themselves.

Commercial banks and black customers

Since about 1990, all bank groups have sought to attract previously 'unbankable' customers. In some cases, this involves cooperation with NGOs or black organisations. In others, banks have set up schemes for lending to poor black people, usually entrepreneurs, or have re-focused existing financial products more directly towards the 'black' market. While all four banking groups addressed problems of 'banking the unbankable', and all set up separate departments or research units, the level of activity remained rather different between them.

However, these attempts have, in some cases, looked less than plausible. In order to demonstrate credible interest in the low-income black market, a bank will need to strive to develop methods of serving poor customers in a profitable way. As long as banks view their engagement in this market segment as permanently loss-making, they will understand it as a costly image-oriented activity - similar to corporate sponsoring for other worthy causes - rather than as a serious business in its own right. In general terms, most banks have tended to create small enterprise lending departments within their headquarters structures. These departments were staffed by research and product development staff who were highly motivated and committed to their brief, but isolated from 'serious' decision-making within their organisations. This perception is underlined by the assertion of a senior bank manager in 1994, responsible for strategic planning, who explained to me that it was in the bank's profit-making interest 'to be seen to do our bit for society'.

One example was the Business Growth Plan, a trial scheme run by Standard Bank. It operated in Katlehong, a township south of Johannesburg, during 1994, but was discontinued in 1995. It was started with special meetings where a loan officer addressed the public outside a Standard Bank branch, followed by a business viability workshop for approved applicants. If the field officer finds applicants' businesses viable, they were asked to save 20 percent of their prospective loan amount. Loan amounts could vary from R1500 to R2500 for the first and from R2000 to R5000 for all successive loans. The scheme was discontinued because loan demand proved disappointing and costs higher than expected. According to

Standard Bank staff, defaults were not an important reason for the termination of the programme.[18]

Non-bank financial institutions: formal and informal lenders

Institutional credit is available to most South Africans, even the previously disadvantaged, in the form of retail credit. Most furniture chains as well as many other retailers provide credit (Van Rooyen, 1993). Credit conditions are sometimes very competitive, but this may be misleading as cash purchasers are often in a position to negotiate discounts. Retail credit, though, is mostly of interest to consumers. Producers, even micro-entrepreneurs, tend to seek out cheaper inputs from cash-and-carry warehouses or factory shops.

Credit Unions have only limited impact in South Africa. Several large credit unions are active, but their members are mostly recruited from formal sector employees who tend to be better-off black people. There is little evidence of business lending, and Kwedie Mkalipi, the general manager of the Savings and Credit Cooperative League of South Africa, stated during private discussions in 1994 that 'the poorest are a drain on us'. Although involvement of many households poorer than the national average may contribute to a reduction in

[18] While I am critical about the Standard bank here, it may be important to give banks some credit for running unsuccessful trial operations if they remain interested in the 'unbankable'. Standard Bank continues to serve a low-income market. At the time of the Business Growth Plan trial scheme, Andrew de Beer (manager, informal business lending) told me about the 'design' work for E Bank, a banking facility planned for low-income customer, which relies heavily on ATM machines. E Bank is now operating, and it remains to be seen whether it will be more successful than other low-income banking schemes. A preliminary analysis provides reason for optimism (Paulson and McAndrews, 1997).

economic inequality, credit unions do not reach typical micro-finance beneficiaries.

Moneylenders offer short-term credit at very high interest rates. Harper (1998, p. 143) reports about interest rates of 50 percent per month while Van Rooyen (1993) mentions similar rates. Although moneylenders perform an important role as emergency lenders, there is no evidence of them providing business finance except for short-term working capital purposes (Preston-Whyte, 1991). On the basis of research in a number of other African countries, Nissanke and Aryeetey (1998) conclude that '[c]redit from moneylenders is not attractive for investment purposes' mainly because of their restricted capital base and market rigidities. However, the activity of informal moneylenders is probably underrepresented in literature on informal economic activities in South Africa. Informal credit is probably widely available as emergency consumption credit, especially in urban areas. But informal moneylending is not even discussed in the Race Relation Surveys and rarely elsewhere.

Stokvels, the South African term for ROSCAs and similar group-oriented savings and credit clubs, vary in size from a handful of friends to over a hundred members (Thomas, 1991). Most are formed as burial societies, which provide insurance against the burial costs of family members, or as consumer clubs aimed at financing consumer durables. Business finance is a motive behind a minority of stokvels (South African Institute of Race Relations, 1993, p. 112). In 1996, about

29 percent of Africans were members of stokvels and contributed about R30 per month to the more popular types of stokvels, such as burial societies, but typically between R90 and R250 per month to investment-oriented stokvels (South African Institute of Race Relations, 1997, p. 282).

This leaves a wide 'market' to the micro-finance institutions. Their niche is a wide open field of poor people who require credit typically because they wish or need to start a business, or because they plan to build or improve residential property. Poor people also value other financial services - mostly savings facilities and insurance - which neither retail lenders nor informal moneylenders offer, but which are typically a feature of many micro-finance institutions. While banks hardly ever get in touch with this section of society, and informal finance is ill-suited for meeting their needs, micro-finance institutions never reported a lack of demand as a constraining factor. The graduation of mature borrowers from micro-finance schemes to formal finance, though, remains difficult. The most important constraint is the Usury Act which limits interest rates on loans above R6,000 to the prime rate plus nine percent. Therefore, micro-finance institutions can charge cost-covering interest rates for small loans, but there remains a ceiling through which only few borrowers can break.[19]

[19] Recently, some micro-finance institutions succeeded in negotiating an exception from the Usury Act. The Start-Up Fund, for example, could therefore raise its loan limit to R12,000. From such a level, graduation of borrowers to banks should be possible. However, loan portfolios have to mature further before conclusions could be reached. It is important to note, though, that most micro-finance clients in South Africa are given access to bank accounts, and therefore have the opportunity of establishing a track record.

Institutional changes and SME Support policies 1994-7

Between the change of government in 1994 and the end of 1997, the small enterprise promotion 'landscape' has been re-modelled substantially. The Small Business Development Corporation has all but vanished from small enterprise lending, the Development Bank of Southern Africa (DBSA) has relinquished its role in this field, new institutions were formed, and micro-enterprises first reached the policy agenda of the national government. Reviewing this period, Thomas (1997) argues that 'South Africa has shown that a concerted, national effort towards a new SME support strategy is possible' but concludes gloomily that 'national strategies, White Papers, Presidential Conferences and consultative mechanisms are all but a few early steps in the complex, slow and highly disaggregated process of small enterprise promotion' (p. 13). In fact, changes have either not yet reached the intended beneficiaries, or, as some critics would point out, the changed superstructure had little effect in real terms.

In 1989, the Development Bank of Southern Africa started to support NGOs involved in micro-credit. This represented the first step of official acknowledgement and support for the micro-enterprise sector. However, allegedly because of the perceived political set-up of the Development Bank of Southern Africa, this function was devolved to a 'black' institution, Khula Enterprise Finance Limited. Therefore, its micro-finance support policies could never fully develop and had only limited effect.

The political troubles of the Development Bank of Southern Africa originate from the days of its role in setting up the Apartheid-based view of Southern Africa. Under Apartheid, it served as a regional development bank with responsibilities for not only the Republic of South Africa and its autonomous homelands, but also the 'independent' countries of Transkei, Bophuthatswana, Venda and Ciskei. The services offered to those four countries, which enjoyed only token independence and were not internationally recognised, were the sole justification of the Development Bank's 'regional' claim. Thus, it constituted a tool in the creation of an Apartheid-conforming Southern Africa and, as such, emerged tinted from the Apartheid era.[20]

Only in late 1997 had South Africa arrived at its new institutional set-up for SME support, and most of the new institutions had started operating. Following the Small Business Enabling Act, approved by Parliament in 1996, the official SME support framework consists of the following institutions:

- the Centre for Small Business Promotion is a policy think-tank within the Department of Trade and Industry, and coordinates the initiatives of central government;

[20] This picture should, though, be complemented by an alternative view which holds that the Development Bank was staffed by those members of the ruling social 'tribe', Afrikaners, who had an authentic interest in black economic and social development. According to this view, they saw the Development Bank of Southern Africa as a refuge where 'subversive' activities of black economic empowerment could be pursued without rebuke. This view of the Development Bank was relayed to my by some of its long-serving staff members.

- the Ntsika Enterprise Promotion Agency provides all non-financial SME support, chiefly through independent service providers (mostly NGOs) in areas such as training and technology support;
- Khula Enterprise Finance Limited is a 'wholesale' lender for micro-and small enterprise credit institutions, but also supports capacity building; and
- the National Small Business Council is a representative institution for entrepreneurs to voice their concerns to government, based on federal principles.

The Ntsika Enterprise Promotion Agency operates via Local Business Service Centres, Tender Advice Centres and a several NGOs. It started to operate in 1996 and supported 65 service providers in mid-1997. Khula Enterprise Finance is the only financial institution in the new small enterprise promotion framework and will be discussed below. The National Small Business Council is constituted by Provincial Small Business Council members who are elected from regions within their respective provinces. These provincial representatives constitute the national council (Kirsten, 1997).

It is important to note that during this phase, from the change of government in 1994 to the establishment of the new small business promotion framework in 1997, there was almost no public debate. Kirsten, summarising the process in 1997, reports that the political process leading to the new framework 'was launched from a very thin base. There were few groups representing SMMEs [small, medium, and micro-enterprises], and amongst them was a lot of infighting. There was insufficient applied research', while donors contributed models of 'best practice not always applicable on South Africa' (1997, p.3; see also Riley, 1996) This all meant that 'the process of developing a strategy was driven from the top, at national government level' (*ibid.*). This lack of public debate can be explained by the overwhelming number of problems facing the government and South African society during transition, and the lack of experienced and trusted personnel at government level. Together with the funding scare mentioned above, this was a further factor leading to the isolation of NGOs during the time of my fieldwork.

Emergence of the new development finance framework

Following the reconstruction of the institutional environment, five institutions are now active in development finance activities. Not all relate to micro-enterprises, but all seek to complement the market-oriented financial institutions in pursuit of government policy objectives. These are:

1. the Development Bank of Southern Africa,
2. the Industrial Development Corporation,
3. the Land and Agricultural Bank,
4. the National Housing Finance Corporation, and
5. Khula Enterprise Finance Limited.

The Development Bank of Southern Africa, as outlined above, had some of its responsibilities removed and concentrates now on infrastructural development, often leveraging private sector investment. However, while its regional focus under Apartheid related only to the nominally independent homelands, it now seeks to become active in SADC countries. There, it seeks to address needs beyond the narrow role in its home economy and to find a role in lending towards development of agriculture and SME promotion, including micro-credit. However, these regional ambitions were still at a planning stage in 1997.

The Industrial Development Corporation, a less important player, lends for manufacturing purposes, mainly to medium-sized firms. It used to concentrate its efforts on industries with demonstrated export potential, and had its focus shifted to SADC countries.

The Land and Agricultural Bank has its origins in the former Land Bank. This government-owned bank constituted part of the design for Afrikaner advancement. It lent mainly to Afrikaner farmers, supporting the acquisition of large farms, often preceded by the forced expulsion of black smallholders, and the adoption of capital-intensive farming methods.[21] In this effort, it was aided by the agricultural marketing boards for the major types of farm output which guaranteed prices and controlled imports and distribution. In the slowly changing political

[21] The Land Bank administered de-facto subsidies to farmers by offering loans at very low interest rates. In 1982, when its function of subsidising farmers through cheap credit was largely removed, the interest rate on short-term loans was raised from 2.75 percent to 17.75 percent, implying that interest rates had been subsidised by 15 percent (*The Banker*, September 1982, p. 18).

climate of the 1980s, the Land Bank 're-discovered' black smallholders as a target group. It now plays a double role in continuing to be one of the major banks for large commercial farmers as well as supporting land purchasing and start-up loans for small-scale farming, in line with the land redistribution objectives of government.

Unlike the previous three institutions, the National Housing Finance Corporation and Khula Enterprise Finance had no predecessors. The National Housing Finance Corporation, created in April 1996, provides finance for the construction, extension and improvement of housing for South Africa's black population. It uses a variety of financial tools, such as mortgage guarantees, refinance for NGOs involved in housing issues, and potentially micro-finance. However, as a very young institution venturing into a new activity, its impact has been limited so far. Khula Enterprise Finance was launched in December 1995 and took over the portfolio of loans to micro-finance organisation from the Development Bank of Southern Africa when it became operational in 1996. Plans are under way to support to capacity building of micro-finance institutions, but, like the National Housing Finance Corporation, Khula is still too young to be able to analyse its development.

Policy towards SME promotion, and development finance, in the early and mid-1990s was thus characterised by inconsistency between the not-yet-vanished old and the not-yet-functioning new. Old institutions and policies, that had been set up with different objectives, ground to a halt as they were evaluated and restructured. New institutions were created where this was thought necessary by the new authorities. It was in this situation of uncertainty of future policy that I conducted fieldwork.

5.4 Micro-finance Institutions in South Africa

The micro-finance sector in South Africa is still small and young, and its core consists of only four institutions. Because of the limited number of institutions vying for funds, and their limited capacity to absorb them, there is practically no competition for funding. Donors, therefore, have not been able to imprint their own designs on micro-finance institutions in South Africa. This situation can be traced to the different objectives under Apartheid: not finance, but racial suppression was the main impediment to successful and equitable enterprise development. Once funding levels increased for 'new wave' micro-finance institutions - due both to political liberation in South Africa and to increasing donor interest in micro-finance world-wide - there were only few institutions in South Africa fitting the new paradigm. Prior to decisive easing of Apartheid constraints, most NGO work was related to the political liberation that was to precede economic objectives. NGOs were, therefore, involved in political organisation besides the more traditional roles in education, health and other social matters. This different, more politically driven approach did not completely preclude lending to the 'unbankable', but provided a different setting for them.

There are examples of the 'old', pre-micro-finance approach. These are integrated institutions built around a 'theme', or policy objective such as poverty alleviation, employment creation or small enterprise development. In fact, these goals are often found in some combination, although they are not identical.

When lending is not micro-finance: the Triple Trust Organisation

One such organisation is the Triple Trust Organisation (TTO) in Cape Town. It was started in 1988. Its name relates to the founder's 'holistic vision of providing training, marketing and finance' (Triple Trust Organisation, 1993, p. 1). It intends to 'train individuals in labour intensive production, using simple technology, business skills and providing access to markets and to credit' (*ibid.*). Its loan programme, operated by the subsidiary Self-Help Financing Trust, advances loans to its trainees for the purchase of capital equipment and raw material. In 1993, it advanced 215 loans, sharply up from 48 loans in 1992. During those two years it received grants and concessional long-term funding of R2.1 million, most of it from the Development Bank of Southern Africa. In 1993, its spending on fixed assets reached R487,000, and its net loan book R220,000 including provisions for bad debt of R142.000, 65.0 percent of the total (Triple Trust Organisation, 1994, p. 31). Neither the level of financial support from donors nor the level of capital expenditure could be justified by its lending activity. Also, its 62 members of staff are mostly busy with business and skills training, not with credit-related activities.

In discussions with Don Shay, a coordinator at the Triple Trust Organisation, in June 1994 the issue of sustainability was discussed. He explained that the philosophy of the organisation emphasised the sustainability of its beneficiaries. Creating sustainable and profitable enterprises was the objective of the Triple Trust Organisation. Achieving high repayment rates from its portfolio of mini-loans is seen by its staff as a good indicator of the beneficiaries' ability to create sufficient income and to stay in business. The high rate of provisions for its outstanding loan indicate, though, that some doubt exists about their beneficiaries' success rate.

The Triple Trust Organisation could not, therefore, expect to become financially sustainable through the interest payments received from its clients. Don Shay argued that the organisation's sustainability rested in its capacity to deliver on its own objectives, on its achievement in creating viable businesses, and its ability to convince donors that this is a worthwhile objective pursued by the Triple Trust Organisation in an accountable and efficient manner. Financial sustainability, he emphasised, could lie in the cross-subsidisation of its core activities by revenue generated from consultancy. The professional staff of the Triple Trust Organisation offer consultancy services to other NGOs and government.

The lending scheme of the Triple Trust Organisation is, therefore, not being implemented with the intention of contributing to the lender's, but to the borrowers' sustainability. It is a tool applied in pursuit of the organisation's developmental objectives. Most importantly, the Triple Trust Organisation does not describe itself as a financial institution. This sets it apart from the new generation of micro-lenders, and in comparison to their lending volumes, the lending activities of the Triple Trust Organisation are insignificant.

Most micro-finance institutions in South Africa were set up later than the Triple Trust Organisation, mostly in the early 1990s. In 1997, the Development Bank of Southern Africa commissioned a study of all micro-finance institutions to which it had contributed resources. This including 13 institutions which, according to another, independent study, 'are the principle micro-lending institutions in the country' (Ashe 1997, p. 6). Together, they serve only 24,000 borrowers; this compares with Ashe's estimates of 3.5 million survivalist enterprises and 8.0 million small, medium and micro-enterprises (*ibid.*).[22] However, the micro-finance sector in South Africa is still underdeveloped,[23] and therefore dominated by a handful of relatively older organisations. 'Nearly 21,000 of the 24,000 enterprises are served by just five programs: the Get Ahead Foundation, the Small

[22] On average, 70 percent of all micro-finance beneficiaries are urban, while 71 percent are women (BEES, 1997).

[23] Especially in comparison to a country like Bangladesh, where several large and established micro-finance institutions compete for clients and funding, each with over 100,000 clients. Similar large institutions exist in Indonesia and Sri Lanka, while in Bolivia a large number of institutions compete a relatively limited micro-lending market (Johnson and Rogaly, 1997; World Bank, 1996). Due to the relative abundance of funding for micro-finance in Southern Africa and the mass of 'eligible' poor, micro-finance institutions in Southern Africa are not in a competitive situation.

Enterprise Fund (sic), Rural Financial (sic) Facility,[24] Start-Up Fund, and IBEC' (Ashe 1997, p. 7).

The average loan size of IBEC (Informal Business Enrichment Centre) is over R8,000 (BEES, 1997, table 22) and therefore falls outside the micro-lending category. From its inception in 1990 onwards, IBEC was the first lender to the informal sector in South Africa lending exclusively to individuals, until it was joined by the Start-Up Fund in 1993. The interest rate on its loans, at 19 percent, is closer to the prime rate of commercial banks than that of other micro-lenders. IBEC's entry-level loans are also rather large - around R2,000 is the lowest its credit officers consider, and most are above R4,000 - and it does not lend for business start-ups or businesses lacking some form of documentation. For this reason, IBEC does not qualify as a 'real' micro-finance institution and I will not discussed it in detail.

The Get Ahead Foundation was the first institution in South Africa to extend credit to 'unbankable' urban micro-entrepreneurs. In the BEES survey, it showed the largest number of borrowers. However, its focus on liberation, its link to the civic movement and the politicisation of its staff had led to financial problems in the early 1990s (Churchill, 1997). When I conducted my fieldwork, the Get Ahead Foundation was in the middle of its restructuring and had all but withdrawn from the micro-finance debate. Mpumzi Pupuma, since 1996 the Get Ahead

[24] It should be the Small Enterprise Foundation and the Rural Finance Facility.

Foundation's new managing director, (now renamed to 'Get Ahead Financial Services') asserted during a brief discussion in Pretoria in early 1997 that the organisation would now concentrate on financial service provision as 'the old battles are fought, won, and over'. While the Get Ahead Foundation had a crisis related to its re-direction from semi-political movement to financial institution, the three remaining micro-finance institutions in the sample were started with a clear agenda focusing on delivering financial services.

Adding value to the banking system: the Rural Finance Facility

Most striking, in this regard, is maybe the Rural Finance Facility. It was established in 1991, but the first loans were made in 1993 through its branch in Brits. Its main office is in Doornfontein, an office area in Johannesburg, and it maintains regional offices in most provinces. The Rural Finance Facility was founded by Chris Hock. He has worked for the Development Bank of Southern Africa and had been the finance manager of the Rural Advice Centre before establishing the Rural Finance Facility. While he is still the managing director, he was joined by three others in providing leadership for the Rural Finance Facility. Prosper Nyirumuringa, originally from Congo (Zaire), is an American-trained economist with experience in rural credit. Jenny Hoffman, a British chartered accountant, joined with some years experience with NGOs. Doug Hamilton, a senior banker, was previously the general manager of Societe Generale in South Africa. At the local level, the Rural Finance Facility seeks to recruit from within the communities it serves. Below management level, the Rural Finance Facility employed 16 further staff members by the end of 1994. All 16 were African, including five management trainees.

The Rural Finance Facility offers three 'product lines' (Rural Finance Facility, 1994a, p. 7):

1. Micro-Loans are general purpose loans available to groups showing strong coherence and passing a character and affordability test (planned repayments must be less than 25 percent of net household income). Loan amounts lie between R300 and R800, and the first loan has to be repaid within six months.
2. Business Loans are based on written business plans. The borrower must have at least 12 months business experience and must pass a character test, loan amounts lie between R1,000 and R3,000. The interest rate is about 50 percent per annum.
3. Guaranteed Loans are general purpose loans, mostly used for business purposes or house improvement and construction. The annual effective interest rate is between 25 and 32 percent, depending on loan size, which can be up to R12,000. Repayment of Guaranteed Loans is through payroll deduction or post-dated cheques. In most cases, the guarantee is provided by the borrowers' employers.

All payments are processed electronically, so that credit officers need not handle cash. All credit decisions are prepared by local staff but subject to final approval by the Credit Committee, which is based in Johannesburg. The Rural Finance

Facility prides itself on customer-friendly service, and this includes very quick lending decisions (Rural Finance Facility, 1994b). Once all documentation is submitted, approval is given within one to five working days. Because of limited risk, larger loan sizes and easier lending procedures, Guaranteed Loans are the 'best business' for the Rural Finance Facility, and Chris Hock said they tried to increase their share in total lending. This approach was further vindicated when fraud was discovered in the Micro-Loan administration, where credit officers had siphoned off funds and artificially increased the default rate. Corrective measures resulted in a significant reductions of loan disbursals under the Micro-Loan scheme.

Chris Hock, who excels in management-type language use, describes the role of the Rural Finance Facility as 'adding value to the production process of the financial system'. As banks cannot do what the Rural Finance Facility does - mainly short-term, unsecured lending on the basis of character assessments - it taps a previously undeveloped business potential. Creating real returns from this ancillary business, 'value is added' to the banking system. This additional value can be shared between the service providers, commercial banks and the Rural Finance Facility.

He sees the roles of the service providers as being clearly delineated. Banks participate because their transmission systems are used for sending and receiving money, and for tracking payments. They thus increase their turnover and receive additional revenue from RFF's rural lending. The Rural Finance Facility has a comparative advantage in its role of designing appropriate products, absorbing the risk associated with collateral-free loans, and controlling the lending and repayment process. The role that Chris Hock identifies and describes is, in effect, that of a specialised financial institution in a diverse market. At the same time, he emphasises that there is no effective competition with other micro-finance institutions. The growth potential for the Rural Finance Facility is, he said, 'practically unlimited' from the current position.

Both the Small Enterprise Foundation and the Start-Up Fund are similarly vigorous in picturing themselves as credible financial institutions. Both are discussed in greater detail in chapters 6 and 7, where their lending models are outlined and their financial sustainability is evaluated. Here, I will merely set them in context.

Towards mutual banking: the Small Enterprise Foundation

The Small Enterprise Foundation is based in Tzaneen, a small regional town serving surrounding farming communities and forest industries. Its current managing director, John de Wit, took the initiative of founding the Small Enterprise Foundation in 1991 and identified the Tzaneen area because of its poverty and, as he described it later, its relative social stability. He was later joined by four other directors, who form the management team of the Small Enterprise Foundation, although day-to-day management remains the responsibility of John de Wit. Patrick Malatji is the coordinator of an Educational Project near Tzaneen, Nathaniel Ramalepe is the principle of a farm school in the area, Marie Kirsten works for the Development Bank of Southern Africa and Daphne Motsepe has previously worked with other micro-finance institutions. The directors were recruited either because they come from positions of authority within the communities served by the Small Enterprise Foundation or for their experience with micro-credit. The total staff comprises 32 people of whom 17 are women, 11 are trainees and 15 are credit officers. The lending model is based on the Grameen Bank model of group lending.

In the view of its management, the Small Enterprise Foundation exists in order to provide financial services - mostly in the form of loan finance but also including savings - to unbankable poor people.[25] While emphasising democratic principles and pointing out its positive effect of credit on the self-esteem of its clients (Small Enterprise Foundation, 1996), the core function is defined as that of a financial institution. All management members indicate the importance of financial sustainability of the institution, but the opinion about the status of this objective is divided. While John de Wit says he was aiming for sustainability, Marie Kirsten believed this was already achieved. However, both described their understanding

[25] This includes a focus on women; although men are not explicitly excluded from the scheme, they constitute only about five percent of membership. The Small Enterprise Foundation is also proud to recruit mostly women for its credit extension work. John de Wit does not, in his own opinion, have a explanation for women's different roles. He says that women are poorer than men but more reliable. Chris Hock, whose Rural Finance Facility lends mostly to men (because guaranteed loans mostly go to male employees of formal enterprises which provide a guarantee, although loan use may lie with another family member), argues that women are keener for credit and keener to repay because they have fewer other choices in their economic environment than men in the same social setting.

of sustainability in strict financial terms, similar to those expressed in relevant literature (Yaron, 1991). The financial reports of the Small Enterprise Foundation vindicate John de Wit's position, and he repeated in discussions the commitment of its annual report to 'become self-sufficient in the medium term (ie. within four to five years) through income generated from interest charged on loans' (Small Enterprise Foundation, 1996, p. 2).

The Small Enterprise Foundation also works closely with commercial banks and, like in the Rural Finance Facility, uses electronic transmission systems for all transactions. While also seeing the Small Enterprise Foundation as a financial institution, John de Wit does not picture it as a ancillary service provider 'adding value', as does Chris Hock. He thinks of it as a growth-oriented, customer-focused organisation that will become technically more sophisticated over time, change with its customers needs, but remain a not-for-profit company. This resembles the Raiffeisen movement last century (discussed in chapter 3) and could lead to its transformation into a mutual bank, where profits are retained to finance expansion and improvements in service delivery.[26]

The venture capital approach: the Start-Up Fund

The Start-Up Fund was founded by Tony Davenport in 1993, a qualified accountant. He had varied experiences before, having been a missionary while also managing a diversified farm in Zimbabwe. Returning to South Africa in the

[26] It is interesting to note that this is the path along which the Grameen Bank has developed. As a formal, registered bank, it is owned by its members (Von Pischke, 1991).

1980s, he became involved with several NGOs and went on to start the Informal Business Training Trust. Although he has now resigned from his last position of non-executive director at the Informal Business Training Trust, this organisation still cooperates with the Start-Up Fund, providing business training to some prospective borrowers.

The Start-Up Fund is located in Durbanville, just north of the Cape Town metropolitan area. It employs only a few people full-time and a couple on a part-time basis, mainly for clerical tasks. Most staff are white, female and mostly Afrikaner. Tony Davenport says that he could recruit at rather reasonable remuneration levels because Durbanville is a predominantly residential area, and people living there would otherwise have to commute for work to Bellville, the large administrative centre to the north of Cape Town. All contact borrowers have with the Start-Up Fund is by telephone, and a number of native speakers of African languages were being recruited for telephone service at the time of my visits.

Tony Davenport emphasises that, in his opinion, group credit can never work in South Africa. He argues that 'that's how South Africa is, we don't have peaceful village communities like in other countries' and he also cites the potential for violence as a reason for better avoiding peer pressure. However, he is an even more ardent advocate of open access to micro-finance services and denounces policies aimed at keeping people out of other schemes. If credit officers were responsible for identifying potential borrowers, he argues, then these would by necessity need to assess people on subjective criteria and would need to turn some applicants away; in his words, only 'smart alecs' would gain access to credit. Therefore, there is no explicit selection of borrowers in the Start-Up Fund. Obviously, access to the lending programme is not as open as Tony Davenport wishes us to believe,[27] but it does not openly discriminate. Interestingly, this also means that women are not specifically targeted, but they still constitute the majority of clients. At about 65 percent of membership, this about reflects their estimated share in ownership of informal enterprises in Southern Africa (Liedholm and Mead, 1998).

From the start, Tony Davenport wanted to achieve commercially sustainable returns from lending to micro-entrepreneurs. In his view, such returns are the requirement for gaining access to commercial (ie venture) capital markets and, thus, for expanding credit facilities to a significant number of poor entrepreneurs. The Start-Up Fund is the first micro-finance institution in Southern Africa to have achieved financial viability, after about four years during which it relied on grants

[27] The very poor are not in the position to afford the up-front membership fee nor do they have the time for compulsory business training. These points have been highlighted in the criticism of the Start-Up Fund by people close to the Small Enterprise Foundation. Group formation, as in the Small Enterprise's own programme, is restricting access as well. Despite their claims, all micro-finance institution aiming at financial sustainability have to restrict access in some way. It is interesting to note that in the two-way exchanges about the topic the third contender, Chris Hock and the Rural Finance Facility, do not enter. Chris Hock accepts the exclusiveness of the Rural Finance Facility's lending procedures but asserts (private discussion in August 1994) that 'I'm under no obligation to lend to everybody. We have to survive. Still, we lend to people the banks won't touch.'

and donor loans. It is now financed by the Micro-Business Development Corporation on a commercial basis.

The core micro-finance sector: preliminary comparison

Despite the differences of their lending models, it is interesting to note that the Rural Finance Facility, the Small Enterprise Foundation and the Start-Up Fund are similar in some respects. All three use electronic transmission systems and avoid cash transactions, and they state the same reasons of security, cost and informational efficiency. Even more important, all three - as well as the re-organised Get Ahead Foundation - emphasise their role as financial institution, setting them apart from other NGOs such as the Triple Trust Organisation or NASASA (as discussed in section 3.3). These four dominant micro-finance institutions in South Africa do not, as argued above, compete for customers or funding - there is more than enough for all to grow. They do, however, vie each other in the competition for the 'best' lending model.

The micro-finance sector in South Africa developed in relative isolation from government policy. The main domestic funder, the government-owned Development Bank of Southern Africa, did not discriminate against any specific micro-finance 'model' in its funding decisions, and became the main donor to all major micro-finance institutions in South Africa. This can be attributed to two factors. First, no single model for micro-finance has yet proven itself for application in Africa, and problems in applying imported micro-finance models in

Africa have been noted (Churchill, 1997; Buckley, 1996a, 1996b).[28] Therefore, experimentation was justified. Second, the Development Bank of Southern Africa was keen on becoming quickly associated with new and politically more acceptable activities in order to secure its status during political transition. Offering support to the emerging and internationally respectable micro-finance sector was one way of furthering this objective. USAID is probably the second most important funder of micro-finance institutions in South Africa, but many other organisations have provided low-interest loans or grants. As there are many potential donors, the threat of one to withhold funds in order to enforce moves towards sustainability (or any other objective) has little chance of success.[29] With the balance of power tilting towards micro-finance organisations, and against donors, some organisations may yield to the temptations of the soft budget constraint: 'bargaining for assistance, and inefficiencies and cost overruns tolerated in the hope that deficits will be covered from public sources' (Kornai, 1986, p. 23). While claiming to move towards sustainability, the ease with which micro-finance institutions can secure additional funding may dissuade some of them from developing true sustainability as consistently as would otherwise be possible.

[28] Buckley (1996a, 1996b) analysis two Grameen replications in Africa, the PRIDE programme in Kenya and the Malawi Mudzi Fund. Especially the later - 'the most blatant attempt to replicate the Grameen Bank model (1996a, p. 283) - is shown to have problems in reaching the same level of group support, while PRIDE experiences problems in copying the loan growth rates of the Grameen Bank in a less populous country.

[29] Tony Davenport, the chairman of the Start-Up Fund, told me about the incident when he was turned down for funding by Miserior, the catholic relief organisation, for being 'too business-like'. He quickly secured funds elsewhere, and the criticism by Miserior was no reason for him or his board to re-consider their own strategies.

To set the dominant micro-finance institutions discussed above in context, it is useful to consider again the data accumulated for the Development Bank of Southern Africa. Within the group of 13 institutions compared in the study by BEES, the costs per loan disbursed range from R95 for the Start-Up Fund to R5,996 for IBEC (which is very high even considering their high average loan size). Following the Start-Up Fund, the second least costly is the Small Enterprise Foundation at R410. Most others have significantly higher costs per loan disbursal, the average lies R1,901 (BEES, 1997, table 26). The Rural Finance Facility spends R702 per loan and the Get Ahead Foundation slightly above the average, R1,969 (see table 5.1).

Table 5.1: Lending data of core micro-finance institutions in South Africa

	Get Ahead Foundation	Start-Up Fund	Small Enterp. Foundation	IBEC	Rural Finance Fac.
Cost per loan	R1,969	R95	R410	R5,996	R702
Average loan size	R3,659	R362	R739	R8,329	R695
Loans per credit officer	76	2,760	161	64	276
Interest earned as % of loans	23	26	39	N/A	20

Source: BEES (1997), table 22 and table 26.

It is also apparent that the target group does not correlate to the choice of lending model. Arguably, smaller loans are more appropriate for poorer people and a poverty alleviation objective, while 'the budding entrepreneur' requires larger loans (see discussion on page 58). The Start-Up Fund, making the smallest average loans, lends to individuals, while the Get Ahead Foundation, whose average loan size is more than ten times larger, uses the group model.

In summary, modern micro-finance institutions developed in South Africa only once the transition towards democracy had been cleared. All major lenders were founded and started operating in the first half of the 1990s - or in the case of the Get Ahead Foundation, which had a different history, were reorganised at that time to create a modern, finance-oriented organisation. Previously, the provision of financial services alone would have made little sense, and viability of lending to informal, black enterprises was elusive as long as their proprietors were officially harassed and their activities technically illegal.

In the following chapters, the Small Enterprise Foundation and the Start-Up Fund will be discussed in greater detail. They are appropriate case studies because they are members of the small club of relatively mature micro-finance institutions and because they implemented lending models - group-based participatory lending and mass-minimalist technocratic lending respectively - in a coherent manner (unlike the Rural Finance Facility which mixes group and individual approaches). Further, they were set up with a agenda focused on financial services from the start (unlike the Get Ahead Foundation, which moved from a more political agenda to an economic after several years, prompted by a financial crisis) and they are the two most efficient micro-lenders, judging from available data, and I intend to compare the best examples of competing models.

6. Sustainability and Group Lending: Does Solidarity Pay?

In solidarity credit schemes 'grassroots' groups are responsible for controlling eligibility for membership and credit. Group members assume joint responsibility and liability for the loans they receive. Joint liability is argued to enhance accountability and improve repayment ratios as compared with standard bilateral loan agreements. Further, groups receive successive loans, which serve as an inducement for continuity. These groups constitute the grassroots form of membership organisation and are intended to instil a form of loyalty.

There is a wide literature detailing working practice and social framework of institutions such as ROSCAs (Ardener, 1964; Bouman, 1979; Nayar, 1986; Thomas, 1991). Also, both independent and donor-inspired accounts report about the workings and social effects of solidarity credit schemes (Berenbach and Guzman, 1994; Biggs *et al*, 1991; Fuglesang and Chandler, 1986; Glosser, 1994; Jain, 1996). In contrast, economic understanding of solidaristic credit institutions is still incomplete. The claim of economic efficiency goes largely unchallenged. This chapter, following a brief summary of the theoretical critique developed in chapter 4, analyses a Grameen-type micro-lender in South Africa, to challenge the notion that solidarity and group structures contribute to financial sustainability in micro-lending. Section 6.2 introduces the Small Enterprise Foundation, then the financial viability of its group lending programme is assessed in section 6.3. Section 6.4 considers the economic costs of participation for the group members, and section 6.5 discusses the relationship between participatory structure, scale economies and lending costs. The connection of participatory credit and social return is also briefly discussed in section 6.6 before section 6.7 sets the long-term subsidy requirements of the Small Enterprise Foundation into the context of its capital structure and concludes this chapter.

6.1 Solidaristic Credit in Economic Analysis - a summary[1]

In the existing economic literature, ROSCAs are concluded to shorten saving times for lumpy expenditure (Besley *et al*, 1993); solidarity credit schemes are superior to standard, 'bilateral' credit contracts because of peer information and supervision (Stiglitz, 1993; de Aghion, 1995). However, as was shown in chapter 4, they all assume that solidaristic groups constitute a 'contractual club'.

The understanding of solidarity as a contractual arrangement does not lead to an adequate understanding of the reality of group formation. Hovering uneasily around the question of group access, Besley *et al* (1993), Besley and Coate (1995), de Aghion (1994) and Stiglitz (1993) seem to acknowledge that groups are not formed by contracting but that a sense of 'solidarity' must exist before loan agreements can meaningfully be adopted. Solidarity provides access to a valued resource flow and constitutes, in this context, 'social capital' (Coleman, 1990, pp. 300-21). Social relations assume economic value chiefly because they promote

[1] The following critique is a summary of the arguments discussed in chapter 4.

economic exchange and reduce volatility; thus solidarity is an input into a joint production process. Group members do not merely exchange resources but commit resources to a shared goal. They are not merely agents, but members, who participate in a joint production process (Hechter, 1987, pp. 40-9). Group members accept obligations for economic as well as social functions of the group, which are accompanied by partying, gifts, food and other expenditure ostensibly for consumption. Personal relations may appear to be not directly productive, but, in fact, they are the *sine qua non* of 'social capital'. Although group members do, obviously, agree on informal contracts, they are different from other economic agents because they are in possession of costly social capital. Solidarity, unlike contractual arrangements, is embedded in individuals and not transferable.[2]

Poor people have no access to credit, but small groups of poor people may have considerable savings capability. The impossibility of gaining access to credit individually creates a situation of dependency: access to a valued good - credit - is dependent on joint production based in a group. Where dependency does not exist, where people can procure goods from private resources, solidarity is undesired and inefficient: people do not normally commit time and resources to credit groups if they can obtain standard bilateral credit from commercial banks or, at reasonable costs, informal lenders (Hechter, 1987, pp. 45, 52-3).

[2] 'Since groups that produce goods for the marketplace can compensate their members with wages, solidarity will be confined to groups concerned with the production of joint, immanent goods for internal consumption' (Hechter, 1987, p. 52). Solidaristic credit, produced by groups for their own benefit, obviously is an immanent good.

While members of ROSCAs jointly produce financial services, members of credit groups in formal group credit schemes produce 'group characteristics' which enable them, jointly, to gain access to credit provided by the formal lender. Solidarity credit schemes seek to benefit from the discipline that group solidarity enforces. They create dependency on the group by making credit available only to those borrowers who can demonstrate a high level of solidarity. Group credit lenders thus play a crucial role in the creation of their grassroots groups. In view of the extensive informal obligations and commitments between groups and lender, it is appropriate to see the lender as a solidarity partner (Von Pischke, 1991, pp. 238-43; Montgomery, 1996, p. 290). This means lenders are answerable to borrowers on matters that transgress the narrow responsibilities of mainstream banks. Most importantly, group solidarity will only be observable for the lender if its representatives - credit officers - participate in some group functions. Meetings are therefore the centre of activity on the interface of solidarity credit schemes and their borrowers.

Solidarity is the foundation of group credit, but also a resource-intensive asset to create. This highlights the concern for development policy: group credit institutions compete for resources - subsidies and donor aid - on the basis of their self-proclaimed efficiency. This claim rests on the assertion that solidarity reduces default, yet this reasoning tends to ignore the negative impact of group formation and maintenance on costs. The understanding of group solidarity as a productive albeit costly factor of production, and not a free good, implies that solidarity credit schemes are less efficient than their proponents claim, and that their advantage over standard, bilateral lenders is less obvious than is claimed in the literature. I hypothesise that the cost advantage of group credit stemming from low default rates is significantly eroded by the resource-intensive mode of operation that is necessitated by their solidaristic lending technology.

6.2 The Small Enterprise Foundation

I will test my hypothesis using data from one solidarity credit scheme operating in South Africa. The Small Enterprise Foundation is a private non-profit organisation located at Tzaneen, Northern Province. It describes its aim as the 'alleviation of unemployment and poverty in the black population of the rural areas of South Africa' (Small Enterprise Foundation, 1994a, p. 1). Imitating the Grameen Bank, the Small Enterprise Foundation is often referred to as one of the more successful lenders in the unsecured loan market in South Africa and enjoys a level of admiration from competitors and local policy-makers (Christodoulou *et al*, 1993, pp. 13-4).

The core of the Small Enterprise Foundation's activity is the provision of credit, but participation in the management of the Small Enterprise Foundation and its sub-units is also seen as an important aspect of 'empowerment'. Credit and 'empowerment' are seen as vital components of a process that enables the poor and unemployed in rural South Africa to become successful entrepreneurs. Prospective borrowers must attend a four-week familiarisation session, and must then arrange themselves into groups. Prior to the disbursement of the first loan, the group has to open a savings account and demonstrate its ability to save. Communal savings are seen as forging closer ties between group members before they are entrusted with borrowed money.

The lending technology involves groups of five or six borrowers; these are explicitly related to traditional stokvels, ie ROSCAs (Small Enterprise Foundation, 1994a, p. 1). Only one loan per group can be outstanding at any one time. Five or six of these groups form a 'centre'. Meetings of centres take place every fortnight and are attended by a member of staff from the Small Enterprise Foundation. At each meeting, therefore, the fieldworker (the Small Enterprise Foundation's title for their credit officers) is able to address thirty to thirty-five borrowers. At the end of the review period, the financial year ending June 1994, the Small Enterprise Foundation employed fifteen extension staff: twelve full-time fieldworkers and three co-ordinators. According to the Small Enterprise Foundation, each of the fieldworkers has the capacity to work with 350 borrowers; this means that within a fortnight each fieldworker attends ten to twelve centre meetings.

From inception of the programme in December 1991 to July 1995 a total of 8446 loans were disbursed, amounting to R5,294,500. The fame of the Small Enterprise

Foundation rests mainly on the fact that the institution claims a zero default rate. Due to the death of group members, a total of R6,566 were written off, and illness was the reason for a debt reschedule of R1,576. In relation to the size of the portfolio, capital write-offs are thus negligible. Total costs, excluding financing costs, were R667,160 in the financial year ending June 1994.

Interest payments follow a simple formula: R1 per R100 borrowed (full initial loan amount) is payable per fortnight until the full loan has been repaid. Loan amounts are scheduled: first time borrowers receive R300; once this loan has been repaid they may receive R700, then R1,000. The first loan is repayable over ten fortnights (at R33 per fortnight), the larger loans over twenty fortnights (at R42 and R60 per fortnight respectively). As can be seen, the fortnight is the basic unit for accounting of time for the Small Enterprise Foundation. This repayment mode implies an annual, non-compounded interest rate of around 42 percent.[3]

Table 6.1 - Loan sizes and net revenue schedule of the Small Enterprise Foundation

Loan sizes	R300	R700	R1000
Repayment Period	20 weeks	40 weeks	40 weeks
Number of repayments	10	20	20
Amount per repayment	R33	R42	R60
Net revenue per fortnight	R3	R7	R10
Total net revenue	R30	R140	R200

[3] For loans repayable over ten fortnights the interest rate is 42.9 percent, for loans repayable over twenty fortnights 41.3 percent.

From this schedule, it can be seen that the Small Enterprise Foundation's income is dependent on loans size and duration. Assuming on-time repayment (which is the rule), a R300 loan is repaid after twenty weeks and has generated total income of R30, the larger loans of R700 and R1,000 are repaid after forty weeks and generate total income of R140 and R200. During a standard two-week time interval, the net revenue (repayment less capital redemption) is R3, R7 and R10 for small, medium and large loans respectively.

6.3 Group Credit and Financial Viability

The Small Enterprise Foundation states that its 'programme is being structured from the outset so that it will become self-sufficient in the medium term (ie within four to five years) and should be able to achieve this self-sufficiency through the income generated from the interest charged on loans' (Small Enterprise Foundation, 1994a, p. 2). One of the arguments in favour of solidarity credit schemes is, as was argued above, that credit officers can generally address many customers at once because lender-borrower contact takes place in larger group meetings. In the following I will show that the predictions of the Small Enterprise Foundation are unrealistic and that the economies of scale embodied in group and centre organisation do not result in reasonable transaction cost savings. Because solidarity credit scheme-type intermediation evolves around the credit officer-borrower group interface, the credit officer serves as basic unit of analysis and my calculations show that revenue and cost structures result in a systematic loss for the lender. The analysis is based on the Small Enterprise Foundation's own data base and covers the year to June 1994. Where necessary, I will apply assumptions biased in the Small Enterprise Foundation's favour.

The potential viability of the Small Enterprise Foundation's lending technology can be assessed by calculating the net revenue (interest paid by credit groups on their outstanding loans) generated by each credit officer. This figure, then, can be compared with the fully allocated costs of administration of the Small Enterprise Foundation. Much of the following analysis depends on the level of costs of the Small Enterprise Foundation. However, the level of costs is determined by the staff-intensive system of credit delivery: At the end of the review period, June 1994, fifteen extension staff were employed, twelve fieldworkers and three co-ordinators. If their average wage cost, including social benefits, is R25,000 per year and additionally R100,000 were spent for two or three headquarter staff in Tzaneen, then total labour costs are R475,000 per year. In fact, in June 1994 there were twenty-three full members of staff, some of them part-time, and two trainees. In addition there are costs for renting office space in Tzaneen, for communication and transport, printing information and education material, for occasional consultancies and auditing, and bank charges for loan dispersal and repayments handled through the electronic payments system and for managing the 'reserves'. The actual total costs of R667,160 seem not excessive. However, section 6.7 considers a scenario where many parameters, including total costs, are assumed to have improved. The results prove to be very robust. The Small Enterprise Foundation's costs of funding remain outside the analysis.[4]

Each credit officer can, according to the Small Enterprise Foundation, deal with 350 borrowers. This means that a total of seventy credit groups with five members each are aligned to centres under the responsibility of a credit officer. Under the assumption that all credit groups have loans outstanding at all times, each credit officer's portfolio comprises seventy loans at any time. The average loan size of credit groups was (during the financial year ending June 1994) R693. The ratio of annual revenue to loan disbursements is 26 percent (1 percent per fortnight). The net revenue produced by a single loan officer is therefore

(1) $r = N \times i \times avl$

N = number of permanently indebted groups

i = ratio of revenue to loan disbursements

avl = average loan size

which gives, for 1994 data, r = R12,612.6. Total administrative costs of the Small Enterprise Foundation are R667,160; this figure includes credit officer-related costs and general overheads as well as bank charges, but excludes financing costs.

[4] The Small Enterprise Foundation, as other similar institutions, is funded by grants and subsidized long-term loans. Their private funding costs are thus not indicative of their true social costs of capital, nor could meaningful projections be made.

With twelve credit officers, fully allocated costs per credit officer (c) stand at R55,596.6. Hence only 22.7 percent of total transaction costs could be covered from income from the loan portfolio, assuming seventy average loans were outstanding at all times.

However, the credit officers did not, in fact, serve 350 borrowers each. During 1994 each credit officer dealt with 192 borrowers on average, equivalent to 38.4 credit groups. Assuming that all groups had a loan outstanding at all times, the real revenue per credit officer was only R6,918.9. Thus the contribution to fully allocated costs stood at only 12.4 percent.

The Small Enterprise Foundation claims that large centre meetings enable credit officers to deal with many borrowers efficiently on a large scale. However, each credit officer would need to serve many more borrowers than is possible with participatory lending technology in order to generate the income necessary to break even at current costs. The break-even number of borrower groups is given as

(2) $N = c/(i \times avl)$

c = fully allocated costs per credit officer which yields N = 308.56. For 1994 data, break-even could be reached if a single credit officer could deal with 309 groups. All groups need to be permanently indebted with average-sized loans assuming that the repayment record and total costs remain unchanged, ie under constant absolute fully allocated costs per officer. Under these assumptions, a credit officer would need to see 1,545 borrowers every fortnight and maintain personal relationships with all groups.

A glance at the financial statements of the Small Enterprise Foundation reveals that annual operating costs were almost 70 percent of total outstanding loans (end of period) in 1994. It follows that - were the Small Enterprise Foundation to be self-sufficient - it would need to charge exorbitant interest rates to generate sufficient income. The interest rate that balances costs and revenues is given by

(3) $i = c/(N \times avl)$

which yields i = 208.92. For actual 1994 data, the Small Enterprise Foundation would need to generate income/disbursements at a ratio of over 200 percent per annum; instead of charging 1 percent per fortnight they needed to charge 8 percent per fortnight for the full loan amount. *Ceteris paribus*, the Small Enterprise Foundation thus has its break-even point at up to 210 percent annual, non-compounded interest rate.[5] Obviously, *ceteris paribus* is an unreasonably

[5] For loans repayable over ten fortnights the interest rate is 210 percent and for loans repayable over twenty fortnights 152.3 percent.

optimistic assumption. This estimate still excludes the opportunity costs of the loan capital as Interest Paid is excluded from the cost calculation of the Small Enterprise Foundation.

Hence, the chances of reaching sustainability will be further reduced if any of the underlying assumptions changes for worse: cost per officer, average loan size and number of loans per officer are assumed constant at 1994 levels while repayment problems (defaults and debt rescheduling) and capital costs are assumed constant at a level of zero.

Interest rates in excess of 150 percent are unrealistic and would probably result in adverse selection of borrowers. Moneylenders - the obvious alternative to solidarity credit schemes, and generally open for business to even the poorest - routinely charge less interest.[6] Moneylenders demand high interest and are sometimes deemed exploitative, yet many poor people borrow from them because they impose only low transaction costs (Bouman, 1990; Hyuha *et al*, 1990; Johnson and Rogaly, 1997, p. 20). In reverse, formal lending programmes like solidaristic credit schemes impose relatively high transaction costs but are supposedly offering low-interest alternatives to 'usurious' credit. Unless a group lender offers credit at interest rates sufficiently below informal market rates, the solidarity credit scheme will attract only those clients who do not find credit with

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[6] See Van Rooyen (1994) for a limited survey on interest rates of informal lenders in South Africa and Montiel *et al* (1993, pp. 20-5) on general survey of non-institutional interest in various developing countries.

alternative informal lenders. Adverse selection may then lead to deteriorating repayment performance.

Furthermore, micro-credit institutions have the rationale to apply lending technologies which are geared towards handling small amounts of money in frequent transactions. Because solidaristic lending is staff- and resource-intensive, as I argue, it does not easily lend itself to efficient money-handling methods. The Small Enterprise Foundation is, indeed, not able to deal with small loan amounts efficiently. Following the formula

$$(4) \qquad avl = c/(N \times i)$$

the data for the 1994 financial year yield avl = R5,568.57. In order to reach break-even, under 1994 conditions and with all data constant except average loan size, credit groups would need to take credit on average well over R5,000. As avl is the average of all loan groups, most groups would need to have loans well above the minimum amount for consideration as standard, bilateral credit by commercial banks. Some innovative new commercial banks and development finance institutions would also consider credit applications closer to the R3,000 level.[7]

[7] One such bank is Future Bank which is partially owned and managed by First National Bank, the country's fourth largest commercial bank; others include the Small Business Development Corporation and the Rural Finance Facility.

Table 6.2 - Hypothetical estimates on break-even assumption, year to June 1994

variable	estimate, all other variables at actual 1994 levels
number of borrowers	1,545
interest rate	210% (8% per fortnight on full loan amount)
average loan size	R5,568 (falling to R3,055 with 350 borrowers per officer)

Even if all credit officers did in fact serve 350 borrowers, as is claimed to be possible by the Small Enterprise Foundation, the break-even average loan size would still not drop below R3,000 (avl = 3,054.76). Hence the Small Enterprise Foundation's own description of its lending technology is not consistent with its financial projections. The claim of the Small Enterprise Foundation of focusing on small-scale credit and targeting lower income groups therefore seems not to be supported by the economics of their system of credit delivery.

These figures demonstrate that the poor cost recovery (the relation of potential revenue to actual costs) constitute a major problem for the Small Enterprise Foundation in fulfilling its ambition of attaining the status of self-sufficiency. What could the management of the Small Enterprise Foundation do? The easiest variable to change is the rate of loan disbursal. Management can decide to make the rule of 'one loan per group only' less stringent.[8] The Small Enterprise Foundation has in fact adopted a policy that allows credit officers to disburse several loans simultaneously to members of one group. What would happen if all five members of a group received loans simultaneously? This would mean that all

[8] In fact, in many group credit schemes this happened informally, when loan officers felt sympathetic to credit groups and disbursed new loans before all group members have fully repaid. This is adequately described as a breakdown of discipline and is often followed by declining repayment rates (Churchill, 1997).

members could be permanently indebted, and that each credit officer could - according to the Small Enterprise Foundation's own estimates - manage a portfolio of 350 loans. According to current data, though, the number of loans would be limited to the number of borrowers per credit officer of 192.

Going back to equation 1, this shows that the revenue could indeed reach 113.5 percent of costs, indicating financial viability by some margin. However, with the actual number of borrowers per credit officer, the ratio falls to 62.0 percent (see Table 6.3). Not only falls this short of viability by a significant margin, but it also assumes, like all earlier estimations, that all members are permanently indebted, and that the cost of funds is zero.

Table 6.3 - Revenue as percentage of costs per credit officer, year to June 1994

	192 borrowers per officer	350 borrowers per officer
one loan per group	12.4%	22.7%
five loans per group	62.0%	113.5%

6.4 Participation and the Costs of Grassroots Contribution

The main analysis in this chapter concentrates on assessing the contribution to joint production, including the costs of accumulating social capital, from the perspective of the solidarity credit scheme. It thus focuses on the cost (and benefit) calculation as given by the accounts of the Small Enterprise Foundation.

This argument is used to refute the claim of economic sustainability from the view of the Small Enterprise Foundation as a supposedly viable corporate entity.

However, in assessing the viability of the Small Enterprise Foundation's lending technology it is equally important to assess the costs of group participants. If their contributions are larger than the benefit derived from participation, the stability of the membership base is under threat. As detailed in section 6.6, the Small Enterprise Foundation does indeed experience very high drop-out rates.[9]

Presently, monetary commitments are existent only in the form of loan repayment at the prevailing interest rate of 42 percent. Also, there is a risk that individual members may have to 'fork out' the repayment of another member 'falling on hard times', ie experiencing 'approved' repayment problems. Yet these are the tangible costs of group loans that group members are made aware of when joining a credit scheme, and that have been discussed in the literature.

This approach neglects the non-tangible costs of participation. In the Small Enterprise Foundation's scheme, they consist largely of time. Groups are required to participate in pre-entry educational and group building exercises which are run

[9] It has been argued that dropping out may be graduating and thus constitute a measure of success. Unfortunately, most groups drop out after the first few stages; 58 percent drop out before reaching the R1000 loan level. At this stage, individual group members have not received significant credit amounts but have already absorbed costs associated with group formation and gaining credit eligibility. Also, the Small Enterprise Foundation was burdened with the costs of integrating new members into centres, including initial training. Early drop out, therefore, is not to be considered a success.

by the Small Enterprise Foundation staff. On completion of these courses, they are tested for group coherence by the managing director of the Small Enterprise Foundation. Once admitted, all group members are required to participate in fortnightly centre meetings which typically last half a day. In addition members have to 'monitor' other members of their immediate (five member-) group; this monitoring is not regulated by the Small Enterprise Foundation.

In the following, I assume that time devoted to participatory activities is equal to income foregone, that there is no other benefit accruing from participatory activities other than credit, and that there is no surplus labour (eg in the family) available to fill the gap. Under these assumptions, the accumulated non-tangible costs per unit of credit (k*) can be expressed as

(5) $k^* = (Y \times m \times w)/ L$

Y = weekly income

m = share of total working time spent on meetings

w = repayment period in weeks

L = loan amount per member

which represents the opportunity cost of participation in relation to the loan amount. As can be seen, higher income (ie higher opportunity costs of time), longer meetings and longer repayment periods all raise the real costs of procuring credit from participatory lenders. In the absence of alternative, cheaper credit, participation is beneficial only if $k + k^* < r + u$, ie when the sum of tangible costs k (weekly 'interest' of 0.5 percent over the full repayment period) and non-tangible interest costs k^* is smaller than the sum of return on capital r and utility u derived from participation, such as enjoyment of company or learning effects.

In the case of the Small Enterprise Foundation, regular centre meetings require the member to devote more than half a day per fortnight to participatory activities.[10] If we assume that all is adequately classified as work, then at least 5 percent of total working time is spent on centre meetings. The first loan of R300 takes twenty weeks to repay. At this stage, the members may only earn a low income of R30 per week (fieldwork experience suggests this is a reasonable estimate). Over the twenty-week repayment period the total income thus amounts to R600. If 5 percent of labour time is spent on not directly productive activities, there is an income loss of R30. If shared equally between the five group members, the loan at this stage amounts to R60 per participant. Each member thus pays R6 over twenty weeks in interest charges and the fivefold amount in non-tangible contributions. The opportunity cost represents 50 percent of the initial loan amount. Although high, a poor and credit-constrained person may find it acceptable if investment opportunities with high returns exist.

[10] Including the travelling time to get to the meeting place, which can be as much as a two-hour walk one way, up to one whole day may be spent on participatory meetings each fortnight. This would suggest that closer to 10 percent of working time is spent on centre meetings, but I continue to use the more favourable estimate of 5 percent.

A loan of R1,000 takes forty weeks to repay. A more successful entrepreneur, having passed through earlier loan stages, may at this point earn R100 per week. Thus the income over the forty-week repayment period amounts to R4,000; 5 percent opportunity costs add a total of R200 to the repayment costs which is equal to 100 percent of his/her share of loan. This cost may be more difficult to justify, especially if the entrepreneur has now access to alternative sources of finance such as credit from moneylenders or trade finance from suppliers. Possibly, a five-member group could exit from the lending programme because only one member has had the success that made continued participation uneconomic.

In both cases, my analysis assumed that the participants see group activities as work. This evaluation is subjective and it has been suggested that in some circumstances meetings are enjoyed, time spent there was seen as a benefit and not only as a cost.[11] Especially in research on group lenders in South Asia, such benefits were often argued to stem from women's lack of social exchange outside their homes. In such a situation, they enjoy group meetings, which then constitute an asset, not a liability for participatory schemes (Fuglesang and Chandler, 1986).

[11] Especially reports focusing on the non-economic aspects of solidaristic financial institutions often discuss the enjoyment of meetings. In South Africa, Lukhele (1990) is exceptionally optimistic about the fun of stokvel meetings, while Thomas (1991) points out important differences between various types of stokvels.

However, this view depends on the specific societal context in South Asia; women in Africa usually enjoy access to various channels for social interaction.[12] Also, women living in seclusion may encounter problems in setting up their own businesses without help by male relatives. In this case, the 'empowerment' of women could be seriously thwarted by their reliance on male relatives for loan utilisation (Goetz and Gupta, 1996). Arguably, a more successful and business-minded entrepreneur is less likely to attach social value as opposed to economic costs to meetings. Also, the emancipatory value of exercising self-determination in the organisation - as cited by the Small Enterprise Foundation as an important learning process - is less valuable once an entrepreneur has economic success; emancipation would work more strongly through commitment to his/her enterprise.

Finally, my estimates of the duration of meetings, travelling times and incomes are only approximate. One might change the parameters, but the basic finding

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[12] While it is beyond the scope of this thesis to investigate the role of women in society, comparing South Asia with Southern Africa, it is possible to find evidence for a significant difference in existing literature on micro-finance schemes. Johnson and Rogaly (1997, especially p. 100-1) and Goetz and Gupta (1996) report extreme cases of women borrowers' suppression from Pakistan and Bangladesh respectively, all leading to the erosion of the borrowers' control over loan use. Worse still, conservative societal norms in parts of South Asia restrict the interaction of women with people who are not members of their households. Hulme and Mosley (1997) report that that regular meetings give women 'an opportunity to share information and discuss ideas. Such opportunities previously did not exist. Measuring the results of such association was beyond the limits of this study but the creation of a regular forum at which large numbers of poor women can meet and talk represents a "breakthrough" in the social norms of rural Bangladesh' (p. 120). Although women are generally in an inferior social position in society in Southern Africa in comparison to men, reports do not indicate such a dramatic gender differentiation. Preston-Whyte (1991) describes comparatively independent female entrepreneurs in Natal. My own fieldwork did not discover cases of intentional fronting (see also footnote 7 in chapter 8) and showed that female borrowers were significantly more independent than their counterparts captured in reports from South Asia.

(that participation imposes considerable costs and becomes more expensive when members experience business success) remains valid. My estimates exclude the costs of in-group monitoring. The inclusion would strengthen the findings.

6.5 Participation, Scale, and Costs

The analysis of section 6.3 is based on data for the financial year ending June 1994. The projections of the Small Enterprise Foundation's management foresee a growing organisation that gains advantage through economies of scale. More recent data, however, refute the plausibility of these projections. Neither loan size nor number of loans has grown substantially, while costs are on a steep upward movement. Half-year results to December 1994 show a slight increase of the loan portfolio, but also an accommodating increase of operating costs. At an annualised rate, operating costs are still equal to just under 70 percent of the outstanding balance on loan accounts. Data for July 1995 show monthly costs of R95,116; at an annual rate, the cost/loan portfolio ratio has risen to 103.84 percent. The number of clients has decreased to 157 per credit officer; average loans would need to equal R10,754.45 were the Small Enterprise Foundation to break even (Small Enterprise Foundation, 1995b).

From these indicators it is easy to see that the Small Enterprise Foundation has moved away even further from financial viability. The disappointing performance was partially attributed to the high drop-out rate of borrowers. The semi-annual report (Small Enterprise Foundation, 1994b, p. 2) finds that '20 percent of clients leave the programme on completing a first loan, 38 percent on completing a second loan and 27 percent after the third loan'. This means that 85 percent of members desert the programme before reaching credit levels which could be economical for the lender, while initial capital outlays, particularly in the form of training and group formation, have to be absorbed by the Small Enterprise Foundation. High interest and opportunity costs may be a reason: above a certain credit amount and with a certain credit record borrowers may be able to find cheaper alternative suppliers. Moneylenders may also require high interest rates, but they are usually easily approachable and their lending procedures do not impose hidden costs (Bouman, 1990). It appears that it would be crucial to address the time-intensive banking method especially for more mature borrowers - who, if they have success in business, face higher opportunity costs for their time - in order to entice more borrowers to stay in the programme.

It is conceivable that borrowers desert the lending programme because, after initial access to credit, the solidaristic structure imposes high costs on them in terms of obligations for fortnightly meetings and mutual screening, and also because of the risk involved in joint liability. This poses the question whether sustainability may be enhanced by easing the group requirements for mature groups, ie those which have passed through several loan stages and thus have created a repayment record. These groups may, for example, be required to meet with credit officers only on a monthly or quarterly basis; also, individual members could be considered for loans without joint liability.

There are several cautioning factors, however:

- As 85 percent of the initial intake of members do not progress into the fourth loan, few clients do in fact reach a stage where they could be considered 'mature'. If these few were to cross-subsidise the costs of the many who drop out early, the economic rationale of this differentiation may well be undermined.
- If a large number of mature borrowers would enter such a scheme, it would without doubt lead to a further duplication of administrative work. There would be different 'classes' of borrowers, each of which was subject to differential rules and requirements. Some contact with loan officers would be necessary for all of them, but the agenda for such meetings may not overlap. Hence credit officers could be required to visit their respective areas more often in order to have meetings with all different 'classes' of borrowers.
- Differentiation of borrowers is against the solidaristic spirit of institutions like the Small Enterprise Foundation. The image of the Small Enterprise Foundation is based on participation and internal democracy; the contact between credit beginners and advanced borrowers is crucial to the participatory spirit and the self-understanding as not merely a lender, but a social movement. Coleman finds that 'social capital depreciates if it is not renewed' (1990, p. 321), like any other form of capital, 'through regular communication' (*ibid.*).

Hechter (1987) argues that visibility, ritual and public commitment to group values are crucial to instil 'solidarity' and enforce obligations within artificially created groups such as the Small Enterprise Foundation structure. Thus, the Small Enterprise Foundation is supported in its claim that frequent meetings are indeed crucial to their lending technology, although some cost reduction may be obtainable from optimisation of the exact frequency and time requirement of centre meetings.

- Finally, lean credit for mature borrowers on a bilateral basis may be more efficiently organised by other lenders, possibly those with a higher minimum loan size. Various South African institutions, from both public and private sectors, do attract clients who have matured from informal lending programmes. Also, mature clients could be 'creamed off' by commercial banks which are eager to create business in poorer areas.

Indeed, currently the Small Enterprise Foundation's policy looks in the opposite direction. The mid-term evaluation of the Small Enterprise Foundation, carried out by USAID and endorsed by the Small Enterprise Foundation, emphasises the importance that 'the Small Enterprise Foundation must track and enforce attendance at Centre meetings, making it almost more important than actual repayment, since Centre meetings are the primary tool to forge group cohesiveness and encourage good repayment' (Small Enterprise Foundation, 1994b, p. 3). Commitment to the participatory principle is apparently assumed to be the key to sustainability. Ignoring the opportunity costs of time spent on participatory duties means that the Small Enterprise Foundation implicitly assumes that its clientele has no constraint on labour. It should, however, be emphasised that the Small Enterprise Foundation's problems lie in the cost structure and the drop-out rates, not in deficient repayment.

It could be considered whether, despite the limitations, it is possible to cut back the complexity of participatory structure for the benefit of operational efficiency, while maintaining the participatory, supportive character of the Small Enterprise Foundation, because this is viewed as a valuable social development tool. However, it should be clear that the results from the financial data are robust; even large reductions in costs, or increases in group size would not quickly alleviate the deficit. Even hypothetical improvements of all factors could not, within reasonable limits, produce financial self-sustainability (see section 6.7). The problem lies in the limitations imposed by the requirement for contact between borrowers and lender; unless one credit officer can manage a portfolio of several thousand borrowers, financial sustainability is unobtainable. Borrowers in micro-lending programmes are low-margin customers, and personal service is essentially a luxury for which they cannot pay. This insight refutes the notion that group credit is an appropriate way to target especially the very poor (see section 2.2) for micro-finance institutions aspiring to financial sustainability. In the context of participatory frameworks, credit officers are therefore facing an impossible task as they are required to generate volume, be personally engaged with customers and approach the poorest clients.[13]

In conclusion, the Small Enterprise Foundation's claims 'that it will become self-sufficient in the medium term' and that it 'should be able to achieve this self-sufficiency through the income generated from the interest charged on loans' (Small Enterprise Foundation, 1994a, p. 2) seem unrealistic. Neither does the Small Enterprise Foundation explain on which assumptions it bases its expectation for greatly improved interest income. As the analysis shows, no sensible change in parameters can be expected to generate the income to cover administrative costs, nor is there reason for assuming that administrative costs will decline steeply.

6.6 Participation and Social Return

While credit delivery is the main activity of solidarity credit schemes, their mission is the alleviation of unemployment and poverty. The Small Enterprise Foundation emphasises 'that the programme structure enables the communities which the Small Enterprise Foundation serves to increase their sense of security and self-esteem not only through the loans provided [...]. Participants are thus

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[13] This dilemma reflects another conflict of interest: it is now widely accepted that focusing on the core activity of credit helps a micro-lender to achieve sustainability (Robinson, 1996, p. 155). At the same time, the concern is often expressed that cutting out non-financial activities leaves micro-lenders without the developmental, compassionate touch that is expected of charitable organisations (Dichter, 1996). Group credit lenders invariably have a strong emphasis on non-financial, participatory community-development activities; this could be seen as a fundamental, albeit costly, aspect of their mission.

given control over their own lives in many ways that stretch beyond simply providing finance for business growth' (Small Enterprise Foundation, 1994a, p. 2). Therefore, the Small Enterprise Foundation could be justified in claiming that social returns exceed private returns in the form of enhanced employment opportunities and reduced poverty. In this case, continued subsidies may be defensible, if subsidies are achieved used efficiently and in a transparent manner.

Yet the claims of the Small Enterprise Foundation to 'do good' rest on unrealistically optimistic interpretation of their data. Since inception to the end of June 1994 (end of financial year), the Small Enterprise Foundation has disbursed 5330 loans and claims to have served an equal number of business people. According to its data, its borrowers own businesses that employ an average of 2.4 people (including owners and part-timers). Thus, the Small Enterprise Foundation claims to have 'supported' 12,754 job positions (Small Enterprise Foundation, 1994a; 1995a). If this claim is to be meaningful, 'support' might be taken to mean that the Small Enterprise Foundation's services have significantly enhanced the viability of employment, guaranteed its generation and continued existence. However, it is a steep claim that each (average) loan of R568 (that is the average loan size since inception) keeps 2.4 people in permanent employment. If true, it would mean that each job could be 'supported' with a loan of a mere R236.67. Even in South Africa, employment creation is more resource-intensive. It may be suspected that every helping hand has been counted as a 'job opportunity', possibly including credit group members helping each other (as group peers have a strong incentive to support each other).

Further, the Small Enterprise Foundation, like other micro-lenders, claims that it is capable of serving the 'poorest of the poor'. However, the self-selection process underlying group formation can imply the exclusion of very poor people without regular income (Montgomery, 1996). Such a dynamic would, probably undetected by the lender, lead to further erosion of the social benefit of lending because a core target group would be implicitly excluded from access to credit.

The Small Enterprise Foundation claims to be 'able to ensure that all participants have a strong influence over the Foundation's policies' and developmental goals are aided by '[c]entres which function as community structures' and 'participation in giving direction to the Foundation' (1994a, p. 2). Particularly important are workshops which the Small Enterprise Foundation holds with representatives of borrower groups. These workshops comment on and influence the Small Enterprise Foundation's policies, thus introducing an element of grassroots democracy and contributing to borrowers' perception of the Small Enterprise Foundation as a participatory enterprise. Participation is seen as desirable in its own right, as a valuable social development tool.

However, it has also been pointed out that participatory structures are often inappropriate when the expected return is mainly economic efficiency such as managing a firm (Brett, 1996) and problematic because of interest conflicts as members double as joint producers and consumers (Abel, 1988).[14] Participatory decision-making is then also more costly than the imposition of authority. Participation forces costs of consent on the multiple decision-makers - groups and centres and their members - and on their joint enterprise - the Small Enterprise Foundation - without removing the need for control.[15] Participatory enterprises, then, would need to show plausibly that their decisions are better - that their control mechanisms are more effective, and higher decision costs therefore are recouped from savings in the production of the joint good - or that participation entails other, social benefits which justify higher decision costs. In the Small Enterprise Foundation's case, control is strong - there is no default problem - yet the savings alone cannot justify the costs associated with time-consuming personalistic banking practices.

Intended to further the 'empowerment' of disadvantaged people, participatory structures endanger this aim whenever democratic ideals dominate economic reasoning, thus becoming a threat to sustainability. The proliferation of parallel top-down and bottom-up channels of communication contribute to the high cost nature of the Small Enterprise Foundation's lending programme. It could well be

[14] Arguably, solidarity credit schemes like the Grameen Bank and the Small Enterprise Foundation avoid this problem by imposing strong patriarchal structures on their members. In practice, members are thus 'guided' by a benevolent authoritarian - usually the founder - towards decisions for the good of the community.

[15] See Hechter (1987, pp. 60-77) on the necessity of control in solidaristic production and on control in ROSCAs (1987, pp. 108-10).

argued that a viable and effective commercial lender would do more for the empowerment of poor black entrepreneurs not because of internal democracy, but because it could be better in providing affordable venture capital.

6.7 Sustainability in the Long Run

The revenue shortfall of the Small Enterprise Foundation cannot be blamed on temporary variations nor on start-up problems (see Table 6.4). Even optimistic projections cannot provide credible scenarios for future financial sustainability. If costs declined by 10 percent (cost per credit officer of R79,019.44) and the income disbursement ratio climbed to 40 percent per year, thus raising the annual interest rate to around 60 percent, and credit officers were indeed able to serve 350 customers as claimed, average loan size would still be beyond micro-credit levels under equilibrium conditions because

(4) $avl = c/(N \times i)$

yields avl = R2,822.12. Thus the average loan size necessary to break even would be almost four times the actual, present average loan size, and this result is based on optimistic parameters and implausibly optimistic assumptions.

Yet the Small Enterprise Foundation is financially secure. Grants from both foreign and national sources have built up a sizeable stock of capital. At the beginning of 1995, the Small Enterprise Foundation had reserves of R5.2 million, and these were projected to cover administrative costs for several years (Small Enterprise Foundation, 1995a, p. 13).

Table 6.4 - Core data of the Small Enterprise Foundation, 1992-1996

Year	1992	1993	1994	1995	1996
Number of clients	400	1,345	1,925	2,051	2,625
Average loan size	356	770	693	750 (est.)	765
Total staff	4	16	25	29	32
Credit officers	3	6	12	13	11
Clients per credit officer	133	224	192	157	239
Loan portfolio (Rand)	80,177	562,478	954,057	1,099,145	1,545,103
Max. potential revenue (Rand)	59,808	434,973	560,290	646,065	843,412
Total annual costs (Rand)	N/A	N/A	667,160	1,141,392	1,642,608

Source: Small Enterprise Foundation, Performance Summaries.
Notes:
1. All years referring to financial year ending in June, except year up to end July 1995 and year up to end September 1996.
2. Maximum potential revenue assumes that all members are permanently indebted with average-sized loans (five loans per group at all times, zero default).
3. The number of clients per credit officer for 1994 is based on information given by the Small Enterprise Foundation and is based on ten full-time credit officers. There were, however, two trainee credit officers, so that the overall average number of clients is reduced to 160 per officer.

The Small Enterprise Foundation currently generates more income from its reserves than from its loan portfolio; in fact, the reserves are five times larger than the loan portfolio. The Small Enterprise Foundation presents this as good news - the Small Enterprise Foundation is financially sound and safe - but it also illuminates the need for subsidies.[16] Investments in formal financial markets are not in the spirit of the Small Enterprise Foundation's mission, and such investments generate no visible social returns over and above their private returns. The requirement for subsidies on a continuous basis, however, is not indicative of waste on behalf of the management of the Small Enterprise Foundation. The Small Enterprise Foundation was chosen as a case study because it has a reputation for professionalism in its field. USAID supports this view and concludes in its mid-term evaluation that the Small Enterprise Foundation 'is a very sound organisation' (as quoted in Small Enterprise Foundation, 1994b, p. 1).[17] Insufficient financial controls cannot, therefore, be blamed for the Small Enterprise Foundation's unfavourable financial performance. This case study has shown that more attention needs to be paid to the requirement of social capital in participatory institutions. The cost implications of the reliance on social capital and solidarity are fundamental; even to poor people, solidarity does not come free.

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[16] In this case, these are internal cross-subsidies from interest income of the 'reserves'. However, it is important to understand these as equivalent to external subsidies as the 'reserves' are the accumulation of grants and external subsidies.

[17] In addition to ongoing funding, the Small Enterprise Foundation won the APPLE award which USAID endows and which is given, competitively, to the most meritorious applicants worldwide.

7. How to Lend like Mad and Make a Profit: The Start-Up Fund

Micro-credit is now an accepted development policy tool and attracts attention and funding at record levels. Donors, development officials and researchers discuss the problems of uncollateralised lending - primarily exposure to moral hazard and bounded rationality - and appear to agree on a model of 'best practice' for solving them. Generally, a tight grip on defaults is recommended, including 'strict auditing and accounting procedures, suggesting the value of monitoring technologies for inducing the desired behaviour' (Braverman and Guasch, 1989, p. 14). In addition, most writers agree on the desirability of 'some form of joint responsibility or liability by small groups [...], whereby default of one of the members would imply the cancellation of any future loans to the whole group' (*ibid.*). Inevitably, both recommendations are two facets of one lending strategy, as joint liability is a further incentive for close supervision, exercised mutually by solidaristic borrowers. This approach is seen as the answer to previous attempts with subsidised credit which have generally failed due to the lack of financial discipline (Adams *et al*, 1984). The paradigm of group credit is associated with concepts such as social collateral, peer selection, supervision and pressure, and all are aimed at using 'local' information and 'connectedness' to ensure high repayment rates.[1]

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[1] The "paradigm" on micro-credit is illustrated by Thomas (1990), Rhyne and Otero (1994), Stiglitz (1994), Wenner (1995), Chaves and Gonzales-Vega (1996), Robinson (1996) and others; its foundations are laid out in earlier report about the comparative advantage of informal finance (World Bank, 1989; Bouman, 1990).

The previous chapters have shown that these concepts do not easily translate into efficient lending operations. In fact, such operations typically do experience very good repayment rates, but their operational costs are high, sometimes prohibitive. Most prominent group lenders have not succeeded in reducing the total costs of lending - the sum of operational and default cost - to sustainable levels (Hossain, 1988). Therefore, it has been argued that group credit 'can also cause severe inefficiencies and has many of the same problems that are associated with common ownership and team production' (Braverman and Guasch, 1994, p. 58).[2]

However, while traditional, 'cheap' credit programmes offered little incentive for exercising prudence (Adams *et al*, 1984), neither by loan officers nor borrowers, this chapter argues that it is possible to design lending schemes that do enforce prudence, achieve sustainability, but avoid joint responsibility structures and the disadvantages associated with them. This proposition will be illustrated through a case study of one individual lender serving a marginal, collateral-free market in South Africa. Its lending strategy uses several of the structures discussed above, but also eschews most standard 'rules' as they are presently accepted by mainstream thinking on micro-credit. The lending strategy of the Start-Up Fund is characterised, inter alia, by the absence of explicit and discretionary screening of loan applicants, absence of direct contact between lender and borrower, absence of

[2] Participatory structures create 'costs of consent' in decision-making, and may not always be viable in competition with authority and contracting (Olson, 1971; Hechter, 1987). Arguably, the grass-roots approach to development, including the group credit movement, does not pay sufficient attention to the costs of participation (Brett, 1996).

supervision, and absence of default enforcement.[3] In contrast to the hands-on approach of group lenders, the Start-Up Fund relies fully on mechanisms for the self-selection and self-motivation of its borrowers. Further, as sophisticated computerised payment mechanisms are used, staffing levels are minimal and services are provided in an anonymous fashion. Flouting all conventional rules, the Start-Up Fund operates with good success.

Section 7.1 will discuss some issues in institutional design with regard to financial sustainability, section 7.2 will introduce the Start-Up Fund, while section 7.3 will evaluate the development of its financial performance and sustainability. Section 7.4 analysis the relationship between self-selection, borrowers' characteristics and repayment behaviour. Section 7.5 concludes this chapter.

7.1 Issues in Institutional Design

Group credit lenders typically report very high repayment rates, from around 95% in the case of the Grameen Bank in Bangladesh to above 99% in the case of the Small Enterprise Foundation in South Africa (Berenbach and Guzman, 1994; Small Enterprise Foundation, 1996). The dominant problem for these supposedly financially sustainable institutions was identified in the previous chapters as their

[3] The Start-Up Fund now reports defaulters to local credit bureaux. This excludes them from accessing credit elsewhere, notably consumer credit. However, it remains doubtful how strong a deterrent this is considering that most Start-Up Fund clients are unlikely to be considered creditworthy anyway.

operational structure, leading to excessive costs. As total costs of lending are constituted by the sum of default and operational costs, group credit institutions cannot claim to have solved the problem of finding sustainable micro-credit delivery systems. Innovative lenders, therefore, are challenged to find ways to reduce operational costs significantly, without losing control of defaults.[4]

Group credit lenders control repayment behaviour through intensive personal interaction, invoking 'peer pressure' and social collateral. The intensive contact between borrowers and credit officers constitutes the core characteristic of group lenders as 'caring' institutions. However, it is also the reason for unsustainable levels of cost, as each credit officer is limited in the number of borrowers he or she can handle, while the income generated from micro-loans cannot justify the costly nurturing.[5] An innovative, cost-conscious lender will not be in a position to provide the 'cosiness' of group-based institutions. In order to reduce costs significantly, scale economies must be used which require a simple, 'mass-produced' financial product. Such a 'Fordist' approach needs to reduce the unit

[4] For micro-credit institutions, there is a trade-off between default and operational costs. While a lender should seek to minimise the sum of default and operational costs, it is not feasible to minimise both simultaneously. The more resources are allocated for borrower selection and control, the lower will be defaults. Low defaults, however, are not necessarily the appropriate criterion for efficient credit extension. Group lenders probably pay insufficient attention to that relationship.

[5] The point is sometimes made that the costs of personalistic lending practices depend on the environment; notably, literate and numerate staff are more easily available and cheaper in Asia than in Africa. While this is generally true, there is no evidence that Asian group lenders have achieved financial sustainability.

costs, i.e. the costs of providing credit to one borrower, below the unit price, i.e. the income received from loans to one borrower.

In the absence of collateral and comprehensive business documentation, loan officers cannot make informed judgements about the creditworthiness of loan applicants. Attempting such evaluation would surely prove too expensive for very small loan amounts and contradict the objective of mass production. Neither will a low-cost lender be in the position to follow up repayment performance on a personal basis. In both cases, the margins of micro-loans cannot justify the costs. In the traditional view, this creates a vulnerability to adverse selection and opportunistic behaviour.[6]

Credit groups and group-based lenders screen loan applicants through interaction, making an assessment on the basis of character and social standing. A low-cost lender, in contrast, will rely on self-selection and effective incentives to select applicants and motivate repayments. Therefore, such institutions use business-mindedness and self-interest of potential borrowers, not their 'character', as a criterion for lending. It is sometimes argued that an important reason for the default of micro-loan borrowers is not opportunism,[7] but the inability to repay.

[6] Typical micro-loan schemes offer first loans often below US$100, rising over time for borrowers who keep repayments up. Even high annual interest rates - fifty percent and more are common - generate low income streams per borrower, which cannot cover such transaction costs. Banking with low-income people thus requires simplified procedures for collecting relevant information and verifying creditworthiness (Bhatt, 1989).

[7] Williamson describes opportunistic behaviour as 'seeking self-interest with guile' (1988, p. 569). An opportunistic borrower could, for instance, plan to default when making a credit application.

Hence a mechanism for self-selection should stipulate rules that discourage those from participating who are not fully motivated to use their loans productively. Self-motivation is provided through rules that offer a benefit for repayment - usually access to ever-growing loans and, eventually, graduation into formal finance.

By creating an incentive framework that emphasises self-selection of the candidates and strong, appropriate incentives for continued participation with good repayment standing, an innovative lender should be in a position to reduce overall costs of lending significantly in comparison with both traditional rural finance and group credit organisations. Providing the right incentives does not require personal borrower contact, and credit delivery could be rationalised. If default rates remain reasonably low, such a lender has a good chance of being a more efficient provider of micro-loans than a staff-intensive, group-based organisation.

7.2 The Start-Up Fund

The Start-Up Fund is a lending scheme located in Durbanville, near Cape Town. It 'operates a phased and incentivised micro-credit programme in conjunction with various training organisations, using electronic administration for large-scale delivery of small business loans through the banking system to emerging entrepreneurs in the informal sector throughout South Africa' (Start-Up Fund, 1995, p. 1). The first loans were issued in October 1993 and at the end of December 1996 more than R5.8 million had been disbursed to 5418 borrowers. Since September 1995, the accounts of Start-Up Fund show a net monthly surplus (see Table 7.1).

The Start-Up Fund makes loans available to individual borrowers. In order to qualify for a loan, prospective borrowers must participate in an approved small business training programme offered by several partner organisations. The courses cost approximately R400 per trainee, and the training institutions are funded separately from the Start-Up Fund. These training programmes provide basic business skills, such as identifying market opportunities, preparing a business proposal, marketing, stock-taking, and basic accountancy. Following the successful completion of the course, and thus acquiring the "Township MBA", the trainees may ask the Start-Up Fund, through their trainers, for start-up capital. There is no further selection, but applicants have to pay an initial deposit of R100, attend a credit-familiarisation session, during which the rules and obligations of the Start-Up Fund are explained, and open an account with a major South African bank, First National Bank, into which all loan disbursements are made. The loan programme is phased so that new borrowers receive R500. On repayment of their loan, borrowers qualify for another, larger loan. There are five stages, and the largest loan level offered is for R2000.[8] Repayment of loans takes six months; following full repayment, the next loan is automatically disbursed.

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[8] The levels of the initial deposit and the respective loan stages have frequently been reviewed since inception of the programme. The deposit was originally set at R60. Until 1995, there were

Table 7.1 - Start-Up Fund core indicators, March 1995 - December 1996

	total number of loanees	net loan book (Rand)	net monthly surplus (Rand)
Mar-95	1707	609,313	-7,197
Jun-95	2117	832,288	-9,901
Sep-95	2630	973,484	1,988
Dec-95	3129	1,378,455	454
Mar-96	3503	1,563,646	1,513
Jun-96	4147	1,744,204	12,835
Sep-96	4796	2,524,077	70,700
Dec-96	5418	3,191,679	22,888

note: net monthly surplus excludes donations, but includes funding costs.

The Start-Up Fund also offers life insurance and savings accumulation and may pay a bonus for reliable repayment records at the end of each year. All these services are packaged into the loan programme, thus only one "product" is available from the Start-Up Fund. The various features of the Start-Up Fund package are explained in detail in the credit-familiarisation session, where both obligations and entitlements of loanees are discussed. Borrowers pay for the package through their loan repayments. The effective "price" for the package at all stages is 105% of the respective loan amount per annum, including the interest on the loan, life insurance, annual performance bonuses, and accumulated savings to which they have access when exiting from the scheme.[9] Borrowers effectively

four loan stages ranging from R200 to R1500. Since early 1997, loan stages range from R500 to R12,000. It is hoped that graduates of the loan programme will find other, more mainstream sources of credit, helped by the fact that the Start-Up Fund programme has given them a track record of loan repayment.

[9] When joining the programme, borrowers pay a deposit that will be refunded when they decide to withdraw from the scheme, having repaid all liabilities in full. When loans are disbursed, 16.7% of the amount are deducted and channelled to the Group Indemnity Trust, so that borrowers receive only 83.3% of the nominal loan amount. This is a default insurance premium and is not refundable. Repayments have to be made monthly, starting a month after disbursal, for six months. Monthly repayments are equal to 20% of the nominal loan amount. On the basis of net disbursals to the borrowers, the repayment schedule implies an interest rate of 105% per annum. As long as borrowers are up-to-date in their repayment schedule, they are entitled to end-of-year bonuses, depending on the surplus of the Group Indemnity Trust, and they receive life insurance. As all

reduce the interest rate when paying late, yet this 'tactic' will also delay the disbursal of new loans, reduce the pay-out of life-insurance, and preclude access to annual bonuses.[10]

Both loan disbursal and repayments are made through the electronic payment mechanisms of commercial banks. The Start-Up Fund has an arrangement with First National Bank for using its transfer mechanism. Further, all transfers, both loan disbursements and repayments, are accessible almost instantly through the computer link between the Start-Up Fund and First National Bank. Borrowers are issued with a 'loan book' in which all transactions are recorded, in order to facilitate transparency from both sides.

During its existence a number of changes have been made to the loan scheme. Most importantly, the scheme insured against the direct risk of defaults by creating an indemnity fund, the Group Indemnity Trust, in 1995. This fund is financially separate from the Start-Up Fund, but constitutes an integral part of the Start-Up Fund's lending operation and will therefore be included in the analysis.

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services are packaged as one product, it would be misleading to understand the 'interest rate' as the cost of credit alone.

[10] It is not possible to distil the 'pure' interest rate of the loan, excluding the costs of all other benefits. For the life insurance, there is no alternative market to which reference could be made; further, it is designed as an incentive for repayment and linked to repayment performance, therefore no independent insurance contract exists. Insurance pay-outs from the group Indemnity Trust thus far have been almost negligible (R720 from inception to end of December 1996). Bonus pay-outs were substantial: for the year ending 31 December 1996, the Group Indemnity Trust paid out bonuses amounting to 27 percent of the eligible loanees' gross annual repayments in 1996. 387 loanees qualified and benefited from bonuses ranging from R90 to R1500.

Further, the loan sizes at the various stages are frequently revised. Data in section 7.3 use monthly data from January 1995 to December 1996, both on the income and cost development of the Start-Up Fund, and on income and default liabilities of the Group Indemnity Trust. Section 7.4 uses cross-section data of borrowers' details of April 1995; hence loan stages, loan sizes and respective liabilities refer to the structure as it existed prior to the inception of the Group Indemnity Trust.

The analysis presented here can only be a snapshot of the Start-Up Fund as the organisation is undergoing continuous change, both through organic growth that could enhance or threaten the institution as it matures, and through explicit changes in the lending scheme. Some future plans of the Start-Up Fund are ambitious; notably, plans are finalised to make borrowers pay for their own business training, so that the complete model, from training to loans, could become independent of subsidies. However, as borrowers would pay for their training together with the loan repayments, the effective interest rate would become even higher. Hopefully, this will not overstretch the repayment ability of marginal entrepreneurs with immature business ventures. If it did, this development could lead into the abyss of mass default. Further, another danger is that - for whatever reason - larger than expected default threatens the ability of the Group Indemnity Trust to compensate the Start-Up Fund for the defaults it experiences. In this case, the cost structure of the Start-Up Fund would experience severe set-backs and possibly threaten its financial sustainability. However, the data available, and the development discussed here, show that it possesses more favourable characteristics than many comparable group lending schemes.

7.3 Financial Performance and Sustainability

This section will demonstrate that the Start-Up Fund has made strong progress towards achieving financial self-sufficiency. The analysis will focus on the cost-revenue streams generated from each individual borrower, as the 'mass-minimalist approach' should manifest itself in a low-cost structure and predictable income streams. Typically, the costs of lending are then comprised of default costs and operational costs. Group credit achieves almost zero default costs at the expense of high operational costs. Individualistic credit, especially in the absence of monitoring and enforcement, would be expected to experience substantial default costs.

The analysis will exclude funding costs of the Start-Up Fund. This approach is in line with the methodology applied in the study of the Small Enterprise Foundation in chapter 6. Micro-credit institutions are invariably financed by a combination of grants, subsidised credit and, in South Africa, "guilt money" from major "white" corporations.[11] The actual costs of funding do thus not adequately reflect the

[11] Most major South African firms now operate 'social conscience' funds with which they support worthy projects through equity investment, concessionary loans and grants. The apparent objective of these funds is to improve their parents' social acceptability by blurring the memory of their collaboration with the Apartheid regime. However, neither donors nor recipient organisations like acknowledging the nature of these funds. Most participants prefer to maintain the notion that these are 'market-oriented' financial instruments.

social costs of their capital, nor any inherent strength of the institution. I assume, therefore, zero capital costs which, although this implies a subsidy, allows ready comparisons in the cost efficiency of various suppliers of micro-credit.[12]

Monthly interest income of the Start-Up Fund per loanee has grown steadily from R11-R12 in the early months of 1995 to around R18 in late 1996, which includes both interest received from micro-borrowers and from other investments (see Table 7.2). This development reflects both increased loan amounts, due to revisions of the loan stages, and a larger number of mature borrowers at higher loan levels. However, the return from micro-lending has grown more rapidly than these figures suggest. Like other micro-credit institutions, the Start-Up Fund invests surplus funds on established financial markets. During the financial year ending September 1996, total interest income was R694,101 of which interest received from loanees constituted 69.4 percent. Invariably, during the start-up period, when loan repayments only started to gain momentum, loanees' interest payments constituted a much smaller share of total interest income. At the present level, the Start-Up Fund would be able to cover all operational costs from interest received from loanees alone.

[12] This could also be justified using the infant industry argument, as both the lender and its clients are hoped to mature and become independent of subsidy. It should be noted that the Start-Up Fund is now profitable.

Table 7.2 - Monthly cost and income per loanee in Rand

	total costs per loanee	interest income per loanee	profit per loanee
Mar-95	12.44	12.94	0.50
Jun-95	12.20	12.22	0.02
Sep-95	7.72	11.67	3.95
Dec-95	9.71	13.40	3.69
Mar-96	11.07	16.04	4.97
Jun-96	10.26	17.61	7.35
Sep-96	9.47	18.17	8.70
Dec-96	8.71	19.41	10.70

note: total costs exclude the costs of funds

Defaults have been very volatile and, in some months, very high. Their average level, however, does not give reason for concern. Most importantly, since July 1995 the default costs have been borne by the Group Indemnity Trust, insulating the Start-Up Fund from all direct implications of default. This Trust is a partner organisation founded to absorb the default costs of the Start-Up Fund. It is run as a non-profit organisation, although it aims at achieving surpluses. The separation of the risk-bearing part of micro-lending accelerated the attainment of profitability of the Start-Up Fund and enhanced its access to commercial finance. The Group Indemnity Trust is financed by the loanees through deductions - effectively an insurance premium - of 16.7 percent from the nominal loan amounts paid out by the Start-Up Fund. The Group Indemnity Trust indemnifies the Start-Up Fund against default and death of borrowers, and also extends life insurance to all borrowers, depending on the level of recent repayments.[13] Both contributions to

[13] The audited annual financial report states the '(i)n view of the fact that the Group Indemnity Trust was comfortably able to cover all bad debts incurred by defaulting borrowers during the past year, resulting in zero bad debt impact on the Start-Up Fund, and the likelihood of this continuing in the future, it is not considered necessary for the Start-Up Fund to have a provision for bad debts.' (Start-Up Fund, 1996) Default risk has thus been successfully removed from the Start-Up Funds operations, at the cost of lower interest income.

the Group Indemnity Trust and defaults vary strongly from month to month, but contributions have averaged around R11 and defaults just under R10 per loanee since the inception of the Trust.[14]

The Start-Up Fund further argues that default costs are significantly reduced by self-selection through the staging of loan amounts. Most defaults occur in the first loan stage, where the exposure of the Start-Up Fund is low (Informal Business Training Trust, 1995). Those borrowers who progress rapidly to higher loan stages not only generate most income, but are also least likely to default. This claim is weakly supported by the analysis of default probabilities in Section 7.5.

Operational costs have increased significantly over the observation period, contrary to expectation. However, the data are misleading here, since during the early years of the observation period the Start-Up Fund received sizeable indirect subsidies as it made use of office accommodation and clerical support of another firm. These subsidies were phased out over time, and only in recent months have they been withdrawn completely.[15] The cost calculation also excludes

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[14] These figures reflect the deductions from loan pay-out of 16.7 percent and an average default rate of around 14.0 percent.

[15] More detailed information on the subsidies made available to the Start-Up Fund and their subsequent removal is not available on a monthly basis. However, a comparison of the financial years 1994-5 and 1995-6 illustrate the effect: Several cost items have risen reflecting both inflation and increased business volume: audit fees rose by 12%, and bank charges by 25%. In contrast, previously subsidised items rose much more rapidly: salaries and staff related costs rose by 141% to R91,183, printing, postage and stationary rose by 313% to R66,130, expenses for telecommunication, travel and accommodation by 354% to R40,888. These costs are all incurred at the headquarter, located on the premises of the independent Trident Institute. The rapid rises represent mainly the removal of subsidies as no new staff were hired. Management fees rose from zero to R65,044 as the management had not been paid previously. Miscellaneous items showing strong growth, such as consultancy fees up by 71% and depreciation up by 157% arise from one-

depreciation of capital assets, because depreciation costs may not always be comparable across institutions and countries. However, depreciation costs are a relatively minor cost component and their inclusion in total costs would not alter the cost development significantly. Depreciation has been relatively stable at around R1 per loanee per month during 1996.[16]

In summary, the costs of providing a loanee with the micro-loan services of the Start-Up Fund, including operational and depreciation costs, are around R11 per month but falling as the client base expands (see table 7.2). If default costs are included - which are now covered by the Group Indemnity Trust - total costs per loanee rise to around R21. Interest income per loanee stands at just over R12 - or around R18, if interest income from institutional sources is included - and each loanee contributes another R11 to the Group Indemnity Trust per month.

In comparison with other micro-credit institutions, it is a major achievement to be able to cover costs, excluding capital costs, from credit income. Notably, in direct comparison with a group lender such as the Small Enterprise Foundation, the 'competitiveness' of individualistic credit becomes clear. Both institutions lend in similar markets in South Africa, both use electronic transfer mechanisms, and both have a high proportion of female borrowers. After three years of operation, in

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off needs; depreciation is up strongly because of high expenditure on information technology (Start-Up Fund, 1996). See also note 16.

[16] Depreciation costs are relatively high in 1996 because the Start-Up Fund acquired computer equipment and software for R116,808 which are depreciated at 33% and 50% respectively.

July 1995, the Small Enterprise Foundation had 2051 borrowers, while the Start-Up Fund had 4393 after three years. At this time, the Small Enterprise Foundation incurred monthly costs per borrower of R46.38. In the micro-loan business, it would be difficult to raise monthly income per borrower to this level. Yet, as a group lender, the Small Enterprise Foundation does not provide loans to each borrower, but to groups of five. The income per borrower is therefore even lower, amounting to only R3.23. The large cost-income gap appears almost impossible to overcome, and it was shown in chapter 5 that reasonable projections do not provide plausible scenarios of self-sustainable group lending for the Small Enterprise Foundation.

However, it should also be noted that the Start-Up Fund's lending scheme relies on the screening function of a training programme. Although there is no active selection of potential borrowers by the trainers, the requirement to participate in the course is an important element of borrower self-selection.[17] This feature may be seen as an implicit subsidy, as the Start-Up Fund does not pay for the training of its borrowers. Initially, all training was done by one partner organisation, the Informal Business Training Trust in Cape Town, but in the process of expansion other training institutions became involved. Currently, the costs of training stand at about R400 per person.[18] Although training has its own rationale, it should be

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17 Potentially, a lending scheme could use business training and examinations for filtering out less promising candidates and selecting the most able entrepreneurs. This is not the function of training and examination in the Start-Up Fund.

18 This figure refers to the costs of the Informal Business Training Trust in Cape Town. This is a partner organisation founded with the single purpose of providing the "Township MBA" training.

remembered that the Start-Up Fund's success depends, for the moment, on the fact that informal business training is subsidised by foreign aid and domestic welfare organisations. In future, this will not be the case. The Start-Up Fund has now become highly profitable and is introducing changes so that future training will be paid from interest income.

7.4 Self-Selection and Defaults

Above it was shown that the Start-Up Fund succeeded in containing default rates. It was argued that the relevant mechanisms were self-selection of borrowers and motivation once they have climbed beyond the initial loan level. In this section, cross-section analysis of the Start-Up Fund's borrowers will be used to attempt to ascertain to what extent the lending structure can explain the default behaviour, and whether it is possible to determine high-risk groups. If self-selection was seen as a powerful tool for containing defaults, then more specific targeting towards low-risk groups may improve the repayment rate.

A large data-set was analysed, containing information on 459 borrowers who originally trained for the "Township MBA" in Cape Town and 1182 borrowers who trained in Johannesburg. The data were copied from the Informal Business Training Trust's records in April 1995 and contain all borrowers of the Start-Up

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Other training institutions, which offer the "Township MBA" course, are multi-purpose, such as trade unions and welfare organisations. Therefore, training costs may depend on the type of institution offering it.

Fund who, at that time, had been expected to have at least one loan repaid. The data-set contains eight explanatory variables, including borrowers' loan standing and loan level at the time, and further details about themselves and their businesses (see Table 3). These variables were chosen because they describe the criteria through which micro-lenders view the social and business characteristics of their clientele, and because relevant and reliable data are usually available in micro-credit schemes. A Probit estimation was carried out to determine their relative importance for repayment probabilities. It is assumed that repayment probabilities can be expressed as a function :

$$\text{(1)} \qquad \text{Prob(REPAY)} = \text{F}(a + b\ \text{GENDER} + c\ \text{EDU} + d\ \text{LEVEL} + e\ \text{DURATION} + f\ \text{BUSOWNER} + g\ \text{SPAZA} + h\ \text{AGE65} + i\ \text{LOCATION})$$

Of the coefficients, those for GENDER, LEVEL, AGE65 and LOCATION are significant at the one percent level, while EDU is significant at five percent and DURATION at ten percent. The coefficient for BUSOWNER and SPAZA are found not significant at reasonable levels (see table 7.3).

As expected, and often reported in other studies, women are shown to be more conscientious with their repayments. Almost 60 percent of the borrowers in the sample were women, and the results suggest that the average repayment rate may be improved if women were to participate in greater numbers. Maybe contrary to intuition, higher levels of formal education are associated with reduced repayment probabilities. This result suggests that it is not ability that determines repayments, but the dependence on self-employment and, therefore, future access to loans. Borrowers with higher levels of education may find it easier to find alternative sources of finance or wage employment, while those with more limited alternative opportunities value highly continued participation in the loan scheme.

Table 7.3 - Coefficient estimate results of Probit analysis
(REPAY = 1 if borrower in good standing, otherwise = 0)

Variable	Definition	Coefficient	Standard Error
constant		.7118	.1438
GENDER	= 1 if male; = 0 if female	-.2431	.0724
EDU	standardised index indicating highest school level attended ($0 \leq EDU \leq 1$)	-.2510	.1131
LEVEL	= 0 if borrower is at the R200 loan level, or has defaulted at that level, = 1 otherwise	.2588	.0880
DURATION	= 1 if borrower joined the scheme before 1 January 1994, = 0 otherwise	.1289	.0731
BUSOWNER	= 1 if borrower owned a business before joining the programme, = 0 otherwise	.0101	.0744
SPAZA[19]	= 1 if borrower did not intend to operate a spaza shop, = 0 otherwise	.0701	.0980
AGE65	= 1 if borrower born before 1 January 1965, = 0 otherwise	.2091	.0766
LOCATION	= 1 if borrower trained in Johannesburg; = 0 otherwise	.2830	.0816

19 Spaza shops are small 'corner' shops in South African townships (Rogerson, 1991). They typically sell some food, notably bread and tinned food, simple consumer items such as matches, soap and batteries, and sometimes beer. Many spaza shops offer less than ten different products. While many spaza shops are operated from wooden shacks, some are located in their owners' homes; here the category also includes hawkers operating from mobile 'premises' - usually a table or cardboard boxes - in public spaces.

DURATION is only weakly significant with a relatively small coefficient. Those who stay in the programme longer, thus presumably showing more commitment to the programme, are less likely to default. Neither BUSOWNER nor SPAZA is significant, and the coefficients do not warrant interpretation. Therefore, the results here do not support the often-held notion that spaza shop-owners and hawkers have exceedingly high failure and default rates because their sector is overtraded (see footnote 18). However, the initial self-selection of participants may contribute to this result, and less than 16 percent of borrowers in the sample borrowed for simple retail activities. Young borrowers, ie those under the age of 30, are found to be significantly less likely to repay their loans. Possibly, young borrowers continue to scan the labour market and are also more employable than their older peers. Further, older entrepreneurs often have acquired relevant work experience in previous jobs, which benefits their own enterprise.

The strongest result was received for LOCATION; borrowers in Johannesburg are much more likely to repay than their peers in Cape Town. Possibly, the demographic and socio-economic particularity of Johannesburg could explain some of the difference. Johannesburg attracts more rural-urban migrants than other cities in South Africa and social instability and crime are at record levels. However, additional motives may be found in the different quality of business training and therefore the effectiveness of the self-selection mechanism.

The most notable result, in light of the Start-Up Fund's lending strategy, is the effect of the loan level on repayment rates. If self-selection and motivation works, than defaults should decline significantly as borrowers progress towards higher loan stages. In the sample, borrowers with loans above R200 account for only 25.3 percent of all borrowers, yet they are holding 48.3 percent of the loan volume, as their average loan size is R553. Therefore, if their default probability is significantly lower than that of borrowers on the first loan level, half the loan portfolio could be considered relatively 'safe'. Of all borrowers in the sample, 79.3 percent remain in good standing. However, of those at the R200 loan level only 77.2 percent have duly repaid, but at the higher loan levels 85.1 percent are in good standing.

In fact, borrowers on a higher loan level are less likely to default. The strong results of the Probit estimation for LEVEL indicate that the self-selection mechanism works, as defaults are most likely to occur on the first loan level. Controlling for all other variables, borrowers at loan levels above R200 are almost six percent more likely to be in good standing with the Start-Up Fund. Therefore, there is significant and noticeable self-selection leading to declining default probability as borrowers move upwards through the programme; on the other side, the effect is not as large as one could have hoped, as an estimated default rate of 15 percent among mature borrowers remains relatively high.

Cape Town not only has a higher default incidence, but the patterns are less discernible there as well. A separate run, containing only Cape Town borrowers, found only duration significant.

7.5 Spreading and Expanding the Model

The discussion on financial sustainability centres on the objective of becoming independent from continued subsidisation by donors. Based on the analysis of data up to the end of 1996, I have shown that the Start-Up Fund is about to achieve its aim. However, aiming even higher means reaching profitability, ie covering the real costs of capital and achieving commercially viable returns on capital. The rationale of striving for profitability is based on the objective of micro-finance to reach as many deserving beneficiaries as possible.

Following its impressive track record in raising net income, the management of the Start-Up Fund decided to establish the Micro Business Development Corporation, an investment vehicle for capitalising the Start-Up Fund's lending portfolio on commercial principles. The Micro Business Development Corporation was incorporated in January 1997 with an authorised capital of 20 million ordinary shares, of which 5 million were offered to investors at R2 per share. Promotional material predicts pre-tax earnings per share of 62.0 cents in 1999, a dividend of 20 cents, rising to 40 cents in 2001.

The management of the Micro Business Development Corporation has targeted institutional investors with a long time horizon; the offer has been taken up enthusiastically mainly by pension funds, insurance companies and investment management companies. It was clear that these investors were attracted by the ethical image of investment in micro-finance and may have been willing to overlook some of the associated risk. A further inducement was found in the fact that for the next few years, the Start-Up Fund can still draw on concessional development finance, mainly from the Development Bank of Southern Africa. Leveraging private investors' capital with low-interest development loans enhances the earning capability of the Start-Up Fund. However, investors needed to be convinced that the Start-Up Fund had the potential to produce commercially acceptable returns in the long-run.[20] The controlling shareholder of the Micro Business Development Corporation is the Coronation Group, an aggressive and successful young investment management firm. Their engagement would suggest that the potential of the Micro Business Development Corporation is being viewed exceptionally positive by the private sector. However, the Start-Up Fund remains a foundation dedicated to micro-enterprise lending and controlled by trustees. The owners of the Micro Business Development Corporation have only limited influence on its policies.

[20] In the final quarter of 1996, the months preceding the formation of the Micro Enterprise Development Corporation, the Start-Up Fund had total assets of about R1,000 per borrower. At the same time, it generated net income (interest revenue less costs, excluding the costs of funds) of just over R10 per month. The implied rate of return on assets of 12 percent was above the prime lending rate at the time (and rising quickly), but below open market funding costs.

Internationally, the Start-Up Fund's model starts to attract imitators. Plans are being developed to set-up franchised operations in various neighbouring countries, including Lesotho, Zimbabwe and Mozambique. In the course, adjustments have to be made to the Start-Up Fund's model in order to deal with the absence of a highly developed electronic banking infrastructure. These approaches are being viewed positively by private investors and will be financed solely from private investors' capital, leveraged by the International Finance Company, the private sector arm of the World Bank. Once the Start-Up Fund's lending model is fully financed by private investors, its obligation to justify its existence in developmental terms ceases, although it will continue to lend to poor entrepreneurs without collateral.

7.6 Conclusion

This chapter has argued that efficient institutional design can succeed in making 'mad' lending - uncollateralised, impersonal, and without enforcement - financially sustainable. It does so by establishing a framework of incentives that entices borrowers to behave predictably and show relatively high levels of financial prudence. Through self-selection and appropriate incentives the lender passively promotes the right people to join, and to see their interest not opposed to, but in parallel with that of the lender. Therefore, opportunistic behaviour is kept within limits and does not undermine the viability of the lender. Efficient operational procedures compensate for default losses.

Contrary to the current paradigm postulating a 'grass-roots approach to development', the scheme analysed here is consciously non-participatory. Borrowers have little contact with the lender and no influence on its business; terms and conditions of borrowing are determined, on technocratic grounds, by a small group of managers who see cost-efficiency and outreach as dominant policy objectives. The borrowers are provided with a standard product, on pre-determined terms, with the aim of helping their graduation out of the informal sector, and possibly becoming bankable with more conventional institutions. Such a scheme is unusual in that it does not involve 'community' participation, and eschews softer, more socially oriented objectives. Development, in this context, is through business success and financial discipline, not 'empowerment'.[21] This case study has argued that this orientation is one of the reasons for the financial success of the 'mass-minimalist' approach, but it will surely be viewed critically by many members of the development community.

The analysis presented in this chapter excludes questions concerning the social return. On the basis of operational efficiency, however, the individual 'mass minimalist' lending technique is feasible and viable, and appears preferable to other, more mainstream forms of organisation.

[21] In fact, it could be argued that this approach 'empowers' borrowers more than the participatory principle of group lending schemes, which tend to limit personal responibility and are sometimes seen as paternalistic (Brett, 1996).

8. Hear the Grassroots Grow! The Start-Up Fund on the ground

Micro-credit is motivated by social and developmental considerations. Micro-lending schemes are implemented in order to achieve goals which are viewed as politically or morally desirable. Therefore, it would be inappropriate to base decisions about micro-credit delivery on financial performance alone. The efficiency with which micro-credit institutions achieve the social objectives, thus, is a function not only of repayment rates and operational costs, but of employment generation and poverty eradication. Such successes are invariably more difficult to measure than purely financial performance. Further, the evaluation of social change is also more subjective and contentious than the assessment of financial data. While this thesis focuses on the assessment of lending technologies from a financial perspective, plausible indications of the positive social return of low-cost lending could strengthen its argument.

This chapter reports and discusses empirical results stemming from a small survey of present and former clients of the Start-Up Fund, in townships around Cape Town. Section 8.1 introduces the survey method, section 8.2 summarises the aggregate survey data and assesses its evidence on social impact, and section 8.3 discusses the influence of geographical setting on business success and repayment rates. Section 8.4 characterises 'types' of entrepreneurs and illustrates them with several cases, section 8.5 analyses the contribution of various 'types' of entrepreneurs to the Start-Up Fund's financial and social return, and section 8.6 concludes.

8.1 Methodology and Objectives of the Survey

The intention behind the survey discussed in this chapter was to develop an initial insight into the real effects of the Start-Up Fund programme and to assess its value in the environment of micro-entrepreneurs. Due to practical constraints, the size of the survey had to remain limited. This chapter illustrates the development of informal enterprises and discuss their owners' success in gaining economic independence.

The interviews were conducted in March 1995 over two weeks in three locations in the vicinity of Cape Town. All interviewees had been trained by the Informal Business Training Trust, the partner organisation of the Start-Up Fund. At the time of the interviews, the Informal Business Training Trust was fully funded by donations; the One-Up Training course costs approximately R400 per person.

Generally, the interviews were conducted at the homes of the Start-Up Fund clients. As most interviewees operate their small business from home, the visit in most cases included a tour of the business premises or section. Only two interviewees operate their enterprise from separate premises, and the interviews were held there. All interviewees were met individually except three women in

Mitchell's Plain, who met to be interviewed jointly. The length of the meetings varied according to the interviewees' ability and willingness to provide detail. On my tours, I was always accompanied by interpreters, but these were rarely needed for translation as most interviewees spoke some English, but more often for navigation and negotiation. Except one interviewee, all Start-Up Fund clients I met were open and willing to share their experience with me. All instantly agreed that I could make their history public; in fact, many were glad to have an opportunity to air their views and grievances.[1]

From the list of all programme participants, 35 were selected on grounds of accessibility - living in one of the three townships selected and with a complete and potentially traceable address - and length of programme participation - preferably at least 2 years.[2] On 24 borrowers sufficient information could be gathered for an evaluation of their experience with the business training and loan programme, and about their businesses; a summary of this is included in the following section. In addition, on a further nine borrowers some scant evidence was found about their history, and whether they had ever had a business. They were either interviewed personally or, in a few cases, information was sought

[1] Twice I had to dispel the hope that my study would lead to increased levels of assistance. I asserted that I had no power to sway donor aid their way, and also that I was independent of the Start-Up Fund and thus could not influence decisions affecting their programme. I had the impression that all interviewees understood my independence and talked openly about their experience with their businesses, their expectations and their relationship with the Start-Up Fund.

[2] I was equipped with data sheets from the Informal Business Training Trust's data base. These sheets provide information on the borrowers' names, their address, their prospective type of business, and their loan status. However, the data was originally entered when the clients had joined the programme. Except for data on clients' loan status, the data base is never updated.

from family or neighbours because several borrowers had moved, some were away working, and one had died.

The business activities pursued by the interviewees ranged from hawking clothes to running shebeens.[3] Most clients had already passed into higher loan stages, although several interviews were conducted with defaulters. While this survey claims no statistical significance, its open-ended, unstructured nature led to insights which are probably of interest in the context of this analysis.

8.2 Impact Assessment

The survey suggests that participation in the Start-Up Fund programme made a substantial change to the productivity and viability of the small business in about half the cases in the sample. In these cases, the business volume had increased substantially, often more than doubled, or a seemingly successful business had been set up with the first loan. Further, the management appeared to have improved, and therefore the danger of a liquidity crisis of the enterprise, and its abandonment, had decreased. Both business training and access to loans had contributed important shares. Training led to improved intertemporal decision making, notably heightened awareness of future liabilities and the importance of

[3] Many informal activities illustrate the new opportunities - and previous suppression - of economic life in the non-white section of South Africa's population. Shebeens are informal bars in townships which were illegal under Apartheid, but thriving, and thus acquired an aura of subversion and vitality. Recently, fashionable 'shebeens' have opened in the well-off parts of Johannesburg, providing the opportunity for politically correct entertainment to culturally challenged whites. Hawking was also prohibited, but experienced a boom from the mid-1980s.

appropriate capitalisation. Therefore, the risk of financial crisis was reduced. At the same time, most successful entrepreneurs needed capital (and continue to need capital, if they are on low loan levels) in order to make more effective use of their skills. The ability to buy bulk and receive discounts for inputs was a priority for many.

Others, who were not so successful as entrepreneurs, often had a business that would probably survive and earn some income, but did not seem to thrive and could not support their household. Several borrowers had found wage employment that they thought preferable to entrepreneurship, although one borrower combined formal sector employment with a thriving informal business activity. Only three respondents had not found a reliable source of income and continued to depend on their families. These results should be seen in the context of South African townships, where most adults are unemployed, but most participants of the Start-Up Fund programme had their own enterprise, or another source of reliable income.

Most respondents claimed that the loan had been either crucial to getting started, or helpful in consolidating their business. Many who were involved in manufacturing activities, however, claimed that the loans were not large enough, as important pieces of capital equipment - usually a sewing machine - could not be purchased during the lower loan stages. This, so they argued, impaired their ability to make punctual repayments during the early stages.

Table 8.1 - Summary of results from interviews with borrowers

	Loan Level			
	R200	R480	R960	all levels
borrower had business when joining	1	3	4	8
borrower had business when interviewed	4	5	7	16
borrower found alternative employment	4	1	1	6
borrower has defaulted	6	1	1	8
business is developing very successfully	1	1	4	6
business is stable and major income earner	2	3	1	6
business exists but is unlikely to prosper	1	0	2	3
total number of borrowers interviewed	9	6	9	24

There are several problems with deriving conclusions from these interviews: first, the sample was small; second, it presents a biased selection of all Start-Up Fund clients, due to the inevitable problems of tracing borrowers in poor townships and informal settlements; and third, Start-Up Fund clients are probably a biased selection of average township entrepreneurs. It seems plausible to assume that more successful entrepreneurs are less likely to 'vanish' from their neighbourhoods; however, I often heard that those who had moved had found formal sector employment or attended institutions of further education. As was pointed out in chapter 6, the Start-Up Fund's lending scheme relies on the self-selection of its clients; therefore, the group interviewed does not constitute a representative cross-section of South Africa's poor. The self-selected individuals who decide to participate in this training and loan scheme may also have had above-average success without the help of Start-Up Fund; therefore their township peers are not an adequate control group for statistical purposes.

Also, there is another potential source for bias in the sample: some interviewees could have considered it impolite to answer questions about the Informal Business Training Trust or the Start-Up Fund negatively. This bias, though, could be more easily controlled. All interviewees affirmed that the training course had been helpful, but some could neither specify the most helpful elements, nor had they made visible use of the knowledge they had gained. This was most evident when interviewees identified as benefit from the course skills such as 'how to run a business' and when they had not set up a business nor identified a market opportunity. Most interviewees, however, could indicate quite precisely which sections of the training course had proved most valuable.

Almost all borrowers stated that the financial management and planning parts were the most important components of the training course. Also, those who had established their business prior to the training course could generally point very precisely to the gains stemming from the course. On several occasions I was shown financial records as proof. However, the township MBA training course contains other important elements such as identifying market opportunities, advertising, and choosing suppliers. None of these were mentioned as specifically helpful elements of the course. Speculatively, it could be concluded that capital constitutes the biggest obstacle to entrepreneurial development: this would not only relate to credit availability, but the entrepreneurs' ability to plan financial matters, and to maintain sufficient working capital while meeting current liabilities.

8.3 Location: Does Geography matter?

For these interviews, three locations were selected, partly for practical reasons, partly for the diversity they offered. Mitchell's Plain is a vast township for 'coloureds',[4] Gugulethu is one of the oldest 'African' townships around Cape Town, while Mbekweni is a mixed township outside Paarl, about 60km from Cape Town. The survey allowed me to collect qualitative data on both the interviewees' living circumstances, and also on location-specific factors. As a result, it appears that the location explains some of the variation of income, business development and repayment behaviour found in the sample group. To understand the reasons for the location-specific differentiation, it is necessary to consider the history and social characteristics of the three locations.

Mitchell's Plain

Mitchell's Plain is a large and rather homogeneous township. It was created when the coloured people were forcibly moved out of 'white' Cape Town. While it contains pockets of middle-class wealth, most inhabitants are poor. On the other hand, Mitchell's Plain contains less squalor, and fewer make-shift huts and squatter camps than many other townships, such as Gugulethu. Possibly, this is accounted for by the fact that Africans were often forcibly moved to the

[4] In broad terms, the apartheid race legislation differentiated between white and black people. The black category included Africans, coloured people and Indians. In terms of the apartheid race classification, coloured people are non-African blacks of mixed race origin, with Asian ancestry, but separate from Indian descendants. Afrikaans is the main language within coloured communities.

homelands, and returned from there illegally to the Cape Town area. In contrast, Apartheid administrators considered the coloured native to the Cape Region. Therefore, Mitchell's Plain is a planned township with a large number of Apartheid-era low-cost houses. All interviews in Mitchell's Plain took place in solid, stone-built houses in extensive residential areas.

Mbekweni

Mbekweni, near Paarl, is a more diverse township and not easily classified as 'coloured' or 'black'. It contains an older section that was established under the Apartheid settlement planning. In this section, solid stone houses with tended gardens dominate. However, most people in Mbekweni live in sections that were added later through previously 'illegal' and more recently informal settlement. There is a form of 'rolling' formalisation of informal settlement, and thus older squatter areas are turned into acknowledged quarters, while people who moved to Mbekweni more recently erect new squatter settlements, to be formalised in a few years' time. During my visit to Mbekweni, roads were being paved and electricity connected in areas where temporary buildings made of plastic lining and old tyres had already given way to more permanent tin huts.

Gugulethu

Gugulethu is one of the oldest 'African' townships around Cape Town. More recently, especially after the abolition of the Group Areas Act, it has grown rapidly through migration from rural areas, and especially the former homelands.

Therefore, overcrowding of formal housing and the sprawling of squatter settlements are now urgent problems in Gugulethu. As the township is now almost completely surrounded by squatter camps, the initial impression of Gugulethu is one of endless rows of shacks made of plastic bags, tyres and metal scrap. Many international visitors to Cape Town come away with the impression that such oceans of squatter dwellings are the typical look of South African townships because Gugulethu displays them with great effect along the motorway from the airport into town. However, like all old townships, Gugulethu also has a relatively well-built centre, and a good number of established houses with well-tended gardens. Finally, there are also many hostels, originally intended to house single migrant workers from the homelands. These hostels, usually extremely crowded, have become hotbeds of violence as in other parts of South Africa.

Geographical variation of micro-economic activity

Across the three locations, noticeable differences occurred relating to both circumstantial factors as well as business success and repayment behaviour. Poverty seemed less acute in Mitchell's Plain than in the two other townships. In Mitchell's Plain, all meetings were held in solid stone houses, while in Mbekweni and Gugulethu most were held in significantly less comfortable environments. However, the sample group in Mbekweni contained the greatest income diversity and a large group of desperately poor squatters. The sample in Gugulethu contained generally very poor people, some living in overcrowded hostels, but few squatters.

Defaults were most prevalent in Mbekweni and least in Mitchell's Plain, while Gugulethu assumed an intermediate position. In Mbekweni, almost all defaults are attributable to current or previous squatters. This may suggest that borrowers with a fixed and formal address are less likely to default.[5] Possibly, squatters tend to default because they often lead an economically less secure life and cannot afford the luxury of long-term financial planning when immediate needs are overwhelming. In Gugulethu, sluggish repayment behaviour, including consistently late payment, was more often found than default.

On average, the most successful entrepreneurs - in relation to their social and economic starting position - seemed concentrated in Gugulethu. The wealthiest entrepreneurs were found in Mitchell's Plain, although this owes more to their pre-participation income than to recent micro-enterprise activity.

8.4 The Entrepreneurs: Profiles

The interviews were carried out partially to develop an understanding of the characteristics of entrepreneurs participating in the Start-Up Fund programme, and to determine who stands to gain from participation and which factors influenced the lending costs of the Start-Up Fund. While carrying out the interviews, six

[5] The Start-Up Fund requires township MBA finalists to produce a formal address before admitting them to the loan programme. However, such addresses are not checked, so they may change or may never have existed.

categories of participants became evident. All but two interviewees fell unambiguously into one of the following groups:

- Clients coming from social groups outside the Start-Up Fund's target group, due to their wealth and economic independence from micro-enterprise activities;
- former 'survivalists' who had found other means of living and left the informal business sector;[6]
- true survivalists who operate a micro-enterprise out of economic necessity, but would prefer other forms of income if these were available;
- young and ambitious entrepreneurs with initial success and growth potential;
- owners of stable enterprises with several years of experience and reliable income earnings, but without further ambitions; and
- growth-oriented, success-seeking and well-skilled nascent entrepreneurs with high potential.

The two exceptions were cases of unintentional 'fronting' where the programme participant, for some reason, had failed to set up an enterprise but used loans and skills to support the enterprise of a family member. The entrepreneurial relatives,

[6] The term 'survivalist' is frequently used by practitioners and researchers in the micro-enterprise field. According to Hulme and Mosley (1997), survivalists' 'income-generating activities are usually for the purpose of short-term sustenance, few entrepreneurs are in a position to develop their businesses for longer-term growth and capital accumulation' (p. 299). Rogerson (1996) argues that 'circumstances within the informal economy militate against the transition of the vast mass of survivalist enterprises into fledgling small businesses with the potential for long-term, sustainable employment creation' (p. 30).

though, were a true survivalist and a nascent capitalist, respectively.[7] In the following, these six categories are explained with more detail and supported by typical examples,[8] before some general conclusions are drawn.

Off-Target: Hobby-Entrepreneurs and Polito-Entrepreneurs

The members of this group are generally better off and economically independent from micro-entrepreneurship, although most run a micro-enterprise and may contribute to household income, or run an established, informal small (not micro-) enterprise. The motive behind participation in the Start-Up Fund scheme for members of this group is not business development but some forms of self-fulfilment. Some in this group are elderly and treat entrepreneurship as a pensioners' pastime. While the old constitute a small group in the sample, they were a noticeable group. Others run a successful business, but they already had significant success prior to joining the Start-Up Fund programme. They have probably benefited from the programme, especially the training component, but this was not the decisive contribution to their business achievements. One interviewee in this group - Mr Fredericks - joined the programme explicitly for political reasons, in order to gain credibility as a spokesperson for micro-enterprise entrepreneurs. Others seem to gain

[7] There was no indication for intentional fronting in the sample. As the Start-Up Fund does not differentiate amongst its clients according to criteria such as gender or business activity, there is no reason for fronting as in other micro-lending schemes (Goetz and Gupta, 1996). It is interesting to note, however, that in one case a women had participated in the Start-Up Fund programme, but made this support as well as her own labour available to her husband's shoe-making enterprise. Due to his outstanding economic success, and the domination of shoe-making over the household, she seemed extremely unlike to ever start her own enterprise. In the other case, an elderly participant made his advice and credit line available to his son.

[8] These examples are shortened transcripts drawn from my interview notes.

status in their neighbourhood as 'serious' business people due to their participation in the programme. Although this group is not part of the target group, support to them may well increase their business growth and employment capacity for the poor.

Mr Frank Gabriel Fredericks

Mr Fredericks, who lives in Mitchell's Plain, joined the loan programme in 1993 and has now reached the R960 loan level. He owned a business prior to joining the loan programme. Having been in the construction industry for 14 years, he set up his own firm in 1988. At the time of joining, his firm had two employees besides himself and has now grown to a workforce of 8. In 1993, annual turn-over was R110,000, growing to R300,000 in 1994. For 1995, he anticipated annual turn-over of R560,000. His profit margin was 20%.

Mr Fredericks is divorced with five children. He has three brothers who help out with work and finance. He claims to have extensive family obligations, paying R3,000 per month per child to their mother. He started his career in the building industry as an employee at a larger, formal sector firm, where he rose from clerk to managing director. When the firm went bankrupt, he established his own, informal company in 1988 with R25,000 of own capital. The Small Business Development Corporation helped out with bridging finance in 1990, but its loan procedure entails lots of red tape and clients are often unwilling to accept the delays. Mr Fredericks has negotiated a standing loan agreement with Community Bank. Other banks consider builders too risky.

Mr Fredericks quotes for construction contracts from R500. His largest contract so far was the construction of a complete house for R240,000, but most contracts are in the region of R30,000. He does not keep separate books for business and private expenses, but maintains weekly and daily schedules for income and expenditure. He claims to have assets worth R270,000 and liabilities, mainly a bond on his house, of R100,000, plus a car loan. He regularly quotes for an estimated 30% profit.

He considers his obligation towards employees as one of 'upliftment'. He lends money to them and pays their doctor's bills. All employees have 3 weeks' holiday leave and 10 days' absence. Artisans - he employs two - are paid R120 per week, the 6 labourers R50. All are eligible for bonuses. However, he thinks that upliftment is not for him but for 'people that hasn't got money'. He feels adequately labelled as a 'micro-business' owner, and even used the term 'survivalist' to describe himself. However, he also emphasised that 'you are not out there to make money, that is only the cherry on top - what you really want is job satisfaction'.

Mr Fredericks is rather critical about the Start-Up Fund. He said that the training helped especially in money management, but the loan programme was too small.

A second course would not interest him although he felt it might help other people. His finance needs were rather for R30,000 bridging loans to start work on specific projects. He participated for acquiring a track record, not for the loan itself. He is aware that the Informal Business Training Trust saw him as a role model, because he is a successful entrepreneur, but his success was 'not for what they did'.

He criticised the Start-Up Fund for not looking after the individual. He said 'they sit with millions' and that the 'money should go out to the people that needs it'. He felt he should be given a grant, as the Start-Up Fund was given the money by donors. Also, they should start with loans of R1500 and they should screen the borrowers. Equally critical about the Small Business Development Corporation, he argued that they should 'clean the plate' and start anew. He said they should 'clear the history' of their operation under apartheid.[9]

Mr Fredericks was a surprising candidate. He owns a business that, although informal by legal status, is large enough to be regarded as 'established', and he was the only interviewee in the sample employing non-family members. His business is too large to benefit in any significant way from the Start-Up Fund loans. Also, as a relatively successful business, the training is not only ill-suited,

[9] The Small Business Development Corporation was set up under the Apartheid regime with support from the private sector. Initially, its assistance was focused mainly on small, formal enterprises with traceable assets and good records, thus benefiting mainly white-owned enterprises. The allegations about racial biases of the Small Business Development Corporation are still pervasive.

but the time for participation must have led to lost earnings larger than the loan amounts. Equipped with cell phone and a language mixing Cape coloured expressions with the terminology of the development set, he seems on the way to establishing himself as a lobbyist.[10]

Mr Mawonga Alfred Reza

Mr Reza completed his business training in February 1994 and received his first loan in March that year. He is a very reliable and punctual repayer and has now reached the R960 loan level. He operates a small business selling goods in his neighbourhood in Gugulethu. He first ventured into part-time selling in 1993, before he joined the business training programme, and since January 1993 he sells only one good - first linen, then, from January 1994, vitamin tablets.

Mr Reza found that linen was too expensive and his business volume not large enough. Therefore, he opted to drop linen-selling after a year when he heard of Sportron International, a company marketing vitamin products in South Africa. Mr Reza is an agent for that firm, selling only their products. He orders his merchandise from Sportron International through a toll-free telephone number and the goods are delivered to him within 48 hours. He receives a discount of 23% of the list price and sells his goods to his customers at the full price. He buys for about R250-350 per order, and he orders two or three times a month. His customers are friends and neighbours who have health problems. Sportron

[10] In fact, he showed me his air ticket, paid by another NGO, for his participation at a conference on small business development.

International offers several different products for different uses; a simple table instructs selling agents like Mr Reza which products should be promoted for which ailments.

Mr Reza said he would like to expand but is constrained by money for buying stock. He would happily take credit from sources different from the Start-Up Fund. His preference is not for bigger loans, but for more frequent loans. All loans he receives are used for buying stock, and all repayment is made from sales proceeds. He has not had any problems repaying credit. He would, he said, be interested in selling other products as well, but he has not yet inquired about such possibilities. He said he found the business training very helpful because of 'the way they teach you how to buy goods, how to price them, how to do your books, how to approach customers and how to promote your business'. However, he apparently did not notice that, as an agent for Sportron International, he has little autonomy in the management of his 'business' and little scope for implementing his knowledge.

He lives in a comfortable three-room house with his family - his wife and daughter and two grandchildren. His family does not help him run the business, but they are supportive of his business activities. The interview took place in a bleak but neat living room which featured a private telephone - a rare asset but important for ordering new stock of vitamin tablets.

Ex-Survivalists

The members of this group are economically active, but do not make specific use of the skills learned from participation in the Informal Business Training Trust's training programme. Many of them defaulted after the first loan. Most are now either formally employed or opted for further training to qualify for wage employment. Many members of this group could be classified 'survivalist' in that they may have participated in the Start-Up Fund scheme in order to widen their options of income sources to self-employment, but they preferred alternatives once these became available. Some members of this group may have benefited from the training, though, in a more indirect way, and some have used the first loan to pay for tuition fees for further education.

Mr Tatane William Bonga

Mr Bonga defaulted after the first loan. He is now formally employed driving a truck. As he was away working, I could only speak with his family. He never had a small business and, as far as his family knew, never seriously contemplated one. He lives with an apparently large family in a small but proper stone house, built by himself and his family, in a 'medium' section of Mbekweni. I could not determine why he had decided to participate in the One-Up business training. With regular income from formal sector employment and irregular contributions of other family members, participating in the informal economy, the family now considers itself comparatively well-off.

True Survivalists

The members of this group live from the income generated by their micro-enterprise, but they are entrepreneurs through necessity, and they are not attached to their enterprise or their activity. If the opportunity arose, they would rather choose alternative forms of employment, especially formal sector wage employment. In this regard, this group seems similar to the ex-survivalists, only that its members have not yet discovered alternatives to their present economic activity. Most members of this group are very poor, but a small minority could be thought of as 'high level survivalists', as their income level is low, but well above survival level.

Ms Estraneta Timotheus

Ms Timotheus joined the Start-Up Fund programme in August 1994 and received the first loan in November. She is still at the R200 level and in good standing. When joining, she did not own her own business but planned to set up her own tailoring business. She owns a sewing machine which she has bought from income of casual labour prior to joining the programme. However, she does not make clothes at the moment as she has no cash for raw materials. She would like to continue, though. She is looking forward to larger loans, but even R480 'sounds a little bit little'. Material suppliers give discounts for purchases above R500, and she thinks she could get started again if she could buy material for that amount. Making repayments for the Start-Up Fund loans 'is a problem'; she specifically mentioned the timing, as the Start-Up Fund repayments need to be made before the end of month.

Her sister helps selling clothes, which are purchased from a clothing factory. However, when she starts sewing again she will be doing this all by herself, while the sister may continue to sell. The sister sells in front of factory gates to workers. Ms Timotheus could make 15 jackets per month, selling for R35-45 each. However, she does not know the costs of material for those jackets, nor the profit she could make. At the moment she uses her sewing machine for making clothes for the family, but she does not sell any of them at all. She finds the programme helpful. The business training told her not to spend business proceeds on private expenditure, and she learnt about the need to advertise. The major obstacle she faces for setting up her tailoring business is money.

Ms Timotheus emphasised that it was important the Start-Up Fund did not insist on repayment in mid-month, but that repayment should be due only at the end of the month. If the end of month fell in mid-week, repayment should be extended to the end of the week. Changing the repayment structure was rather important to make the loans more useful to her.

Ms Zameka Remona Duka

I met Ms Duka in front of her house in the squatter part of Mbekweni. Although it is a tin shack, the house looked relatively well built in such a poor environment. Several naked small children played on the plot. She was surprised by my visit and, at first, not keen on discussing her business with me, but reluctantly answered my questions.

Ms Duka has defaulted after the first loan. She claimed that she has never checked the account that she had to open to qualify for the Start-Up Fund's loan scheme. Somewhat improbably, she claimed not to live in the house any more, but to have moved to the Transkei. She had tried to establish a spaza shop, but did not succeed, as there was too much competition.

Because I developed doubts about her story, I decided to make further probing enquiries. It transpires that she commutes between the Transkei and Cape Town, dealing in Marihuana (dagga). She asserted that this line of business was much more profitable than her spaza. Having divulged her illegal activity, she was now more confident and criticised, mockingly, the Informal Business Training Trust for not making its trainees aware of such good business opportunities. She also said that she was not afraid of legal consequences of her illegal trade because 'the police don't care'. My guide on that day, a former bible teacher, was visibly not amused, and probably horrified that the good work of the Informal Business Training Trust had supported such improper activities. Ms Duka received his admonishments with some amusement, and she appeared unlikely to forsake her lucrative business.

Young Successes

In this group are entrepreneurs who stand out as very young and with little prior experience. However, they are highly motivated, agile and ambitious. They own potentially viable enterprises and often make good profits, but need to achieve stability over time. With experience, some of them may well turn out to become successful entrepreneurs, while others will fail or change their ideas and preferences later. It is noteworthy that in the group of young participants all interviewees seemed exceptionally committed to their enterprise and motivated well above average.

Mr Luvuyo Oliphant

Mr Oliphant completed his business training and received his first loan in early 1994. He is now at the R960 loan level and is a good and punctual repayer. He runs a business hawking clothes. He started his business in 1992 but it was very small until he joined the programme. Now he buys men's and kids' clothes worth R1000 per month while previously, on a lower loan level, he managed to buy only for about R600 per month.

All stock is purchased in Belhar, a 'coloured' suburb of Cape Town, at a discount store at factory prices, and he sells primarily at busy places like taxi ranks (referring to kombi taxis) and at railway stations where commuters pass through in large numbers. He only sells in the evenings, working from 5-9 pm on weekdays, to capture the largest flow of customers in the evening rush hour. During the day he goes buying stock when necessary. Occasionally, a friend helps him and gets paid for his work. He cites the lack of transport facilities and pricing his goods as his major problems.

He decided to approach the Informal Business Training Trust and to participate in the training after reading an advert in a local paper which he still keeps in his room. The training was helpful, he said, as it helped him to control his money. He would also like to do a second course in order to improve his book-keeping. The loans also help as they allowed him to increase the volume of his business. However, now that he is on the R960 loan level, the intervals are too long. He has thought about applying to the Small Business Development Corporation for a loan, but realises that his business is too small and lacks all documentation to support a loan application. He would like to continue his business, but hopes that in the future he can be really successful in business.

Mr Oliphant is a young and energetic man; he is single and came to Cape Town from the Transkei. He does not have to support anyone else and he also has no other income. He shares a large but run-down house in a long-established but now very rough part of Gugulethu. The house appears decrepit from the outside and in the shared spaces inside. His room, where the interview took place, is neat and well organised, the walls are adorned by posters of flash women and fast cars.

Stable Earners

In this category, entrepreneurs run a business with good success and stable income, but without much motivation or intention for further business growth. Most entrepreneurs in this category are content with self-employment and occasional family labour; some, however, seek to improve their profits by moving their business up-market or by increasing their 'volume' of customers. They do, in contrast to 'high-level survivalists', value their economic independence, feel committed to their enterprise and would not prefer alternative employment. However, stable earners are rarely the prime income earner in their family.

Pauline Margarete Lefatsa

Ms Lefatsa joined the programme in September 1994 and has reached the R480 loan level. Prior to joining the programme, she had been in business for 9 years, owning and operating a hair salon. She lives in a comfortable, if small, house in a long-established section of Mbekweni. The style of her house and its decoration are reminiscent of conservative, suburban or rural homes, with heavy wooden furniture and dark textiles.

Ms Lefatsa reported that she found the Informal Business Training Trust business training helpful, notably the classes on costing and pricing, financial planning, and 'how much to put aside'. Since participation in the programme, the business has improved. Ever since, she has more customers, and she has much more efficient stock-taking. The business is seasonal, as customer flows vary strongly according to the time of the year. Now, since participation in the programme, she typically serves 25 customers per month. Previously, she had about 10 customers per month. Her prices vary from R8 for hair wash to R250 for 'fancy' hair-do. She has a husband, who is permanently employed at a government department (clerk at the Department of Labour), and three children. The eldest daughter, who is 16, occasionally helps in the hair salon, but only when she 'feels like'. According to her mother, she views it as a social event rather than income-earning opportunity.

The loans received from the Start-Up Fund have helped Ms Lefatsa. When she received R480, she used half for plans to build a separate salon. Previously, she had to work in her living room. Loans of R200 were not enough, so she had to use her own money for purchases, but even the small loans did help. She would be interested in follow-up business training. Also, she is looking forward to larger loans, but giggles as she confirms that she plans to use loans for business. She relates the story that she had once applied to the Small Business Development Corporation but never received a reply. However, her husband helps occasionally with finance. Ms Lefatsa is proud of running a good salon. Customers have to make a booking before they come. The business takes in about 2000-3000 Rand per month. the costs of inputs are approximately 400-500 Rand. She buys inputs mainly from one brand (Black Like Me) and purchases them from a warehouse in Cape Town. She normally travels to Cape Town by train or car, but has to take someone with her for carrying all stock. The daughter uses some of her earnings to finance school.

Ms Nomvula Ruth Martin

Ms Martin joined the programme in February 1994 and received her first loan in March that year. She is now at the R480 loan level and although she tends to have sluggish repayment behaviour, she remains in good standing with the Start-Up Fund. Ms Martin started her business in 1990 selling soft drinks and cigarettes from her home in the old part of Gugulethu.

Ms Martin said that her turn-over is below R500 per month. She buys fortnightly 12 cases of soft drinks and 60 packs of Rothmans cigarettes. Since reaching the R480 loan level, she has also started selling chips and sweets, but she finds that 'there is more money in the old lines'. Her income, she said, is less than R200 per month. Her little sister helps her in the business, answering customers when she is busy, but she does not get paid. Repayment is frequently a problem for Ms Martin. She said she would want to expand, and she wants to get bigger loans, but she cannot repay. She also said that she was looking forward to receiving R960 from the Start-Up Fund in July.

Her customers are local people, living in the neighbourhood. Ms Martin lives in a large old house. She has a large, if somewhat damp living room with a number of comfortable, well-used sofas where customers can rest while being served. Also, in front of the house is a small porch overlooking a football field. Next door, her brother runs a shebeen whose customers tend to buy cigarettes from Ms Martin.

Therefore, she thinks she will be able to attract enough customers to expand her business. She once had a clerical job in Cape Town but she now prefers her own business and does not look for employment elsewhere.

Florence Ntombentsha Mbarane

Ms Mbarane completed her training and received her first loan in 1990. Because she often experiences problems and delays her repayments, she is still only at the R480 loan level. She operates a sewing business which she started in 1989 when she bought a sewing machine with her own money.

She said that she found the training course 'OK' and generally helpful, but her biggest problem was finding money and the loan level offered by the Start-Up Fund was a 'joke'. She uses her loans to buy material. She wants to stay with the Start-Up Fund to reach higher loan levels. At the time of our meeting, she experienced problems with her sewing machine which slow down her work. She could have the machine repaired, but this would cost R130 and would still leave her with an old and unreliable machine. She reckons that she would need an overlocker sewing machine, but a second-hand overlocker costs R2000 and that is way beyond her means.

Still, she earns about R5-600 a month, and she is so proud of her independent business that she would not go into formal employment even if she could earn more. She is confident that her business, already five years old, will improve over time. Her husband works in the informal economy, and he frequently helps her buying material when she is short of cash, or finds the Start-Up Fund loans insufficient for taking advantage of discount or for accepting more jobs. They have two children.

Ms Mbarane does not operate her business from home. Together with another woman entrepreneur, also sewing, she has rented a small room in a hostel. The hostel, like most in Gugulethu, looks grim and lies in a crime-ridden area. However, this one is somewhat safer than many others. Also, there is a small shop next to the entrance run by its owner, an ethnic Chinese. The interview took place in the room rented by Ms Mbarane and her fellow sewer. It is crowded with a cutting table, two sewing machines and stacks of material as both women keep left over material for later use, even small patches. However, good spirit seemed evident. The ability to work away from home helps Ms Mbarane to work longer hours, in co-ordination with her obligations at home and her husband's work time. Previously, at home, she had to finish work at 4pm, but now she can continue to 10pm. She lives close to her business.

Nascent Capitalist

This group consists of enthusiastic entrepreneurs with the required skills to succeed. Most of them have already several years of experience both in running a small enterprise and in their specific trade, and their enterprises look well-organised, if rather small. Nascent capitalists, in contrast to stable earners, see their enterprise as their route to significant social and economic improvement, and they were always the primary source of income in their families. Their enterprises are stable and often experience healthy rates of growth. However, they face increasingly external constraints such as security and lack of adequate premises.

Ms Beauty Nqumse

Ms Nqumse joined the programme in November 1993 and received her first loan in February 1994. Now at the R960 loan level, she is in good standing. She started her sewing business with the first loan, although the start-up costs were more than R1,000 and she had to supplement the loan with her own money. She thought the course helpful, as she learned how to save money. Also, the loan programme is helpful as she can buy material.

Ms Nqumse does not advertise explicitly; customers just hear about her by word of mouth. She produces 5 dresses per week and charges twice the costs of material for them. Material is typically R100-200 per week, but can be much higher when she receives orders for wedding dresses or other fancy products. She regularly takes money to the bank for savings. Her business premises are separate from her home, although both are located within the same hostel in Gugulethu. One of her biggest problems is security, and she had a break-in a few weeks before our meeting, but luckily only her books were stolen. Therefore, she thought about moving to a container, but is not sure about security there either.

Ms Nqumse lives with three children, a sister, two cousins and other family members who are all supported by her. A total of nine people share one room. She had some other on-the-job training as waitress and works the nightshift at a Spur restaurant, a large South African chain of steak houses. Every day, she leaves home at 4.30 pm by train and kombi taxi, paid for by her employer, and returns late at night on a bus provided by her employer. Her most serious constraint on expansion at the moment was, she reported, lack of space. She would consider giving up the job at Spur if her sewing business was able to provide secure permanent income, and if she could be assured that her business was safe from crime. Her workshop, where the interview took place, is crammed with material, a cutting table, the sewing machine and a few other items of basic furniture. It appears neat in an otherwise squalid environment. The hostel is overcrowded; rotting animal carcasses and waste lie around in the sewage-filled central open area.

Mr Thomas Manene Martin

Mr Martin, the brother of Ms Nomvula Martin, completed the business training in March 1993 and received his first loan in the following month. Motivated by his own success as the owner of a shebeen, he had recommended the Start-Up Fund programme to his sister.

Mr Martin is now at the R960 loan level. He started his business in 1990. When he started, he used to buy cases of beer for R200 at a time, by the time he had received the first loan from the Start-Up Fund he bought for R600, and now he buys for R1500, receiving bulk discount as a volume buyer. At the time of our meeting, he usually has one order for 30 cases of beer of R1500 per week. In addition, he buys 'wine' (he insisted on calling it wine, although the bottles are labelled as 'cider') every 2 weeks for about R1400, and four cases of Brandy for R800 every fortnight. He also offers several other spirits, but orders them only infrequently depending on demand.

He affirms that he can easily sell his purchases as he has about 40 guests each night, more on the weekends. His prices are at par with bars in down-town Cape Town and the tourist areas of Sea Point. He charges R3.20 for beer and R4.00 for 'wine', while Brandy and other spirits are R8.00. He is sure to make a profit, but cannot estimate how much, as he has to 'pay things all the time'. However, he is very careful to set money aside for orders and loan repayment, and he has never experienced any problems in meeting his commitments to suppliers or the Start-Up Fund. He cites as his major problem the financial family commitments as he supports four children and his mother. However, his sisters also help him cleaning the glasses. They are not paid an explicit wage, but receive ad-hoc financial support when needed.

Mr Martin thinks that the business training has helped him as he learned 'how to operate money'. In fact, he took pride in showing me his books with which he plans the business expenditure for the next few weeks, and where he keeps all invoices. The books are maintained with skills he learnt from the Informal Business Training Trust. Also, he added, the training helped him to relate to customers. The loans were helpful, but too small. However, he also said he would be afraid to take on larger loans from somewhere else as the responsibility may be too big. Yet he was looking forward to reaching the next higher loan level.

The interview took place in and around his shebeen. As we met in the early afternoon, there were no guests, but the shebeen was sparkling clean and ready to receive the first customers in a few hours' time. The guest lounge was a relatively comfortable if bare room with basic chairs and simple tables, the walls were decorated with beer advertisements and colour photos taken from news journals. I imagine the shebeen to be rather crowded with 40 guests in attendance, but some customers may always sit outside. Attached was a small area separated by a wooden bar, which Mr Martin had constructed himself, from where customers could be served, and a separate room where supplies were kept and glasses and other equipment were cleaned. By township terms, Mr Martin's shebeen is a well-established and attractive place.

Ms Yoliswa Magobolo

Ms Magobolo completed her business training in mid-1993 and received her first loan in October of that year. She is now at the R960 loan level and, although sometimes slow in repaying, remains in good standing with the Start-Up Fund. Initially, she had intended to set up a spaza shop, operating from her residential property in Gugulethu. But when she received her first loan, she decided to set up a business selling baby clothes. She emphasised that she set up her business only in 1993, with her first loan, although she had started selling clothes in 1991 on a less permanent basis.

When she receives a loan, she phones the factory shop and makes an appointment for purchasing her merchandise. She buys from a factory in Constantia, Cape Town, fortnightly for about R800. Before she reached the higher loan level, she was able to buy for only about R400. Selling the goods, she travels through the Western Cape region, selling in places like Worcester and Paarl, but also in the Cape Flats. She estimated that her net earnings can be as high as R200 per week, but they fluctuate 'quite a bit'.

She did find the business training helpful as she learned how to keep money and how to prepare for the week. She would also like to attend a further, second course and has in fact already inquired about it. The loans were also valuable to her as they allowed her to buy regular stock. She will also take the larger loans as soon as she is eligible for them. However, she cited as a problem that she has no place to sell the goods; she would like a shop in Gugulethu in addition to her selling trips. Her mother often helps her out in her business and she could take care of the shop while Ms Magobolo travels to sell in other places. However, she said it was difficult to find the right premises and that she was concerned about security in Gugulethu.

Ms Magobolo lives in a solid stone house in one of the older and more established areas of Gugulethu. The house has two rooms and a kitchen blackened from the use of coal and wood for cooking. The family of 13 shares the house, including five children who took great interest in the interview and in showing me around the house.

8.5 The Effectiveness of Intervention

The Start-Up Fund does not, as a matter of principle as much as of practical considerations, screen credit applicants by social or economic criteria; hence, it does not target credit by exclusion. In so far as better targeting cannot be achieved through indirect methods and without exclusion, the conclusions of this survey are relevant mainly as an assessment of the Start-Up Fund's contribution to business development and poverty alleviation.

The six categories of borrowers in section 8.3 are intended to provide a ranking by 'social creditworthiness', stated in the order of ascending social desirability of lending to each category of client. However, the 'value' of lending to a client depends both on the social return that a loan is likely to cause - along the lines set out by the lenders 'mission' - and the costs of serving this client. Although the Start-Up Fund covers its costs from internal revenue, the costs of micro-lending vary between different clients. This variation is caused primarily by clients' repayment behaviour. The rest of this chapter will try to draw some broad conclusions about the expected social return - or 'social creditworthiness' - and private costs of lending to clients from various categories.

Off-target group members are unlikely to promote the social change that underlies the rationale for micro-finance. However, off-target group members appear to be good clients from a financial view. None of them have defaulted and they had exceptionally good repayment records. Hence, they contributed to the viability of the Start-Up Fund programme by implicitly cross-subsidising lending to other groups of clients. Supposedly, non-target group members constitute only a small group of the Start-Up Fund's client base and therefore their impact on the lending programme's social impact or financial performance is small. Due to their prolific character, however, this group may well be overrepresented in media coverage and popular images about the Small Enterprise Foundation and similar micro-lenders.

Lending to survivalists is an important part of most micro-finance programmes. Survivalists, supposedly, benefit from micro-finance services because they are notoriously short of capital, but by necessity inventive and energetic. As survivalists are among the poorest in society, they are seen as exceptionally deserving in terms of development services, including micro-finance. The sample seemed to confirm this view; especially 'true survivalists' appeared to have improved their income as a result of their participation in the Start-Up Fund programme. However, they also constitute a difficult clientele due to the unpredictability of their own economic circumstances, and subsequently of their financial commitments to a lender. In the sample it was found that all ex-survivalists had defaulted, as well as about a third of true survivalists. This means that a large share of all defaults suffered by the Start-Up Fund programme is traceable to the survivalist sector.

However, the classification of clients as survivalists or any other type of entrepreneur becomes possible only after clients have been given a chance through participation in the Start-Up Fund programme. Prior to their joining the programme, many nascent capitalists, but especially many young successes and stable earners would have shown social characteristics typical for survivalists. Hence, the differentiation visible after the first few loans is potentially caused by participants' responses to the opportunities arising from the Start-Up Fund programme, and may not be detectable before participation. In conclusion, while it may be desirable from a financial perspective to reduce the participation of survivalists, this seems neither practical nor socially desirable.

The last three categories all represent micro-entrepreneurs who have achieved above-average success, in ascending order. I was pleased to note that these three groups constitute more than a third of the total sample. Young successes probably have the best chances to leave poverty and to move up significantly, because they have a vastly greater time horizon and fewer family commitments. Stable earners are important agents for poverty alleviation, especially as many of them contribute important resources to their families. Because stable earners are usually not responsible for feeding their family, the additional household income they create is often spent on 'upliftment' items, such as education, and often benefits children. Both groups are generally reliable repayers. Nascent capitalists are, of course, the best clients from a developmental perspective. They typically were very poor when entering the programme, achieved high income growth and established promising enterprises, many with the potential to offer non-family employment in the future. Also, they are financially reliable. Perhaps predictably, nascent capitalists are a small group.

Some micro-finance proponents have argued that poverty alleviation and business development are two potentially conflicting objectives of micro-finance (Cotter, 1996). However, it is not surprising that the Start-Up Fund receives its highest return - both social and financial - from the more successful entrepreneurs. Its involvement with survivalists seems still a measured success in terms of poverty alleviation.

8.6 Conclusion

This survey, unfortunately, does not permit to draw definite conclusions about the Start-Up Fund's contribution to poverty reduction and employment generation. As was pointed out earlier, the Start-Up Fund's lending scheme relies on the self-selection of its clients; therefore, the group interviewed does not constitute a representative cross-section of South Africa's poor. The self-selected individuals who decide to participate in training and the loan scheme may have had similar success without the help of Start-Up Fund. In no rigorous way, therefore, can the marginal contribution of the Start-Up Fund's work be deduced from the average success of its clients.[11] Further, the sample was small and probably biased, due to the inevitable problems of tracing borrowers in poor townships and informal settlements.

However, the lack of conclusive evidence should not be construed as a failure of the Start-Up Fund to produce the intended social effects. In fact, the evidence presented in this chapter suggests that the Start-Up Fund has assisted poor people in becoming economically self-reliant, while the previous chapter has shown that this was done in a cost-effective way. Further, as the work of the Start-Up Fund is not reliant on high subsidies - and appears determined to eliminate any subsidy element in the future - it is not competing in the market for development funding in the same way and with the same claims as most others.

[11] In the assessment of one of its partner organisations, the Start-Up Fund was found to make a valuable contribution to the establishment of new enterprises (Informal Business Training Trust, 1995).

9. Conclusion

This thesis has analysed the economic efficiency of micro-lending, comparing two alternative models. It has concentrated on aspects of economic efficiency and viability, and it has argued that group credit is not the safe route to sustainability that many see in it. Below, I point out the relevance to development policy in South Africa and show that international evidence seems to confirm my results. Some final comments on the future role of micro-credit point to the market-creating role of micro-credit, but caution against over-stretched expectations that micro-credit could deliver on redistributional development objectives. In the final pages, I will discuss the implication of the findings of this thesis for development policy and identify three fields in which further research is called for: on appropriate delivery mechanisms for financial services, on social effects and impact assessment, and on the role for participation in non-financial development projects.

Subsidies, minimalism, and the contradiction of micro-finance

Micro-finance development emerged from the minimalist debates at the end of the 1980s to dominate debates on poverty alleviation and small enterprise development. It has cast itself as a movement that is politically and morally desirable as well as financially sustainable. Arguably, the micro-finance movement has stolen the limelight from traditional development NGOs by laying claim on social effectiveness and, especially, economic efficiency. Micro-finance has also achieved the feat of attracting both policy-makers' goodwill for, *inter alia*, its supposed independence from public subsidies in the long-run and, at least to some extent a contradiction, policy-makers' support for sharply rising levels of subsidy.

Chapter 5 has shown that redistributive objectives of macro-economic policy, a priority of the ANC before 1994, were abandoned for the sake of fiscal prudence once it led the government. Land reform, housing development, education reform and numerous other policy areas produced fewer benefits for poor people partially because policy debates became increasingly concerned with fiscal constraints. Resources were limited because the South African government sought to follow relatively conservative macro-economic policies, and because external funding - aid - for development is limited. At the same time, micro-finance institutions received funding as needed, and sometimes in excess of their lending capacity. Their funding stems mainly from central government sources, through the government-owned Development Bank of Southern Africa, and from external aid. The trends of scarce, and often declining, funding for redistributive causes and excess funding for micro-finance institutions continues in South Africa as well as many neighbouring countries.

This thesis has examined two contrasting approaches in micro-finance. A 'radical' minimalist approach such as that by the Start-Up Fund can, in fact, reach its objective of financial sustainability within a short time and wean itself off further subsidies. Its expansion, both domestically and in neighbouring countries, will not burden funds available for other forms of development intervention. However, this approach, being minimalist, makes only limited help available to its clients who probably deserve more. An ostensibly minimalist, but in effect indecisive approach such as that by the Small Enterprise Foundation does not succeed in freeing itself from subsidy dependence. But its claim of potential sustainability helped to secure abundant funding, to which non-credit, non-sustainable institutions such as the Triple Trust Organisation and the Informal Business Training Trust had only limited access.[1]

Hence, some hard choices are to be faced by policy-makers and donors in South Africa. A truly minimalist, 'Fordist' approach to micro-finance as mass-production offers the possibility of financial sustainability, at the cost of sacrificing what some would see as important characteristics of a development institution. But training, mentoring, and social intervention for empowering poor people - any form of development work with a redistributive agenda - remains costly. Long-term subsidies for micro-finance institutions, given in the vague hope for financial sustainability in the future, has opportunity costs as these subsidies cut into the available resources for other, equally desirable forms of intervention. Micro-finance is no panacea, and should be made to account for the support it receives.

[1] A good example is Tony Davenport, chairman of the Start-Up Fund and former board member of the Informal Business Training Trust, who said on several occasions that finding funding for the credit organisation has always been much easier than for the training organisation.

The costs of solidarity - international evidence

Results similar to those presented in this thesis are borne out by the experience of other group lenders worldwide. The adverse relationship between transaction costs and group lending technology has also been noticed by Hossain in his analysis of Grameen Bank. He notes that 'elements like taking the bank to the people and intensive interaction of bank staff with borrowers may not be appropriate and could become too costly for sparsely settled environments' (Hossain, 1988, p. 81). Concluding on the applicability of Grameen's technology in various developing countries, he asserts that the 'Grameen Bank approach has a fair chance of success in densely settled, poverty-stricken areas of Asia, but for Africa an appropriate delivery mechanism has to be worked out through trial and error' (*ibid.*).

Population density may only be a rough indicator of the costs of communication and connectedness: Bangladesh, where the solidarity credit scheme model originated, has 759 inhabitants per square kilometre, while Transvaal, where the Small Enterprise Foundation applies the technology with little success, has only 28 inhabitants per square kilometre.[2] Also, political instability and high levels of violence are rampant in South Africa. The countryside has not been spared; indeed, former homelands, where many micro-lenders operate, are among the most affected areas. Social instability has a negative impact on group cohesion

[2] The respective population densities of Bangladesh and Transvaal are calculated from The Times (1993, pp. ix, xii).

and economic stability and thus indirectly disadvantages South African micro-lenders in comparison with institutions in less volatile regions.

Hence several obstacles encountered by micro-lenders in South Africa are specific to their special circumstances, but the inadequacy of contemporary understanding of solidaristic lending technology is not. The fundamental characteristic, the costliness of group credit, is common to all group lenders, even those operating in more conducive environments. Both the Grameen Bank and BancoSol are popular models among the community of proponents of solidarity credit schemes, yet the literature is suspiciously thin on the subject of their financial stability. Statements about 'financial sustainability' abound, yet the contribution of grants and subsidised credit often remains a mystery.[3]

Like the Small Enterprise Foundation, the Grameen Bank relies on investment in formal money markets for most of its income. It receives large grants and subsidised loans which are reinvested in local money markets. In 1988, about 50 percent of its assets were funds lent from international agencies at concessional rates (via the government which borrows at 1 percent and re-lends to the Grameen Bank at 2 percent for twenty years) and invested in Bangladesh as time deposits with returns of 14 percent (Von Pischke, 1991, p. 243). Through this channel, the

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[3] See Glosser (1994) on BancoSol; Fuglesang and Chandler (1988), Berenbach and Guzman (1994) on the Grameen Bank; Manuel (1992) on both PRODEM and Grameen; Christodoulou *et al* (1993) on the Small Enterprise Foundation.

Grameen Bank received up to US$125 million in 1988 annually from various sources (Thomas, 1990).

Also, the Grameen Bank's ratio of cost to the size of the loan portfolio is lower than that of group lenders in South Africa but higher than with comparable non-participatory lenders: it had costs of 27.4 percent of loans outstanding in 1984, while the individualistic lender Badan Kredit Kecamatan in Indonesia, with a comparable customer profile, had 12.9 percent (Biggs *et al*, 1991, p. 44).

The FINCA group credit scheme in Costa Rica was found to make good use of social capital for improved 'informational efficiency' and reduced default rates (Wenner, 1995). Although Wenner does not primarily inquire about operational efficiency, he notes high administrative costs and concludes that 'group credit is a cost-sensitive institutional design' and 'may not be immediately viable' (*ibid.*, p. 278).

BancoSol experienced revenue shortfalls similar to the Small Enterprise Foundation. Its projection of profitability, too, rest on assumptions of rapid expansion. Yet costs are projected to remain largely stable. It is unclear whether the cost and revenue structure will remain favourable. There is considerable pressure from the bank's employers for wage increases and it is unreasonable to assume that the bank's management would be in a position to placate those in a phase of expansion. Considering the staff-intensive technology, the wage is an important determinant of the bank's financial performance (Glosser, 1994).

Micro-credit and development - the current euphoria and the long-term trend

Micro-credit has taken over from the previous movement of 'cheap credit'. As its critics argued, cheap credit is incapable of achieving its social and economic development goals, and credit as a vehicle for redistributional policies was found inefficient. In the field of micro-credit, few institutions are sustainable in the strict sense of being self-financing. However, the debate about subsidised interest rates does not seem to capture that problem well, as most micro-credit institutions charge interest rates which are significantly above prime interest rates in their host countries. The relatively high interest rates of micro-credit effectively dispel many of the criticisms levelled at 'cheap rural credit'; in fact, both monetary and non-monetary costs of accessing micro-credit limits the distorting effects that bedevilled 'cheap credit' programmes. In micro-finance the focus is not on subsidised interest rates but on subsidised lending institutions. As the credit delivery in many mainstream finance programmes remains dependent on subsidies, micro-finance remains vulnerable to the critique that credit is an inefficient tool for achieving redistributional objectives.

In addition, most reasonable observers now agree that micro-credit is overburdened with expectations extending to gender equality, poverty alleviation, and addressing the employment crisis brought about in developing countries by structural adjustment programmes, the legacy of apartheid, or other calamities.[4] These objectives go far beyond the original desire to address credit rationing - or exclusion from credit markets. Overcoming credit rationing has in itself welfare-enhancing effects for the poor, but neither is it directly redistributive nor efficient in achieving rather specific social objectives. Self-financing micro-credit schemes, such as the Start-Up Fund, will be least affected when the development community finally discovers the weaknesses of the micro-credit euphoria. Self-financing micro-credit schemes benefit the poor by moving the frontier of credit markets. However, specific redistributional policy objectives could alternatively be addressed by the provision of goods such as education, training and health care to disadvantaged groups. Indirectly such measures may even benefit micro-finance institutions and micro-enterprise development: educated and healthy poor people are more likely to achieve upliftment, and they are more likely to be in a position to repay business loans. Further, the provision of infrastructure - roads as well as telecommunication - could often be a boost as much for service providers in micro-finance as for the poor people they are targeting.

Delivery mechanisms

The 'cost of solidarity', which is the focus of my critique of group-based micro-finance, is likely to differ between countries and locations. The costs involved in

[4] In Malawi, micro-credit is used to counter the socio-economic effects of the AIDS epidemic. In Mozambique, both returning exiles and fishermen who had suffered from natural disaster enjoyed specific micro-credit programmes. In Botswana, unemployed youth, who are seen as a threat to the hegemony of the ruling party, gave the impetus for the development of national micro-credit policy. In effect, micro-credit is often used as a general cure to diverse problems involving loss of income.

group communication are invariably higher where population density is low, society fragmented, infrastructure poor and the cost of loan officers' time high. These factors seem to disadvantage Southern African countries, and the more rapid development of micro-lenders in Asia and Latin America seems to bear this fact out. However, one could argue that this disadvantage helps to identify a universal problem of micro-lending: viability is seen excessively to lie in high repayment rates, while the operational costs of lending - except in rare cases of obvious waste - have been out of focus for two decades.[5]

However, in Southern Africa, many micro-lenders operate with tolerably high repayment rates. Most major lenders experience default rates of 0-20% of advances, with the majority at the lower end of this band. However, none of them is viable - except for the Start-Up Fund which has an above-average default rate. Therefore, the level of cost-recovery cannot significantly be improved by focusing on defaults and repayment rates. Following the stabilisation of acceptably low default rates, the most important step towards achieving viability is the development of cost-efficient delivery mechanisms.

In South Africa, micro-lenders are in the fortunate situation of being able to use highly advanced electronic transmission systems for sending and receiving

[5] A point in case is the Women's Finance House Botswana. Although not one of the more efficient micro-lenders in Southern Africa, it is Botswana's largest by far and enjoys robust support by major donors. Their core lending programme shows a historical repayment rate of 93%; their lending costs stand at about 800 percent. Their chosen way to viability is to improve the repayment rate by adopting administratively expensive policies.

money. However, even in South Africa, parts of the rural population are difficult to reach through bank branches and ATMs. In several neighbouring countries, financial sectors are even less in the position to provide for the needs of micro-lenders. This would undermine the adoption of a mass-minimalist approach exactly like the Start-Up Fund. Solidarity, in the Grameen-type form, is a rather costly method for controlling default and for handling cash. In various parts of Africa, mixed forms are being tried out; many of these rely on the use of large groups, which reduces the costs of participation. Schemes similar to the village bank model are operated, *inter alia*, by World Relief in Mozambique, FINCA in Malawi, and K-REP in Kenya. All these involve the use of commercial banks' facilities, according to local availability. Further research should explain the role of 'cheap' solidarity in large groups and the potential for linkage development in the context of underdeveloped banking systems. This could also provide a link between the development of the overall financial system in African countries and the incorporation of micro-finance institutions.

Social impact assessment

The analysis has shown that the individualistic Start-Up Fund is more efficient in making loans to poor entrepreneurs than the solidaristic Small Enterprise Foundations. This is an important insight since many proponents of group credit argue that this approach reduces transaction costs, both default costs and operating expenses. The data presented here refute this belief. The costs of creating an environment suitable for group lending, namely community-oriented, staff-intensive operations, vastly outweigh the savings. However, the strict efficiency comparison, based on the costs incurred from lending a specific amount, implicitly assume that individualistic and solidaristic credit are essentially the same financial product and thus close substitutes of each other. Indeed, in this thesis I represent them as different production technologies aimed at producing the same good: micro-credit. Yet this assumption is contentious. Many group credit activists would strongly reject the idea that their services could be replaced by Fordist, mass-minimalist forms of micro-credit.

This view may not be pure Luddite sentiment.[6] Agu (1986) writes that

> 'most financial institutions offer heterogeneous services each with different ratio of cost to value, so that operating cost/total asset ratio often depends far more on the mixture of services offered by each institution than on its overall efficiency. This aspect of the problem will very much be experienced in comparing efficiency of financial institutions such as a co-operative bank and a commercial bank charged with rendering completely different services in different forms and circumstances' (p. 74).

[6] A Luddite is 'a member of a gang of English craft workers led by Ned Ludd in the period 1811-13 who showed opposition to the introduction of textile machines in Nottingham [...] and the consequent loss of employment by smashing the machines at night' (Rutherford, 1992, p. 276). Today the term is used to describe those who follow or preach atavistic ideals 'in an attempt to prevent technical change' (*ibid.*) and its social effects. Luddism therefore has a strong anti-innovative flavour.

The same injunction applies to the comparison of individualistic and solidaristic credit. If it could be shown that group credit schemes are in some way superior in achieving the developmental goal of credit, then their costs may well be justified even on efficiency grounds.

The institutions underlying both case studies - each representing an alternative model of micro-lending technology - intends to initiate change beyond pure credit delivery; their raison d'être is the enhancement of independent entrepreneurship and the creation of livelihoods for the economically disadvantaged. Credit extension may be an insufficient measure for their success. Group credit schemes, as was argued in chapters 4 and 5, always provide other, complementary services, often including business advice, to their clients. While solidarity imposes costs it also facilitates interaction between lender and borrower. The creation of solidarity and the institution of regular meetings may support the social dimension of development lending. What appears as the disadvantage of group lending for 'lean lending' might also be construed as an advantage for collective action and forum for support. However, such a view is in conflict with the current paradigm that holds that redistributional and soft, compassionate support structures are best established as institutionally separate from lending.

This thesis has chosen to address the question of economic efficiency in micro-lending, focusing on the production of services and the generation of revenue from serving members of the target group. This should ideally be complemented by an analysis - to stay with the analogy - of the consumer surplus, the benefit derived by the target group from participation in a lending programme. Research on impact assessment of micro-lending is not advanced, and decision-makers in development are keen to find appropriate, workable assessment methods. These, though, are unlikely to yield objective, value-neutral insights. The desirability of social changes is extremely difficult to measure as it is as subjective as individual utility functions and the quality of life. The assessment of micro-credit, therefore, remains dependent on the political and moral values of the assessor; changes in the political paradigm - in donor or recipient countries, or in the community of development professionals - are likely to lead to a different view of micro-credit. Especially the waning of the current prominence of participation and grassroots democracy in development thinking would probably have profound influence on the perception of alternative micro-credit designs.

Participation in development projects

Participation is fashionable in development, not only in micro-finance. Participatory project designs are widely used and advocated by major donors; projects ranging from livestock development, water supply, to AIDS prevention and sexual empowerment of women use participatory methods. Effective ownership in development projects, achieved by involving beneficiaries in project conception and planning, is argued to contribute to its reliability and sustainability. The involvement of beneficiaries should then comprise discussion, the identification of priorities, but often also contribution of labour and other resources in kind or money.

Notably, it needs to be recognised that projects with a non-economic focus - for example, participatory schemes for the provision of safe drinking water - have a differing logic from micro-credit. Participation, and its costs, may be a desirable component in such schemes; otherwise no costs would arise for the beneficiaries. Imposing costs arguably helps to identify relevant projects, because beneficiaries would be reluctant to contribute to projects which they perceive as misguided, and to establish the value of its products in the perception of its beneficiaries. None of this is necessarily relevant to micro-credit. Sufficient repayment rates and the attainment of full cost-recovery demonstrate valued services are rendered to the target group on a sustainable basis.

While recent literature has pointed out the benefits of participation in development project design, there is a noticeable tendency to forget its costs. It seems plausible, though, that the conclusions of this thesis may also be applicable to non-financial development projects. Such costs may then be undesirable if they undermine the efficiency of achieving project aims as a large part of resources is used for maintaining participatory structures, rather than service provision. However, further research needs to establish in which way participation supports the non-economic objectives of projects, and what role participation costs play in non-finance development projects.

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