

SMEs' ACCESS TO FINANCE IN SOUTH AFRICA

– A SUPPLY-SIDE REGULATORY REVIEW –

by

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EXECUTIVE SUMMARY

1 Analyses and findings

The Task Group covered the following areas in its review: (i) the profile of South African SMEs and their contribution to the South African economy, (ii) access of SMEs to equity capital and debt, and (iii) access to other bank services. In this context, the Task Group considered the role of banks, the role of non-bank financial institutions, the role of the securities markets and the competitive environment within which these different institutions function.

It is important to point out that the SMME sector includes a wide range of enterprises. There are major differences between medium-sized enterprises on the one hand, and very small or micro-enterprises on the other. The primary focus of this Report has been on small and medium-enterprises rather than on the micro-sector, and the acronym 'SME' is thus used throughout. However, micro-enterprises play a critical role in income generation in the lives of many South Africans and the Task Group has not ignored this group. In fact, many of the Task Group's proposals would be beneficial to micro-enterprise finance as well. For instance, improvement in the competitive environment in the banking sector and a more "enabling environment" for non-bank lenders would also contribute to better access to finance for the very small and micro-enterprise sector.

This ambiguity having been clarified, the following main findings emerged from the Task Group's study. The recommendations follow.

(1) Magnitude and contribution to the economy. The importance of SMEs in the economy expresses itself in their contribution to the GDP and employment, which is likely to be as high as the large enterprises'

contribution¹. SMEs do not contribute to the same extent to capital formation, and may be investing as little as 25 per cent of gross capital formation. Within the current context of negative growth in employment creation by both large enterprises and the government sector, SMEs have a major socio-economic role to play. (See Chapter 1.)

(2) Equity finance. The size of the enterprise and its stage of growth or development impact upon its financial needs and determine the most likely suppliers of finance. Equity finance is important for young, high growth and potentially high-risk enterprises. SMEs' participation in the country's venture capital and private equity has been limited to date. This may be related to insufficiently developed "exit options" and weak IPO markets. In addition, there is a concern that the international trends of venture-capital investment shifting towards later stages of business development and larger individual transactions will also adversely affect South African small businesses. (See Chapter 2.)

(3) Access to banking services. For those SMEs with acceptable "credit histories" and sufficient collateral, access to bank credit *appears to be* satisfactory². For start-ups, micro-enterprises, entrepreneurs from previously disadvantaged communities or any other group with limited collateral or weak (or limited) credit histories access is more limited. Note that this does not necessarily indicate a weakness in the banking environment or in credit allocation. It may indicate a need for greater institutional variety, for increased innovation and a greater emphasis on mentoring. The Task Group further identified a number of weaknesses in the competitive environment. This may well mean that with increased competition, the supply of finance and level of innovation could increase,

¹ The Task Group's estimations point to a probable contribution to GDP of more than 50%, and a contribution to employment of more than 60% - however, making definitive statements is difficult and estimations vary considerably (see Chapter 1).

² However, there is some ambiguity in this observation. Chapter 4 draws attention to a number of weaknesses in the competitive environment.

with the consequence that access to finance could deepen and the cost of finance to SMEs could decrease.

Another area of concern is SMEs' access to money transfer services and the cost of such services. The Task Group is of the opinion that certain structural features of the sector (such as banks' ownership of settlement systems and the barriers to entry into the banking sector) as well as certain business practices (e.g. the lack of an uniform disclosure regime of fees and charges in terms of a basic banking package) may constitute obstacles to a competitive and consumer-friendly market. This obviously also impacts upon the nature and quantum of financial services being provided, as well as the cost at which financial services are being provided. (See Chapter 3.)

(4) Non-bank financial intermediaries. Non-bank financial intermediaries could play a much larger role in enterprise lending, especially in respect of small and micro-enterprises. A number of constraints are identified. Some of these impact mainly on non-bank lenders (e.g. access to capital) while others impact both on non-bank lenders and banks' lending to the SME sector. The latter group includes the restrictions in the Usury Act and Usury Act Exemption Notice, sharing of credit risk information and prioritisation by banks of different payment types. (See Chapter 4.)

(5) Access to capital markets. Access to capital markets is still under-developed, both for SMEs and for retail lending entities that could lend to them. While direct market access poses transaction cost and liquidity problems, securitisation (for example, via CLO funds) has significant potential for increasing access to capital and lowering the cost of capital. There are several regulatory issues that presently hinder the implementation of these solutions. However, the Registrar of Banks has proposed amended regulations governing securitisation, which, if implemented in their present form, would see these hindrances effectively removed. (See Chapter 5.)

2 Recommendations

The Task Group has identified a number of areas in which intervention is likely to have a positive effect on SMEs' access to finance. These are developed in greater detail in Chapter 6.

(1) Regulatory bias in the allocation of credit

The regulations of the Usury Act, Credit Agreements Act and Usury Act Exemption Notice create a bias in the allocation of credit, against allocation of credit for SME finance. This bias is created both through the interest rate limitation in the Usury Act and Credit Agreements Act, which discourages high risk or high cost credit provision, and through the limitation on loan amount and term in the Exemption Notice. The favourable interest rate environment created by the Exemption Notice is most suitable for short-term consumption finance.

In the short term, these constraints can be lifted through modifications to the Exemption Notice. The long-term solution necessitates a comprehensive review of the Usury Act and Credit Agreements Act, potentially replacing these Acts with a consolidated 'National Consumer Credit Act' with "truth in lending" provisions which should apply to all loan and credit providers. This would be in line with the recommendations of the Financial Sector Programme Mission of the International Monetary Fund.

(2) Legislation governing commercial security

The legislation governing commercial security is complex and outdated and does not support efficient secured finance arrangements in the commercial context. Addressing this area would require a comprehensive reform of commercial credit laws and strengthening of the systems for enforcement of debt and commercial bankruptcy. This holds the promise of substantially widening access to credit by leveraging otherwise "dead" capital.

(3) Access to information

Access to information is important both from the SME's perspective and from the perspective of the providers of financial services. The SME requires information with which to identify the potential suppliers of the financial services. It requires this information to evaluate the cost of the financial services that are being offered. The financial service providers require information with which to evaluate the risk of the SME which is applying for finance, and to assess the prospects of the SME within the market segment and geographical area within which it operates. The Task Group identified deficiencies in all these areas. Addressing these deficiencies requires *public action*, as it involves trade-offs between the individual's right of privacy balanced against the commercial value of information. Moreover, the market economy requires appropriate information in order to optimise the allocation of resources.

Improved access to information requires action in the following areas:

- Introduction of regulations to improve disclosure of the cost of financial services in a format that would facilitate comparison between different financial service providers.
- Improved regulation of credit bureaux in order to enhance their credibility and the integrity of the information being distributed by credit bureaux³.
- An investigation into the types and volume of information related to SME repayment profiles and financial exposure that is currently *not being shared* amongst financial institutions, the implications thereof for the provision of finance to SMEs and recommendations to address potential shortfalls⁴.

³ Note that the Department of Trade and Industry has already launched an investigation on this issue.

⁴ The Task Group identified a number of different types of information which financial institutions view as "proprietary" and thus do not submit to credit bureaux. This impacts on the ability of financial service providers to assess the risk of an SME applicant and to an even larger extent on the cost of performing such an assessment.

- An investigation into the feasibility of establishing a national “register of pledges”, in order to facilitate and lower the cost of assessing the security being offered by SMEs.
- An assessment of the need to expand the collection and dissemination of information on the SME sector and recommendations for addressing potential shortfalls. Such an intervention could make it easier for financial service providers to assess the viability of an SME while increased provision of information could lower the risk perception of the SME sector and increase the level of interest in the sector.

(4) Barriers to entry and expansion in the range of institutions providing finance to the SME sector

International observers consistently conclude that the greater the number of entities that find lending to SMEs profitable and the higher the level of competition in conventional banking services, the greater the likelihood of increasing the supply of finance to SMEs. The regulatory environment should thus facilitate entry and stimulate competition.

To achieve these aims, the Task Group recommends that:

- The feasibility, implications and requirements for legislating the establishment of different categories of “second-tier” banks should be investigated. Such second-tier banks (e.g. ‘core banks’ and co-operative banks) should have limited mandates, thus allowing the regulators to lower capital and compliance costs. This could facilitate the establishment of financial institutions that are appropriate for the SME and emerging market environment and facilitate “progression” of non-bank financial institutions (whether micro-lenders, co-operatives, village banks or any other type of financial institution) into banking service delivery.
- The current model of regulating “common bond institutions” (co-operatives and village banks in particular) through exemptions from the Banks Act

should be reviewed, and consideration given to the need for creating a regulatory authority for such institutions. This may enhance the credibility and growth potential of such institutions.

(5) Access to capital for non-bank financial intermediaries (NBFIs)

Limitations on access to capital are a substantial obstacle to the growth of non-bank financial institutions (including micro-lenders), which in turn limits such institutions' ability to provide finance to SMEs. The profile of capital to which non-bank financial institutions have access legally, prevents these institutions from structuring optimum asset/liability structures. As a result the originating of assets of the size and term structure required for SME financing becomes very difficult for NBFIs.

The Task Group recommends that the definitions of 'banking business' and of 'deposit' in the Banks Act be reviewed with a view to modifying such definitions in order to accommodate increased access by non-bank financial institutions to loanable funds (e.g. investments received from non-retail sources⁵).

(6) Increased access to finance through secondary market development

The secondary capital market can *potentially* play a very important role in intermediating between providers and users of capital. Although the existing regulations on securitisation restrict the development of the securitisation market, the Task Group understands that proposals have already been made for revisions to these regulations, which would lift this constraint. The development of this market could make a significant impact upon the volume and cost of finance provided to SMEs.

Securitisation could provide vehicles through which the upper end of the SME sector could directly access capital or, alternatively, through which

⁵ I.e. excluding retail **deposits**, but potentially including large medium-term **investments** from companies or wealthy individuals.

financial institutions, including micro-finance institutions, could access capital in order to provide finance to the SME sector.

(7) Venture capital

Depending upon their stage of growth, the most appropriate form of finance for SME development is frequently venture capital rather than debt. There are a number of ways through which the provision of venture capital can be stimulated:

- Legislation should be changed to allow institutional investors to increase their investment in venture capital, unlisted shares and small capitalisation companies (i.e. SMEs).
- Consideration should be given to the creation of tax incentives for business-angel investments. This may well be justified as a measure to correct the market failure in the provision of equity for SMEs, i.e. by offsetting the high transaction costs and risks associated with small cap venture capital transactions.
- The United Kingdom has gone much further than South Africa in stimulating the provision of venture capital for SMEs. In addition to various tax incentive schemes, a great emphasis has been placed on direct investment of public funds in equity funds. The British interventions include tax relief to investors through the enterprise investment scheme, tax incentives for 'corporate venturing'⁶, establishment of Venture Capital Trusts as vehicles through which to invest in smaller trading companies, supplementing private finance with public finance in the Regional Venture Capital Funds and encouraging technology investment through the UK High Technology Fund. The Task Group suggests that the South African tax authorities do a thorough assessment of the UK's approach and experience in order to identify the most appropriate approach given the local needs and challenges.

⁶ Commonly, the establishment of business relationships between large and small companies that are in the same line of business. experience in order to identify the most appropriate approach given the local needs and challenges.

- The role of ***business-angel finance*** deserves special attention. This refers to private investment flows into the SME sector and is reported to make a much larger contribution to SME finance than formal venture-capital funds. There are a number of tax and regulatory disincentives for the provision of such funding in South Africa, which should be removed. Given its large potential, serious consideration should be given to the creation of incentives in the tax system for such transactions.

(8) Debt-oriented public policy interventions

The Task Group took cognisance of a range of debt-oriented public policy interventions in the UK and other countries. Although it may be worthwhile to review these⁷, this does not appear to be the highest priority. In respect of the provision of debt finance to SMEs, the Task Group is of the opinion that the priority should be in removing the obstacles and disincentives on the provision of debt finance to SMEs (Usury Act, access to information, security legislation, access to capital for NBFIs), on encouraging the establishment of financial service providers focused on the SME sector and increasing competition amongst providers (and potential providers) of debt finance to the SME sector. This may include the investment of taxpayers' funds into the CLO sector, as a temporary support measure. Such interventions could improve the efficiency of the debt markets and thus improve provision of debt finance, potentially removing the need for further intervention in this area.

(9) Access to the National Payment System

The Task Group identified a number of areas of concern related to access to the national payment system. These include limitation on access to the national payments system by smaller banks and non-bank financial institutions as well as arrangements through which banks create preferences for certain categories of payment. These factors undermine the level of competition, and create disincentives for the provision of certain

types of finance (including SME finance) and limit the growth potential of certain types of financial service providers (including, potentially, smaller and more innovative financial service providers).

In the UK, this issue was considered in a serious enough light for the banking sector to be referred to the UK Competition Commission, with the Commission eventually concluding that the banks were operating a “complex monopoly”. This issue has similarly received high-level attention in a number of other jurisdictions⁸. To the extent that access to and the neutrality of the payments system is fundamental to the competitive environment in the banking sector, it also impacts significantly on all services provided to SMEs.

- In the short term, the Task Group recommends that the Reserve Bank raises this issue with the Payments Association of South Africa in order for the immediate concerns to be addressed. In the longer term, the regulatory structure of the National Payment System *has to be reviewed*. The regulatory authorities have to consider the implementation of fundamental changes in the manner in which the payment system (and access thereto) is being regulated. This could include the following measures:
 - For the Competition Commission to review the existing structure of management, price determination and control over the payment system (and clearing and settlement arrangements).
 - For the South African Reserve Bank to review the regulatory structure of the payment system in order to improve its effectiveness.
 - For the South African Reserve Bank to consider whether the competitive environment can be improved by creating the facility for financial institutions (whether bank or non-bank) to clear their payment transactions through the central bank (i.e. the SAMOS system).

⁷ However, only if the Department of Trade and Industry has not performed such a review already.

⁸ Refer, for instance, to the Wallis Report on the Australian financial system.

(10) Disincentives to the formalisation and growth of SMEs

Last but not least, it is the Task Group's observation that many parties in South Africa express concern on the lack of formalisation of SMEs, and in particular of SMEs in previously disadvantaged communities. This obviously impacts negatively on such enterprises' growth prospects and upon their ability to raise finance. There are many factors that could contribute to this phenomenon, including tax status (and thresholds), company registration requirements and a range of other factors. This is a complex issue⁹, which falls outside of the Task Group's direct mandate. The Task Group wishes to note that this matter deserves further attention as it clearly has great significance in the evolution (including the socio-political profile) and growth of the SME sector.

3 Conclusion

It is with some trepidation that the Task Group raises a range of issues, such as the above, under the innocuous title of "SMEs' access to finance". However, in the context of the poverty and employment challenges in South Africa, the challenges related to the transfer of economic power to previously disadvantaged South Africans and the disappointing contribution that the SME sector has made in this area, minor adjustments in areas that are marginal to the mainstream economy are clearly inadequate. This task has been greatly simplified by being able to draw on the conceptual and theoretical framework that was established in the Cruickshank Report in the United Kingdom and the Wallis Report in Australia.

The Task Group believes that it has identified a number of significant factors that go some way in explaining the current state of SME finance in South Africa. The recommendations should contribute to increased access to finance for SMEs, increased innovation in financial service provision and to increased competition in the financial services sector. However, given that many of these

⁹ The reasons therefore are obviously closely related to South Africa's socio-political history.

recommendations impact directly upon the mainstream of the financial services sector, further analysis would be required in nearly all areas mentioned.

Addressing these issues would require a great deal of co-operation between a number of different government departments and regulatory agencies. Chapter 6 states various detailed recommendations for government departments or regulatory agencies whose mandate relate most closely to this particular issue, or who could take the lead in the implementation of remedial action. It seems appropriate that the different issues be referred to each of these parties. However, it may be necessary for the Policy Board for Financial Services and Regulation to retain a monitoring and co-ordination function in order to ensure that progress is made.

FOREWORD

In South Africa, the total economic output of small and medium enterprises (SMEs) is some 50 per cent of gross domestic product (GDP), and this sector employs in excess of 60 per cent of the total labour force¹⁰. As medium-term employment trends in the formal sector are stagnant at the moment,¹¹ the level of unemployment in the local economy can be reduced meaningfully in the near future only by the successful promotion of SME output. In this sense, SMEs play a far more important role in developing economies than in the industrial countries, since SMEs make a major contribution to socio-political stability. Successful SMEs absorb not only a significant part of the unemployed labour force, but also reduce crime and government expenditure on security and legal services. In fact, unless South Africa succeeds in promoting SMEs, the country will remain saddled with a huge unemployment problem and, therefore, excessive crime in its various forms. Furthermore, creating SMEs is one of the most promising means of progressively redistributing the ownership of productive assets, i.e. SMEs have the potential to be an engine for black economic empowerment.

Obviously, the government is fully aware of the importance of SMEs, and various studies have been commissioned in the recent past. The current framework of SME support and development in South Africa comprises the following initiatives:

¹⁰ It is important to point out that the SMME sector includes a wide range of enterprises. There are major differences between medium-sized enterprises on one hand, and very small or micro-enterprises on the other. The primary focus of this Report is on small and medium-enterprises rather than on the micro-sector, and the acronym 'SME' is thus used throughout. However, micro-enterprises play a critical role in income generation in the lives of many South Africans and the Task Group has not ignored this group. In fact, many of the Task Group's proposals would be beneficial to micro-enterprise finance as well.

¹¹ Owing, *inter alia*, to technological improvements (which enhance labour productivity) and lower levels of import protection (which increase imports at the cost of local production, at least in the short term).

1. The White Paper on the promotion of small business (1995), which sets out Government's strategy on the development and promotion of small business in South Africa.¹²
2. The National Small Business Act of 1996, which defines SMEs¹³ and provides for the establishment of the National Small Business Council¹⁴ and the Ntsika Enterprise Promotion Agency (Ntsika). The Small Business Council was responsible for policy advice to national, provincial and local government, whereas Ntsika is responsible for the provision and co-ordination of training and other non-financial support functions related to SMEs. The Centre for Small Business Promotion has also been established, with the goals of creating an enabling environment for the growth and expansion of SMEs and of developing and supporting the institutions involved in delivering support services to SMEs.
3. Khula Enterprise Finance has the mandate of improving the SME sector's access to finance, primarily through the provision of 'wholesale finance' or guarantees to retail financial intermediaries, which, in turn, finance the SME sector.
4. There are various national/official initiatives on SME promotion by, for instance, the parliamentary subcommittees; The Banking Council South Africa's position papers; and reports by the Department of Trade and Industry's Reference Group and Ntsika.

This Report of the Policy Board for Financial Services and Regulation tries to avoid a duplication of the above initiatives and, therefore, is limited to the analysis of possible constraints on the *supply* of equity

¹² The White Paper anticipates that a Small Business Finance Act may be established, but this has not yet taken place.

¹³ The use of the acronym "SMEs" and not "SMMEs" in this report is intentional, as the financing of micro-enterprises would require a whole report on its own. See Chapter 1 for more detailed definitions.

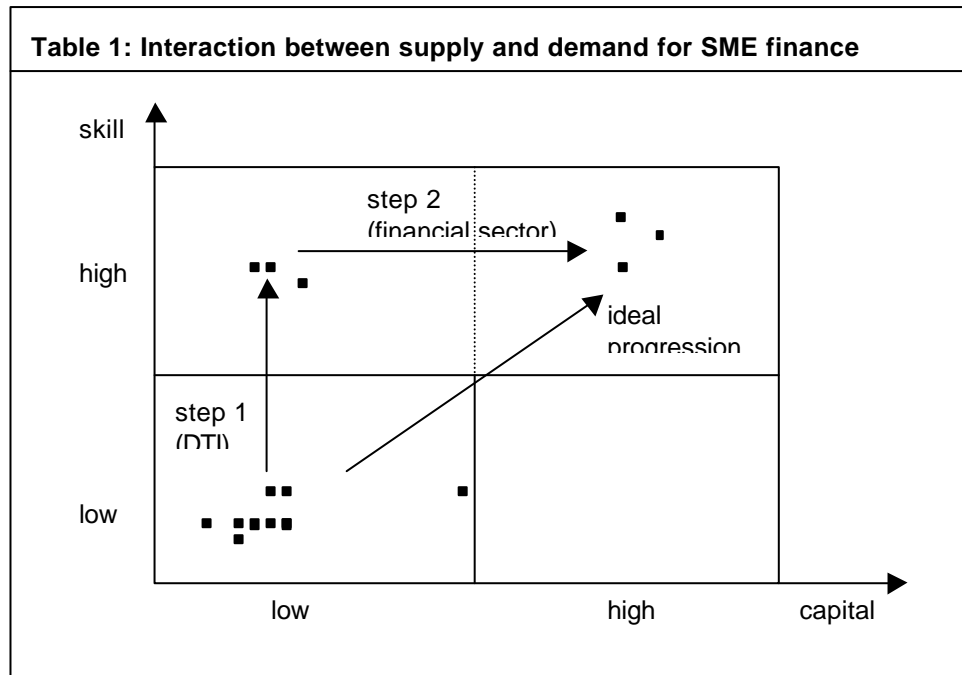
¹⁴ This has since been abolished.

and debt finance to SMEs, the factors impacting on the cost of SME finance and the financial impediments limiting the development of SMEs.

Moreover, the Task Group Report assumes that the reader is aware of the contents of the Cruickshank Report that deals, *inter alia*, with SME finance in the UK in a comprehensive manner. Appendix 1 at the end of this Report summarises the possible relevance of this Report for SMEs in the South African context, while Appendix 2 contains the full executive summary of the Cruickshank Report.

The decision to focus on supply factors is grounded on the following understanding. At present, very substantial impediments to SMEs' access to finance are believed to be on the demand side. Many emerging entrepreneurs are under-skilled and lack business experience, with the result that they cannot gain access to capital. The Task group is confident, though, that through the natural exposure to more experience, as well as the efforts of DTI and its private sector partners, the quality of human capital found in SMMEs will be improved over the next decade. However, the Task Group also identified very substantial obstacles in the supply side that is the primary focus of this Report. The conceptual representation of the demand side issues illustrates the interaction with the supply side in Table 1 on the following page.

The arrow that runs diagonally through the matrix shows the ideal progression that should be aimed at, and can be achieved for example through a close supply-demand relationship (e.g. venture capital). However, the Task Group believes that such progression is not achievable on a large scale, because of the immensity of the SME sector and the logistic impossibility to accompany each of them on the difficult path to a high-skill high-capital status. The danger is to grow the bottom-right quadrant (low-skills high-capital), which is an area of systemic risk for the financial sector and should be viewed a "no-go area".



Therefore, the Task Group suggests a progression whereby the emerging enterprises are first provided with more skills (step 1), so that they will be able to formulate a qualified demand for capital. In governmental terms, this demand-side challenge is regarded as the responsibility of the DTI. However, the removal of the next barrier (bold dotted line on the graph) must happen in parallel, so that when demand is ready, supply is immediately able to provide capital to high-skilled entrepreneurs (step 2). In order to achieve this ability, the financial system needs to undergo a number of regulatory changes, and these are the objects of this Report.

As will be shown in Chapter 1, the number of SMMEs is estimated to be between 1 and 3 million in South Africa. Excluding survivalist and micro-businesses, this number turns to a range of 250 000 to 650 000 enterprises, which represents a contribution to GDP of some 50 per cent – the contribution to employment is even more. But SMEs come in a variety of shapes and sizes and pose various financing problems. An SME with a turnover in excess of R5 million per annum can have access to debt financing (usually in the form of bank credit), whereas small businesses with a turnover of, say, some R150 000 per annum remain crucially dependent on loan finance or equity from either friends

or family. For all SMEs, however, the finance that the owner-managers can access in their personal capacity plays a critical role in the provision of finance to the enterprises.

Both the markets for equity and debt finance for SMEs can be improved in South Africa. With regard to the **equity-funding market**, the government should more actively promote the concept of 'business angel' finance. Fiscal support is justified in this area, because the lack of equity funding for SMEs is a symptom of a deeper problem, namely a serious market failure. For the somewhat larger enterprises, the venture-capital market may be attractive, but only if lower entry requirements are introduced to revive this market segment.

Structural improvements could also be made in the **debt-funding market** for SMEs. For example, better disclosure rules and more competition may improve credit facilities from the banking sector, and the market for asset-backed securities could likewise contribute to better debt-funding mechanisms for SMEs in future.

Finance to small and micro-sized businesses in South Africa could be promoted in a variety of ways. The key issues at stake in the promotion of SME finance may be summarised as follows:

- Competition between banks and the securities markets should be increased by making the securities markets more independent of banking legislation and by lowering entry barriers into the securities markets wherever possible.
- An environment should be created to allow a far greater level of competition between banks, as well as between banks and non-bank financial service providers, in the provision of financial services – and particularly debt finance – to SMEs. This should cut across limitations on access to capital, access to information, access to the National Payment System and issues of market structure.

- Access to information about SMEs should be increased to ensure that all providers and potential providers of finance have sufficient knowledge to assess the risk of SME applications for finance. Similarly, it would be important to ensure that the control over information on SME exposures is not utilised by dominant players (and banks in particular) to inhibit competition for the provision of finance to SMEs, or to inhibit the entry of new providers of finance. Any intervention that improves the ability of financial service providers to accurately assess SME risk would increase their willingness to extend credit and other financial services to SMEs.
- Disclosure rules for the providers of finance could be improved to address the current lack of transparency. At present, SMEs usually do not have a full picture of all the finance charges that the various credit suppliers levy. This hampers choice and, accordingly, competition.
- Incentive structures for the supply of equity-based finance to SMEs should be improved, to facilitate greater provision of funds by 'business angels', or through the venture-capital markets. Equally as important is the removal of the disincentives inherent in existing fiscal policy.
- The impact of the changes proposed above would be limited until the price control embodied in the Usury Act is scrapped or, at least, modified in order to allow the prices charged for financial services (and interest on loan finance) to be set at levels that are commensurate with the cost and risk of providing finance to SMEs.

The proposed regulatory changes should increase access to (or improve the cost of) finance for a range of enterprises, whether by the owners of particular enterprises who access finance in their personal capacity, or whether by a medium enterprise, which obtains equity capital through the securities market.

Despite the great potential to develop SMEs more meaningfully in South Africa, there also looms a big threat. The expected impact of Aids on SMEs in the

years ahead has to be emphasised in the South African context. The Aids epidemic obviously creates major financial risks that have to be part and parcel of the total risk evaluation process of creditors. Specifically in a small business where the owner/manager plays such a crucial role, the impact of Aids is bound to be far more serious than for larger companies where management and labour are more flexible. Despite all the good intentions to improve the market for SME finance, Aids may have a seriously adverse effect in the coming years.

Last but not least, the Task Group would like to note that this Report has been written in the context of weak statistics on both the SME population and the financial sector's exposure to this clientele. As a consequence there exists a serious knowledge gap in many areas that would be of relevance to the question of improving access to finance. Research is currently underway and its findings may impact on the contents of this Report in time to come.

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LIST OF ACRONYMS AND ABBREVIATIONS

ABS	Asset-backed security
ACB	Automated Clearing Bureau
CC	Competition Commission
CDO	Collateralised debt obligation
CHIP	Collateralised Housing Investment Paper
CLO	Collateralised loan obligation fund
CMBS	Collateralised mortgage-backed security
DBSA	Development Bank of South Africa
DCM	Development Capital Market
EIS	Enterprise Investment Scheme
EVCA	European Venture Capital Association
FAF	Financial Aid Fund
FSB	Financial Services Board
IDC	Industrial Development Corporation
IDT	Independent Development Trust
IDTFC	Independent Development Trust – Finance Company
IFC	International Finance Corporation
IPO	Initial public offering
KFC	KwaZulu Finance Corporation
LSM	Living standard measure
M&A	Mergers and Acquisitions
MFRC	Micro Finance Regulatory Council
NBFI	Non-bank financial institution
NGO	Non-government organisation
NHFC	National Housing Finance Corporation
PDI	Previously Disadvantaged Individuals
RFI	Retail financial intermediary
RLE	Retail lending enterprise (or entities)
SARB	South African Reserve Bank

SASRIA	South African Special Risk Association
SAVCA	South African Venture Capital and Private Equity Association
SBDC	Small Business Development Corporation
SME	Small and medium enterprises
SMME	Small, micro and medium enterprises
SPV	Special-purpose vehicle
Statssa	Statistics South Africa
VC	Venture capital
VCM	Venture-capital market

CHAPTER 1

THE RELATIVE IMPORTANCE OF SMEs IN THE SOUTH AFRICAN ECONOMY: AN ANALYSIS OF ISSUES AND QUANTIFICATION OF MAGNITUDES

1 Introduction

Promoting SMEs can have many dimensions and goes far beyond the simple granting of finance. In particular, the experience of other developing countries provides ample evidence of the importance of non-finance policies (such as the importance of establishing economic linkages). Factors that come to mind include the development of horizontal relationships (for example, industrial clusters) aimed at improving the market environment for small enterprises; the development of vertical linkages with larger domestic enterprises, principally through subcontracting agreements; or the development of new interfirm networks that increase the small-scale sector's capacity for dialogue in relation to macro-level policy (for example, export rebates and tax concessions). The following are vital for the development of clusters: a concentration of suppliers of raw materials and components; specialist organisations providing technical, financial and accounting services and national and international marketing agencies; and the availability of a large pool of skilled, specialised workers, specialist training centres and transport services.¹

Besides the importance of the above-mentioned industrial issues, a lack of sufficient capital and credit is often a major handicap to the development of SMEs, particularly in their early growth stages. For instance, international evidence (within developing countries) indicates that close to 95 per cent of

¹ Cook, P., "Support mechanisms for interfirm linkages among SMEs: impact and assessment", Finance and Development Research Programme, Paper 18, University of Manchester, September 2000.

all SMEs have to rely solely on the personal resources of their owners and/or loans from friends and relatives to finance such enterprises.²

Governments in most countries have tried to help their SMEs wherever possible (usually through finance, training or other support by state and parastatal agencies) but the results have generally been poor. For instance, during the period from 1950 to 1990, governments in developing countries failed, nearly without exception, to create industrial organisations that could compete on the basis of collective efficiency. As a result, the World Bank terminated direct lending to SMEs in 1991, and now supports small enterprises only indirectly, i.e. through private-sector agencies.

The broad experience with SMEs in South Africa has been in line with these world trends. An important reason for the disappointing economic and social development since the 1980s may be that policy makers have grossly underestimated the role of SMEs in the South African economy. Today, SMEs account for nearly half of national output, and close to 60 per cent of the employed are working for SMEs, or are employed in domestic service or the informal sectors of South Africa. Yet this reality is not reflected in government policy towards SMEs and this sector does not receive the attention or support justified by its role in the economy.

This chapter sets out to present a quantitative analysis of the contribution of SMEs to the South African economy. The structure of the chapter is as follows: Section 2 defines the terms used. This is important because, more often than not, the debate around SMEs is dominated, at least within South Africa, by a concern for micro enterprises. This may introduce numerous distractions, with potentially serious policy implications. Section 3 contains a review of the key features of SMEs and their systemic implications, especially for the financial sector. Section 4 represents an attempt at quantification of the South African SMEs with reference to key variables

²Cook, P. and F. Nixon, "Finance and Small and Medium-Sized Enterprise Development", *Finance and Development Research Programme, Paper 14*, University of Manchester, April 2000, p.20

such as gross domestic product employment, saving/investment and consumption. Given the paucity of data, and more significantly, the dearth of systematic statistics on such enterprises, the estimates in this section should be seen as indicative and not as definitive. Broad conclusions and the policy implications of the observations and analysis are summarised in Section 5.

2 Definitions and scope of analysis

As in many other fields of analysis, it is critical to define the precise meaning of the terms used. This is particularly true of the debate around SMEs. Very often, the unstated, but powerful, assumption is made that small and medium enterprises are akin to micro/survivalist enterprises. This is erroneous and misleading, particularly regarding the financial products related to debt, equity, and financial services. *'These firms [SMEs] have different financial needs depending on the nature of their company, whether retail oriented or production oriented, the margins on their products, their inventory turnover, and whether they are truly seeking to be growth oriented enterprises. They also have great many other needs, which in some cases outweigh their need of finance.'*³

Despite its importance, there is no generally agreed or universally applicable definition of SMEs. Numerous factors, related to a given socio-economic environment, influence the definition of SMEs. The following are some of the measures for 'SME' given in the literature:

- The Organisation for Economic Co-operation and Development (OECD)⁴ views SMEs as firms with fewer than 500 employees.
- The Cruickshank Report focused on *'those firms which are no longer treated as personal customers by providers of money transmission*

³ Ebony Consulting International, Review and Formulation of Key Issues to Improve SMME Access to Finance in South Africa, *Paper Issues*, December 20, 2000, p.1.

⁴ OECD, *Small Businesses, Job Creation and Growth: Facts, Obstacles and Best Practices*, Paris, 2000.

services and credit, but are too small to have direct access to competitive capital markets, stating that they consist mostly of enterprises with a turnover of up to £10 million, or employment of up to 250 people.⁵

- Standard Bank of South Africa defines SMEs as firms with a turnover of between R150 000 and R5 million per annum.

The most widely used framework in South Africa is the definition of the National Small Business Act, which defines five categories of business as follows:

- **Survivalist enterprise:** The income generated is less than the minimum income standard or the poverty line. This category is considered pre-entrepreneurial, and includes hawkers, vendors and subsistence farmers. (In practice, survivalist enterprises are often categorised as part of the micro-enterprise sector.)
- **Micro enterprise:** The turnover is less than the VAT registration limit (that is, R150 000 per year). These enterprises usually lack formality in terms of registration. They include, for example, *spaza* shops, minibus taxis and household industries. They employ no more than five people.

⁵ With respect to access to debt and related financial products, the Cruickshank Commission defined SMEs as entities with a turnover of up to £10 million, or employment of up to 250 people, but which are no longer treated as personal customers by their financial service providers.

With respect to access to equity, the Commission defines the area of investigation as the needs of firms without access to capital markets, but that require risk finance, particularly to fund rapid growth or substantial innovation. This type of financing is relevant to only a narrow band of the UK's 1,3 million SMEs, probably fewer than 200 000, of which some 20 000 to 50 000 need risk finance at any one time. Although small in number, these businesses could potentially contribute significantly to UK output and productivity growth. In terms of the UK market, the Commission concludes that the firms that are most negatively affected by the failure in the equity market are firms wanting to raise between £0.1m and £0.25m, but with indications that the market failure may begin to affect larger deals of up to £0.5m. The Commission's conclusions are therefore valid for relatively small transactions, even by South African standards.

- **Very small enterprise:** These are enterprises employing fewer than 10 paid employees, except mining, electricity, manufacturing and construction sectors, in which the figure is 20 employees. These enterprises operate in the formal market and have access to technology.
- **Small enterprise:** The upper limit is 50 employees. Small enterprises are generally more established than very small enterprises and exhibit more complex business practices.
- **Medium enterprise:** The maximum number of employees is 100, or 200 for the mining, electricity, manufacturing and construction sectors. These enterprises are often characterised by the decentralisation of power to an additional management layer.

The National Small Business Act's definitions of the different categories of business may be summarised as set out in Table 1.

Enterprise Size	Number of employees	Annual turnover	Gross assets, excluding fixed property
Medium	Fewer than 100 to 200, depending on industry	Less than R4 million to R50 million, depending upon industry	Less than R2 million to R18 million, depending on industry
Small	Fewer than 50	Less than R2 million to R25 million, depending on industry	Less than R2 million to R4,5 million, depending on industry
Very small	Fewer than 10 to 20, depending on industry	Less than R200 000 to R500 000, depending on industry	Less than R150 000 to R500 000, depending on industry
Micro	Fewer than 5	Less than R150 000	Less than R100 000

Given that the focus of this Report is mainly on financial issues, it is even more critical to distinguish clearly between the requirements of survivalist, micro and very small enterprises (called MSEs) and SMEs. The abbreviation MSE stands for 'micro and small enterprises' and reflects the view that there are structural differences between survivalist, micro and very small enterprises on the one hand, and small and medium enterprises on the other hand. Such differences include the level of formalisation (for example, whether a legal entity has been established), whether the enterprise has a

bank account separate from that of its owner and whether it is an entity that is integrated into the household, or whether it is an entity that functions independently from the household of its owner(s).

This Task Group focuses primarily on SMEs, as embodied in the National Small Business Act, to ensure consistency with the framework and initiatives of the Department of Trade and Industry. Only when micro enterprises are specifically at stake will the term SMME be used, which in turn adds the micro dimension to the stated SME concept.

3 Promoting SMEs: macro and micro-institutional issues

The quest for the promotion of SMEs dates back to the mid-twentieth century, and the rise of political-economy concerns over the lack of industrialisation in developing countries. For much of the period, however, industrialisation policies were premised on the segmentation between large- and small-scale producers. Macroeconomic and sector policies were designed accordingly. Broadly speaking, the overall policy framework was to promote large enterprises, often leaving small-scale producers at a disadvantage. Monetary, foreign-exchange and industrial strategies were formulated to support the specialisation of larger firms in capital-intensive production, feeding the higher end of the market, and small-scale producers were left to produce inferior goods, commonly catering for the lower end of the market, and using labour-intensive means of production. In many respects, India's industrialisation strategy, with its successive multi-year plans, exemplifies this paradigm.⁶ There were of course variations on this theme from country to country.

⁶ Little, I., D. Mazumdar and J. Page, *Small Manufacturing Enterprise: A Comparative Analysis of India and Other Economies*, World Bank Research Publication, New York, Oxford University Press, 1987.

The evolution of this conceptual framework, driven largely by its failures and shortcomings, led, *inter alia*, to the emergence of yet another category of firm, namely micro-producers that operated mostly outside the bounds of mainstream economic policy. By the 1970s, the literature on development policy had yielded a new intellectual dichotomy between ‘informal’ and ‘formal’ sector firms. The result of this dualism was the polarisation of mainstream industrial development policy and small-scale sector development. This paradigm of thinking helped to create an environment in which these sectors, more often than not, viewed each other as adversaries, preventing meaningful linkages and mutually beneficial synergies. This was reinforced by a variety of measures, ranging from separate institutional arrangements of business associations and various forms of policy intervention. The enterprise characteristics typically favoured by governments at the time, in a structural adjustment programme for SMEs, are summarised in Table 2 below.⁷

Table 2: Enterprise characteristics favoured and penalised by structural adjustment programmes	
Characteristics favoured	Characteristics penalised
<ul style="list-style-type: none"> - Low import dependence - Development of linkages with growth sectors of the economy - Significant technological enhancement - High barriers to entry - Innovation - Serving an import-substitution function 	<ul style="list-style-type: none"> - High import dependence - Few linkages - demand mostly from low-income groups - Little technological enhancement - Low barriers to entry - Cut-throat competition

Nowadays, policy approaches to promoting SMEs can be divided into two broad categories. The first relies largely on market forces. Underlying this approach is the need to remove policy distortions in pricing, credit provision and a variety of non-market mechanisms that favour large-scale enterprises. In effect, a substantial levelling of the playing fields is essential for the sustainable development of SMEs. The second approach to SME development is associated with a need for proactive forms of intervention to effect progress. The infant-industry argument underlies this ‘structuralist’ approach.

⁷ Cook, P. *Op. cit.*, April 2000, p.30

Significantly, both approaches agree on the importance of an appropriate macro environment for SME development. The differences relate to the nature of the changes that have to be brought about so as to eliminate distortions and biases acting against SME development. The structuralist school of thought, as Cook points out, *'comes with a clearer recognition that previous and existing policies are the results of a complex set of factors, within which vested interests play an important role. It also recognises that the neo-classical view of how the competitive process works through markets that is embodied in the first [market driven] approach is overly simplistic. As a consequence, the second school stresses that the process of policy reform cannot rely on market principles alone'*.⁸

In practice, the promotion of SMEs may well require a creative synthesis of these two seemingly competing policy approaches. Though market distortions and policy-induced biases need to be removed, targeted interventions may well be required to remove bottlenecks so as to facilitate development. Whereas within any given sector there may be tradeoffs between large and small-scale firms, for the economy as a whole there are dynamic linkages and positive synergetic relations among various types of firm. The policy framework, therefore, needs to recognise complex interfirm relationships, the importance of spatial clustering and the significance of 'external economies' to successful enterprises. In view of the rising levels of globalisation, it is imperative to recognise the vital role of consistency between macro- and micro-institutional policies for an enterprise-friendly environment.

The stylised features of a socio-economic environment conducive to SME development can be identified as follows:

- **Macroeconomic stability**

Successful economic development generally requires macroeconomic stability, and this is even truer in the case of SMEs. By definition, SMEs are far more vulnerable to the impact of volatility than an unstable macroeconomic environment might have on the viability of business

⁸ *Ibid.*, p.5

enterprises. At times of price instability, interest-rate volatility and foreign-exchange uncertainty, the number of bankruptcies generally rises, and smaller firms bear the brunt of such adverse conditions.

A well-managed economy is characterised by a high level of predictability, particularly with regard to price movements (inflation), interest rates and the availability of credit. This, in turn, leads to better business planning, high levels of risk taking and superior risk management. Start-up businesses and SMEs in the expansion phase both require a high degree of predictability of the cost and the revenue side of their operations. In fact, the single most critical factor determining the risk premium attached to a small firm is the predictability of its revenue and expenses. Lack of predictability, in turn, translates into a higher-than-otherwise cost of access to credit. At an extreme, unpredictability deters investors from either equity or loan investment in a small firm.

Macroeconomic instability also adversely affects the asset base of SMEs, particularly that of smaller firms. During inflationary times, for example, it is vital to manage various asset categories appropriately. Smaller firms by definition are less likely to have in-house capabilities for sound asset management. This then turns into a major source of financial vulnerability for such a firm.

Both theoretically and experientially, there is little doubt that macroeconomic instability adversely and asymmetrically affects SMEs. Stability in the overall macroeconomic environment, therefore, is the single most critical precondition for SME promotion.

- **Supportive legal framework**

Equally as important as macroeconomic stability is the vital role of an appropriate legal framework for the promotion of business enterprises. Operationally, a vast number of legal issues are important. Global surveys of SME development have repeatedly demonstrated that the

following are the basic elements of a favourable legal framework for business promotion:

- Well-entrenched property rights (legal tenure)
- Efficient business registration procedures
- Simple and transparent rules for operations
- Supportive taxation policies
- Effective and cost-efficient contract enforcement
- Streamlined systems of arbitration and dispute resolution
- Effective law enforcement and crime prevention.

All these factors are critical for the viability and sustainability of business enterprises. These factors affect the start-up expenses, as well as the transactional and operational costs of business enterprises. Yet, in many developing countries and in a number of emerging economies, very little attention is paid to these common-sense requirements for business promotion.

It is important to note that, often, the absence of an appropriate and favourable legal framework is a major impediment to the availability of finance for SMEs. In fact, in many respects, the lack of SME funding is symptomatic of an unfavourable legal framework. The promotion of SMEs, therefore, should begin with a systemic overhaul of the legal framework. To this end, special attention should be paid to issues of consistency and intergovernmental policy co-ordination.

Businesses are commonly subject to legislation that falls under different spheres of government, extending from local to national levels. This raises the need for intergovernmental policy co-ordination. The local government legal framework is of particular significance in this regard. Business firms are predominantly governed by local economic legislation, and the efficacy and efficiency of local governments play decisive roles in the success of SMEs.

In the context of societies in transition, and developing economies in general, there is also often a divergence between 'the formal' and 'the actual' operations of the legal framework. A complex set of socio-political factors is commonly at play to create this divergence. A contributing factor, often at work, is the sheer inefficiency of the judiciary. In effect, this raises the transaction costs considerably, adding to the risks associated with small financial transactions. In such circumstances, the fact that the formal legal framework may well be appropriate is of little consequence. In addition to operational inefficiencies, other factors that may form a wedge between the formal and the actual legal system include corruption within the administration of justice, political interference in the legal system and discrepancies between the formal and the traditional notions of legal tenure (property rights).

- **Favourable human-resource environment**

One of the stylised, yet underestimated, requirements of success in SME promotion is the presence of a supportive human-resource base. In addition to entrepreneurship, high levels of business and economic literacy constitute the foundation of a robust and effective SME promotion. The human-resource development framework is therefore a key element of success in this regard. Not only do formal and informal education and training systems matter, but society's approach towards leadership and achievement also plays a critical role in defining the environment within which latent human potentialities are realised.

A related aspect of the human-resource framework is the ease with which immigration legislation enhances or undermines the domestic skills base of the business environment. The accessibility of relevant skills at a reasonable price is more often than not the critical factor in the success of small businesses, particularly in their expansion phase. Furthermore, it is widely acknowledged that emigration is largely unstoppable. Therefore, the only remedial action is to ensure that the immigration policy compensates, at least partially, for the loss of skills and expertise due to emigration.

In view of the rising levels of global economic integration, it is increasingly important to take seriously the notion of the 'knowledge economy' as it concerns business promotion. SME development in a digital age needs a somewhat different education and training framework than in the agrarian or industrialisation eras. Human resources need to embody far more flexibility and adaptability towards business activities and skills acquisition. The key drivers of this initiative should be business organisations. Equally as important, the formal education and training systems are vital components in ensuring that the national human resources are developed in a manner consistent with the evolving economic structure. To this end, close collaboration between business organisations and the education/training framework is an operational imperative.

- **Appropriate and efficient infrastructure**

Supportive infrastructure for business promotion may be divided into two categories. Firstly, there is the 'hard infrastructure', consisting of, *inter alia*, transportation, communication and urban/business amenities. Secondly, there is the existence of appropriate 'soft infrastructure', in the form of suitable business associations, the availability of relevant and reliable statistics and supportive collective efficiency. Empirical research in the mounting SME literature highlights the imperative need for both types of infrastructure in creating a robust and business-friendly environment. In effect, the existence of suitable infrastructure reduces transaction costs, improves trade reliability and creates opportunities for business networking, which generates economies of agglomeration in information and transaction management. All these are critical aspects of business operations, particularly for start-up and small businesses.

- **Competitive and cost-effective access to finance**

SMEs worldwide rely initially on self-financing by entrepreneurs. Then SMEs move on to debt finance and/or venture capital as they establish business records and expand operations. Generally, SMEs have four key

funding requirements: i) initial infrastructure investments,⁹ ii) lumpy operations costs, iii) 'next-step' expansions, and iv) unexpected opportunities requiring quick access to funds.¹⁰

SMEs' access to external sources of funding depends largely on the development of financial markets, the regulatory environment within which financial institutions operate and their ability to assess, manage and price the risks associated with loan products for SMEs. The latter functions take place within a particular socio-economic context, which is in fact determined by the historical patterns of financial intermediation.

Theoretically, a number of analytical paradigms have attempted to explain the complexities and practicalities involved in small-firm financing. As early as the MacMillan Report in 1931, there has been recognition that British small firms suffer from what is termed the 'finance gap'. In a first-world setting like that in the UK, this situation arises when a firm has grown to a size where the use of short-term finance is maximised, but the firm is not big enough to access capital-market funds. By contrast, in developing countries it is probable that such a finance gap arises at even earlier stages of the enterprise's lifecycle.¹¹

Three major hypotheses have emerged that attempt to explain small-firm financial structuring:

- Lifecycle approach
- Pecking-order framework
- Agency theory

⁹ For example premises, machinery and equipment. Such investments play a particularly important role in developing countries, owing to the often inadequate infrastructure in place (especially in rural or peri-urban areas).

¹⁰ Very small and micro-enterprises are also sensitive to income shocks to the household, i.e. a household crisis may cause the owner to transfer capital from the enterprise to the household and thus harm the enterprise. Access to external funding when such events occur would limit the negative impact on the enterprise and thus protect its income-generating capacity

¹¹ See Ismail, S., "SMME vision needs money upfront for risk taking", *Business Report*, 7 March, 2001.

The lifecycle approach, as described by Weston and Brigham (1981), was conceived on the premise of rapid growth and lack of access to the capital market. Small firms were seen as starting out by using only the owners' resources. If these firms survived, the dangers of undercapitalisation would soon appear, and they would then be likely to make use of other sources of funds, such as trade credit and short-term loans from banks. Rapid growth could lead to the problem of illiquidity. '*The dynamic small firm would therefore have to choose between reducing its growth to keep pace with its internally generated funds, acquire a costly stock market quotation, or seek that most elusive form of finance – venture capital.*'¹² The implication of this hypothesis for SMEs is that expanding small firms are likely to experience rising short-term debt and use little or no long-term debt.

The pecking-order framework, propagated by Myers (1984),¹³ suggests that firms finance their needs in a hierarchical fashion, first by using internally available funds, followed by debt and finally, external equity. This preference reflects the relative costs of the various sources of finance. This is particularly applicable to small firms, since the cost of external funds may be even higher than for large firms, for a variety of reasons. This hypothesis implies that there tends to be a negative relationship between profitability and external borrowing by small firms. In other words, assuming a zero growth, firms with high profitability would generate higher levels of internal liquidity, reducing the need for borrowing. Older firms, it may then be hypothesised, would make less use of external finance and, instead, would rely on retained funds.

The agency and informationalist theory focuses on transaction costs, contracting analysis and agency theory following the work of Coase (1937),¹⁴ Jensen and Meckling (1976)¹⁵ and most important, Stiglitz and

¹² Weston, J.F. and E.F. Brigham, *Managerial Finance*, Hindgale: Dryden Press, 1981.

¹³ Myers, S., "The Capital Structure Puzzle", *Journal of Finance*, (34) 3, 1984, pp. 575-592.

¹⁴ Coase, R.H., "The Nature of the Firm", *Economica*, 9, 1937, pp. 386-405.

¹⁵ Jensen, M. and W. Meckling, "Theory of the Firm; Managerial Behaviour, Agency Costs and Capital Structure", *Journal of Financial Economics*, 3, 1976, pp. 305-360.

Weiss (1981).¹⁶ This body of literature gives vital insights into the problems of ownership, management interrelationships and credit rationing. Issues around information asymmetry, moral hazard and adverse selection are likely to arise in contractual arrangements between firms and external providers of finance. These problems may well be more severe, and the associated costs much higher, for small firms than for large ones, given the complexities of monitoring and bonding. Small firms are also subject to the risk of asset substitution which, in practice, means a change in the firm's asset structure. For very small and micro-enterprises this asset substitution may well take place between the enterprise and the owner's household.

Thus, the proximity to the household, lack of legal formalisation, weak financial disclosure and the owner-managed nature of small firms make it hard for lenders to track ongoing changes to the asset base of the small firm. The presence of these problems in small firms may explain the greater use of collateral lending to small firms as a way of dealing with these agency problems. Lenders' strategies for dealing with these problems also add significantly to the cost of dealing with this sector. For a large enterprise the evaluation of an application for finance may be limited to the assessment of an (audited) set of financial statements and supporting documentation provided by the applicant. For SMEs the assessment frequently has to go far beyond this, implying a substantially higher transaction cost.

Besides the different schools of thought that try to explain the financing needs of SMEs, there are also major differences between the needs of SMEs in industrial and developing countries. Table 3 indicates some of these major differences between the UK and lower income countries in respect of the finance made available to SMEs.¹⁷ The degree of competition between banks and the stage of development of the capital markets constitute an important underlying force that may explain these differences between industrial and developing countries.

¹⁶ Stiglitz J.E. and A. Weiss, "Credit Rationing in Markets with Incomplete Information", *American Economic Review*, June 1981, pp. 393- 410.

¹⁷ Cook, *Op. cit.*, April 2000, p.22

Small firms in the UK	Small firms in low-income countries
<ul style="list-style-type: none"> - Small firms have a high reliance on short-term financing through the banking sector. - A low proportion of small firms' assets are financed by shareholders; so debt-to-equity ratios are relatively high compared to larger firms. - Fixed assets are relatively unimportant in the balance sheets of smaller firms. - Trade credit and trade debt are relatively important. - In recent years, leasing and hire purchase and venture capital have become more important. - Small firms have higher transactions costs than larger firms. - Small firms have higher/greater information imperfections than larger firms. - Small firms have poor business planning, a lack of interfirm co-operation and higher transactions costs than larger firms. - Small firms have poor relations with financial institutions. 	<ul style="list-style-type: none"> - Small firms rely on formal and informal sectors for short-term finance. - Family and friends contribute a high proportion towards financing small firms' assets.¹⁸ - Not established. - Not established. - Relatively less important. - Confirmed. - Confirmed. - More significant in developing countries, particularly with respect to financial accounting and management. - Networks have been shown to be important, but little research has been done on relations with financial institutions.

4 SMEs' economic significance in South Africa: a quantitative approximation

An assessment of SMEs' economic significance requires an examination of the various aspects of such business enterprises. This section discusses five features that have socio-economic relevance. As is well known, very little systematic data on SMEs *per se* are available in South Africa. As in many other developing countries, reliance had to be placed on *ad hoc* studies and/or surveys. Therefore, various sources were used to collate a set of indicators about the SME sector. Although inconsistencies in definition do exist, the indicators below highlight the estimated orders of magnitude underlining the contribution that this sector makes to the country's overall socio-economic conditions.

¹⁸ With the evident restriction, though, that many potential entrepreneurs from previously disadvantaged backgrounds cannot find sufficient resources among their families and friends to start their firms.

4.1 Broad features of SMEs in the South African economy

Ntsika¹⁹ provides the most recent sectoral breakdown of South African business enterprises, as summarised in Table 4 below. Of a total of 906 700 firms operating in South Africa, large enterprises constitute only 6 000 in number, or 0,7 per cent of the total. The remainder is made up of SMEs, including survivalist and micro enterprises. Of course, in terms of value added (income generation or GDP), the large firms contribute disproportionately to their numerical share. This, however, should in no way distract from the organic linkages between SMEs and large firms. All large enterprises rely heavily on SMEs' performance for supply and demand reasons.

The Task Group wishes to note that there are substantial differences in the statistics from different reports on the size of the SME sector. Table 5, on the next page, illustrates some of these indicators.

¹⁹ Ntsika, *State of small business in South Africa*, 1999.

Sector	Survivalist	Micro 0 employee	Micro 1-4 empl.	Very small	Small	Medium	Large	Total
Agriculture	14 700 15%	13 600 14%	26 200 27%	17 900 18%	20 900 21%	3 240 3%	1 520 1%	98 100 100%
Mining	1 100 25%	300 7%	2 200 49%	500 11%	131 3%	112 2%	137 3%	4 500 100%
Manufacturing	19 600 19%	30 900 29%	14 800 14%	30 600 29%	4 800 5%	3 840 4%	1 479 1%	106 000 100%
Construction	19 900 23%	27 600 31%	24 100 27%	13 300 15%	2 300 3%	996 1%	320 40%	88 500 100%
Wholesale trade	900 4%	3 200 15%	3 300 16%	8 900 43%	3 270 16%	660 3%	577 3%	20 800 100%
Retail trade	91 700 28%	120 300 37%	53 200 17%	43 300 13%	13 100 4%	970 0,3%	744 0,2%	323 300 100%
Catering & Accommodation	2 300 11%	3 300 15%	5 700 26%	660 30%	3 450 15%	385 1%	124 60%	21 900 100%
Transport	7 600 13%	28 400 48%	14 600 25%	6 200 11%	1 400 2%	293 0,5%	303 0,5%	58 800 100%
Finance & Business services	7 700 10%	25 400 33%	15 100 19%	24 300 31%	4 600 6%	301 0,4%	425 0,5%	77 800 100%
Community, social & personal services	18 900 18%	30 300 28%	23 600 22%	28 400 27%	4 900 5%	525 0,5%	388 0,4%	107 000 100,00%
Total	184 400 20%	283 300 32%	182 800 20%	180 000 20%	58 900 7%	11 322 1%	6 017 1%	906 700 100,00%

Source: Ntsika, *State of Small Business in South Africa*, 1999, p. 50.

Source	Survivalist	Micro	Very small	Small	Medium	Large	Total
Ntsika 1997 totals (as above)	184 400	466 100	180 000	58 900	11 322	6 017	906 700
Business Partners ²⁰	2,3 million		600 000		35 000	Not reported	2,9 million
Management Sciences Group Survey, 1999	960 740	862 580		445 880			2,3 million
Escom Survey, 1999	900 000+ 'in-home businesses'; total 3 million if one includes small/emergent/established farmers						N/A
Statistics SA, 2000 ²¹							1 628 797

²⁰ Per presentation made to DTI's 'SME Reference Group'.

²¹ Quoted by Ntsika, in: "State of Small Business in South Africa", *Annual Review*, 2000, Table 15, p. 32.

The Ntsika numbers *may* therefore be significantly understated. However, these higher estimates simply reinforce the arguments for the importance of the sector and the analysis below is based upon the statistics reported by Ntsika. *It is clear though, that further research is justified in order to accurately quantify the SME sector and describe its subcomponents as this may well have policy implications.*

Figures 1 to 4 on the next page, summarise some additional characteristics of SMEs in South Africa. Some salient features of Table 4 are the following:

- As illustrated in Figures 1 and 2, SMEs are numerically most prevalent in the five sectors of agriculture, retail trade, manufacturing, and community, social and personal services. The construction sector is the sixth-largest field of activity for SMEs.
- In terms of spatial presence, it is noteworthy that in terms of Figure 3, the geographical distribution of SMEs is in line with the national distribution of GDP in the country. The larger the GDP of a province, the higher the number of SMEs. This supports the well-established notion in the literature that SMEs do require collective efficiency, external economies and the benefit of economic agglomeration.
- In terms of racial composition, SMEs are largely dominated by 'white ownership'. This is due mainly to the legacy of the past socio-economic dispensation. It is probable, however, that the pattern is changing, with African, Asian and Coloured ownership (which is prevalent in micro-enterprises) slowly reaching the threshold of SMEs. However, there are no statistics available to confirm this hypothesis.

Figure 1: Estimated total number of SMEs as defined by turnover of R150 000 - R5m

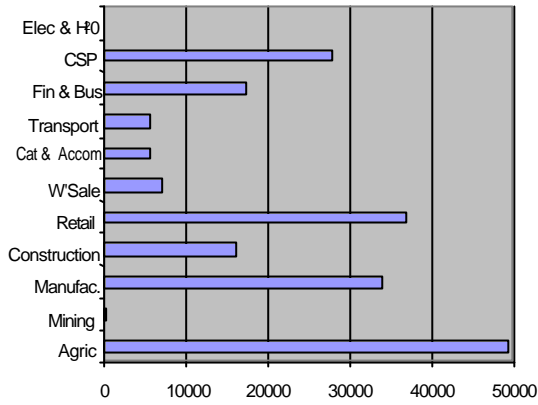


Figure 2: SME sectoral % split (SMEs with a turnover of R150 000 - R5m)

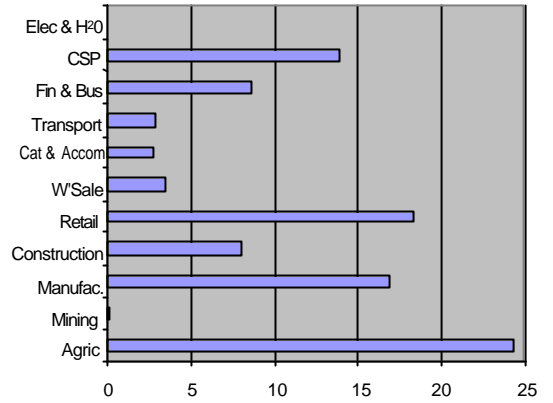


Figure 3: Estimated regional SME % split (SMEs with a turnover of R150 000 - R5m)

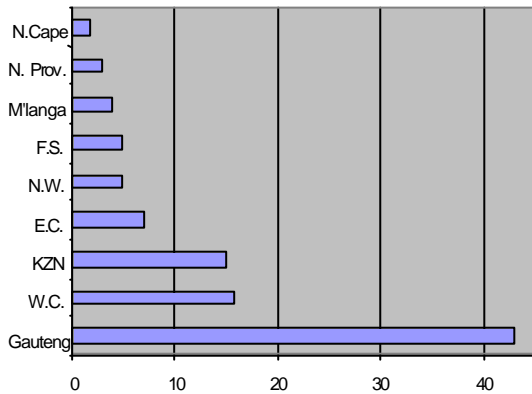
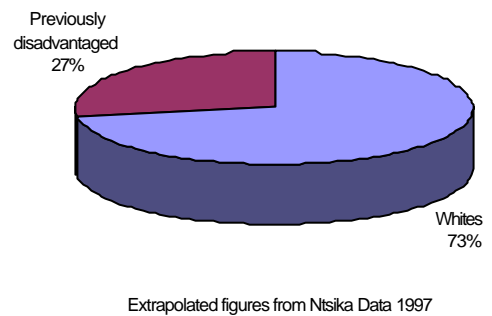


Figure 4: Racial composition of SME sector (SMEs with a turnover of R150 000 - R5m)



Provincial abbreviations:

- N. Cape – Northern Cape
- N.Prov. – Northern Province
- M'langa – Mpumalanga
- F.S. – Free State
- N.W. – North-West Province
- E.C. – Eastern Cape
- KZN – KwaZulu-Natal
- W.C. – Western Cape

Sectoral (SIC) abbreviations:

- Elec & H2O – electricity and water services
- CSP – community, social and personal services
- Transport – transport-related services
- Cat & Accom – catering and accommodation services
- W'sale – wholesale
- Retail – all retail including automotive
- Manufac./Manu – all manufacturing industries

4.2 Gross value added by SMEs

Given the lack of reliable data, estimating the value added by SMEs is a hazardous statistical process. Short of a systematic process of value-added calculation, any methodology is confined to an indirect approximation of SMEs' share of GDP based on a set of assumptions. In what follows, use was made of the aforementioned employment data, for various types of enterprise, to apportion the remuneration component of GDP across firms. The non-wage GDP, generally known as the 'gross operating surplus' is then divided among various enterprise categories by making two sets of assumptions about the relative profitability of enterprise types. For example, it is assumed that a 'survivalist firm' generates no gross operating surplus. Likewise, micro firms are assumed to have 'near-zero' gross operating surpluses.

Using this two-step procedure, indicative estimates were generated for the GDP share of large firms and all other categories of firms. Clearly, this is a crude statistical procedure which, at best, establishes a very broad order of magnitude for the contribution to GDP by these various types of firm. The choice of the 'year' is dictated by the availability of all relevant data for the period under consideration; 1997 was the only year for which employment by categories of firms, as well as the other statistical components, could be collected.

As the estimates in Table 6 illustrates, the share of 'large firms' in South Africa varied between 43 and 48 per cent of GDP in 1997. It is noteworthy that these results differ significantly from those obtained by the Bureau for Economic and Policy Analysis (BEPA) for Ntsika in 2000, who came to a conclusion that large enterprises contributed more than 65 per cent to GDP. Further research is required to explain these types of differences in underlying data.

The contribution of SMEs to GDP, then, is dependent on the definition used. For example, if 'survivalist and micro firms' are excluded, the SMEs' value added would amount to 39 to 42 per cent of GDP in 1997. However, if all

'non-large enterprises' are included, the SMEs share in GDP would vary between 52 to 57 per cent.²²

The actual share that SMEs have in GDP is obviously sensitive to the assumptions made and the definitions used. The statistical approximations, however, demonstrate clearly the material significance of SMEs in the South African economy. In many ways, SMEs constitute the backbone of the economy, with all the obvious consequences for employment.

Value added	Type of enterprise					
	Survivalist	Micro	Very small	Small	Medium	Large
GVA 1 in million R	7 622	81 572	58 061	106 153	93 076	269 312
GVA 2 in million R	7 622	67 721	58 061	92 302	93 076	297 015
GVA 1: % of GDP	1,24	13,25	9,43	17,24	15,11	43,73
GVA 2: % of GDP	1,24	11,00	9,43	14,99	15,11	48,23

Notes on methodology, assumptions and sources of data:

- Total gross value added in 1997 was R615 799 million.
- Total gross value added: compensation of employees was R338 776 million.
- Total gross value added: gross operating surplus was R277 023 million.
- GVA 1 was calculated in two steps: Total compensation of employees in the economy was allocated to the different types of enterprises using, as weights, employment per type of enterprise as a fraction of total employment. The second step was to allocate gross operating surplus to each type of enterprise using the following weights: survivalist 0,0; micro 0,05; very small 0,05; small 0,20; medium 0,20 and large 0,50.
- For GVA 2, the same methodology as above was used in the step 1 calculations.
- For GVA 2, the step 2 weights were: survivalist 0,0; micro 0,0; very small 0,05; small 0,15; medium 0,20 and large 0,60.
- The second half of the table shows the gross value added by each type of enterprise, for the two different calculations of gross operating surplus, expressed as a percentage of overall gross domestic product of the economy.

Sources: Ntsika, *State of small business in South Africa*, 1999; SARB *Quarterly Bulletins*; and Stats SA Releases.

²² Compared to developed countries, this is not a very high result. For example, in France it is estimated that very small and small enterprises (defined as enterprises with fewer than 10 and 50 employees respectively) account for 32 per cent and 24 per cent of GDP respectively. In total the French have 55 per cent compared to South Africa's 37 per cent for those same categories. Source: B. Duchéneaut, *Enquête sur les PME françaises*, 1993.

4.3 SME employment

Table 7 below summarises the latest official survey of employment statistics in South Africa. In terms of the breakdown between large-scale enterprises and SMEs, the data highlight the relative significance of SMEs in the national context.

	No of jobs	% of economically active population	% of jobs
Employment in large-scale firms	3 097 000	25%	39%
Employment in formal SMEs	3 135 000	25%	39%
Employment in informal sector	1 052 000	8%	13%
Employment in domestic service	788 000	6%	10%
Total employed	8 072 000	64%	100%
Total unemployed	4 551 000	36%	
Economically active (extended definition)	12 623 000	100%	
Population aged 15-65 years	22 818 000	-	

Sources: CSS (1998), *Employment and Unemployment in South Africa 1994-1997*, CSS, Pretoria; and Ntsika, *Op. cit.*, 1999.

It is common knowledge that these statistics are subject to some uncertainty. Definitions are again critical in this regard. For example, Ntsika (1999) provides alternative figures indicating an employment share of 43 per cent for 'large-scale firms', but does not include employment in domestic services. If the latter figures are added to the total, the share of large-scale firms in national employment diminishes to about 38,6 per cent of total employment in 1997. This figure is very close to the share of large firms in job creation as shown in Table 7 above. Based on these projections, the share of SMEs in national job creation may be estimated to be at about 62 per cent.²³

As important, over the past few years, is that the trends in large enterprises have been toward unbundling, outsourcing and downsizing, all of which have diminished their share of national employment. At the same time, these efficiency and technology-driven process re-engineering initiatives have increased the relative significance of SMEs in job creation.

²³ This figure is very much in line with the OECD countries. See OECD, *Op. cit.* 1999, p.5.

Furthermore, information technology and the knowledge economy have made it possible for SMEs not only to be job creators, but also to generate high *per capita* value added. This of course applies essentially to those SMEs that are in knowledge-intensive fields.

The structural transformations in the South African economy over the past three decades have increased the economic significance of the tertiary sector to over 65 per cent of GDP at present. Large-scale firms, in turn, dominate the tertiary sector far less. As shown in Table 4 above, only 0,5 per cent of firms in 'Finance and business services', and 0,4 per cent of enterprises in 'Community, social and personal services' are classified as large. The trends in 'technology deepening' are likely to continue, enabling further establishment of SMEs across all economic sectors. The job creation capacity of SMEs is therefore expected to be more robust and increasingly to generate jobs that are skill intensive and well remunerated. Such enterprises are also likely to increase their share of the 'gross operating surplus' in the economy. As such their economic significance, as measured by the percentage share of GDP, is likely to increase over time.

4.4 Gross capital formation by SMEs

SMEs' saving/investment patterns can be estimated only indirectly, based on assumptions about the relative share of SMEs across sectors and the level of capital intensity across firms. Table 8 summarises these estimates based on the assumptions for each sector, as outlined in the notes on methodology below. Once again, the figures are indicative and can be used only to highlight orders of magnitude. With that proviso in mind, the share of SMEs is estimated at 25 per cent of the national fixed capital formation in 2000.²⁴ Compared to SMEs' share in total value added (some 50 per cent) or in employment (in the range of 60 per cent), it is clear that SMEs have a rather low propensity to invest.

²⁴ This compares to 48,2 per cent of gross fixed capital formation by enterprises of fewer than 200 employees in France. See B. Duchéneaut, *Op. cit.*

Table 8: Nominal gross fixed capital formation 2000 (R million)			
Sector	Large enterprises	SMEs	Total
Agriculture	0	4 101	4 101
Mining	10 601	0	10 601
Manufacturing	18 304	12 202	30 506
Electricity	6 980	0	6 980
Construction	606	605	1 211
Wholesale, retail trade, catering and accommodation	2 611	6 091	8 702
Transport	15 480	3 870	19 350
Finance	25 481	6 370	31 851
Community services	17 018	0	17 018
Total	97 081	33 239	130 320
Percentage share of total	74,5	25,5	100,00

Notes on methodology and assumptions:
The following percentage allocation of nominal gross fixed capital formation to large enterprises and SMEs was assumed, respectively:

Agriculture:	0:100
Mining:	100:0
Manufacturing:	60:40
Electricity:	100:0
Construction:	50:50
Wholesale, retail trade, catering and accommodation:	30:70
Transport:	80:20
Finance:	80:20
Community services:	0:100

5 Financing needs of and financing options for SMEs

With a better understanding of the variety and importance of SMEs in the South African economy as presented above, it is now possible to sketch a more realistic picture of the financing needs of South African SMEs, paying tribute to the variety of financing options available at the different growth stages of an enterprise's lifecycle. The following chapters will describe in greater detail the strengths and weaknesses of each financing option in the South African context.

5.1 SME growth phases and funding cycle in a first-world setting

It is widely accepted that not every financing product suits every type of company. Table 9, which was developed for the purpose of UK enterprises, illustrates the financing cycles for different sizes and types of SMEs.

Type of SME	Start-up phase	Growth phase	Stable	Exit for external investor
Traditional, providing income for an individual, family or small group of employees	Family, friends, savings, equity in residential property	Asset-backed finance, factoring, bank debt, trade credit	Often none, but debt if required	n/a
High potential, with growth aspirations	'Angel' finance, team equity, some venture capital	Venture capital, private placement of equity, asset-backed finance, some bank debt	Venture capital; high-yield debt market, bank debt	Either exit via capital markets or direct access to competitive capital markets
Attractive, with high-tech information and life sciences IPR	'Angel' finance, venture capital, corporates	Venture capital, corporates, asset-backed finance	Corporates, bank debt	Exit typically via trade sale
Source: <i>UK Banking Review</i> (cited in Cruickshank Report)				

The financing cycle depicted in Table 9 consists of the following stages:

At the start-up stage, the business is characterised by a heavy reliance on insider finance from owner-managers, family and friends. The motivation for such investments frequently goes beyond financial returns: entrepreneurial ambition and personal ties also play an important part. This is economically rational and efficient, since there is likely to be insufficient information and/or collateral for an external financier to assess the risk. At this stage, therefore, the only external financier who could play a role would be a 'business angel'.²⁵

When trading has been established and growth potential becomes clearer, external equity may be available to a few enterprises in the form of formal venture capital or corporate investment. But statistically, and far more important, the company can contract bank debt. At this stage, it has become possible for the external financier to assess the risk and level of profitability and return on investment.

If the firm reaches stability, it will probably be able to reimburse part or all of its debts. And if it had received external equity, the equity providers would

²⁵ Business-angel finance will be discussed in greater detail in Chapter 2.

now exit, generally via a sale through the securities market or a private sale. If it is large enough, the firm now may have direct access to public capital markets.

At this stage, to investigate more realistically the needs for finance, it becomes important to know how a country's SMEs are distributed across the various categories mentioned above. This, however, depends strongly on the environment. In the US, about 15 per cent of SMEs are likely to fall into the category of 'high potential and attractive', but the Cruickshank Commission believes that the percentage may be lower in the UK.

5.2 SME growth phases and funding cycles in South Africa

Given the third-world setting which prevails for most SMEs in South Africa, their financing needs differ from their counterparts in first-world countries. Consider for instance three factors that affect the availability of various financing options.

5.2.1 Age of SME owners

Although no information is available on the distribution of South Africa's SMEs by age, the available information on company registration suggests that the South African SME population is, on average, much younger than in developed countries.²⁶

South Africa, 2000		France, 1994 ²⁷	
Number of formal enterprises ²⁸	111 149	Start-ups during the year	308 000
Total number of new registrations in Pty Ltd and CCs ²⁹	489 243	Total number of companies	2 166 900
Registration rate	22,7%	Start-up rate	14,2%

²⁶ Statistics on registration concern only the formal sector, but the informal sector is supposedly composed of an even greater number of young enterprises, if one considers the probable high failure rate of these enterprises.

²⁷ Source: Duchéneaut, *Op. cit.*, pp. 359 ff

²⁸ Source: Stats SA, as quoted by Ntsika, in: "State of Small Business in South Africa", *Annual Review*, 2000 in Table 16, p. 32.

²⁹ Source: Registrar of Companies, as quoted by Ntsika, *Op. cit.*, 2000 in Table 18, p. 34.

As a result, there is a strong presumption that the number of companies in the start-up or early growth stage is much higher in South Africa than in any developed country.

5.2.2 Availability of resources among entrepreneurs

Another important specificity of South African companies is the fact that many of them arise from Previously Disadvantaged Individuals (PDI) who, by definition, tend to have fewer resources at their disposal than the average first-world entrepreneur.

The estimates of Ntsika about the share of PDIs among SMEs is as follows (1999):

	Survivalist	Micro	Very small
Number of enterprises	184 400	466 100	180 000
<i>PDIs</i>	<i>163 200</i>	<i>271 200</i>	<i>15 900</i>
<i>Share of PDIs</i>	<i>87%</i>	<i>57%</i>	<i>22%</i>

Obviously, the share of PDIs among owners of very small and small/medium enterprises is much lower in the survivalist and micro sectors. This can be seen, however, as a legacy of the country's history, and is likely to change rapidly in the next few years if the SME support policy is successful.

When designing SME policies, therefore, these PDIs should be at the centre of preoccupations. Indeed, from the point of view of their access to finance, and compared with the resources indicated by the *UK Banking Review*, these PDIs (especially entrepreneurs from African backgrounds) present the following characteristics:

- Little or no savings.
- Little or no access to family finance/neighbourhood finance.
- Little or no valuable investment in residential property.

5.2.3 Growth potential of SMEs

Again, there are no statistics available to evaluate the growth potential of SMEs in South Africa, but the following indicators can be used:

- Innovating firms are likely to grow faster than 'traditional' start-ups. However, research done in this field shows that South African SMEs are less innovative than in developed countries.³⁰
- Because of the frequent lack of domestic markets, exporting firms are likely to have a better growth. But through their concentration in retail, community services and construction, SMEs are unlikely to export much.
- To grow and realise economies of scale, enterprises need fixed assets but the share of SMEs in the formation of fixed capital is much lower than their share in GDP.

These indicators justify the presumption that on average, South African SMEs grow less than first-world SMEs.

³⁰ Refer to Maas, De Coning and Smit, "Identifying factors that can play a meaningful role in promoting creativity in SMEs – a South African study", *SA Journal of Business Management*, Vol. 30 No 3, 1999, pp. 39ff.

5.3 A need for innovative forms of finance

Type of SME	Start-up phase	Growth phase	'Steady state' and exit	Remarks
Minority: Traditional SME (e.g. white-owned family business)	Family, friends, savings, equity in residential property	Asset-backed finance, factoring, bank debt, trade credit	Often none, but debt if required	These enterprises form the majority of white medium-sized firms in South Africa. A number of 'better-off' businesses from PDI backgrounds (e.g. Indian businesses) may also fall into that category.
High number: Emerging enterprise from previously disadvantaged communities	Few resources available – dependence on external funds			For the moment, those enterprises have barely arrived beyond the start-up phase
Minority: High growth enterprises (high-tech, life sciences or any other sector)	Angel finance, team equity, some venture capital, corporates	Venture capital, private equity, asset-backed finance, some bank debt, corporates	High-yield debt market, bank debt, corporates. Exit either via capital markets or via trade sale	Presumably a significant share (30%) of very small and small enterprises belong to this category

Quantifying the importance of the three categories of enterprises is no easy exercise, but guesses are possible. Since Categories 1 and 3 are easier to estimate, subtraction can eventually provide an approximation for the more elusive Category 2.

Category 1:

Probably most of the medium-sized enterprises and between 25 and 40 per cent of small enterprises fall in this category. To them could be added about 10 per cent of very small enterprises, assuming that among the 'emerging' enterprises, some do have sufficient resources to grow largely by

themselves. This would put their number at between 25 000 and 55 000 enterprises.

Category 3:

In the USA 15 per cent of enterprises fall in the category that is internationally recognised as attractive for providers of venture capital. In South Africa, supposedly, this category could represent some 25 to 40 per cent of very small and small enterprises. The sizes of these categories are quantified at 180 000 and 58 000 respectively (see Table 4 above), so the number of attractive companies for venture capitalists could be in the range of 60 000 to 95 000 – possibly up to 150 000.

Category 2:

Rough though they are, the calculations above indicate that probably more than 1 million enterprises (mainly micro- and very small enterprises) fall in Category 2.³¹ Although they may not have the potential for double-digit growth rates over a decade, these firms presumably would be viable and provide sustainable employment if they were sufficiently capitalised.

However, the question of the financing of firms in this 'Category 2' remains tricky: the usual primary sources of finance for such enterprises, i.e. the entrepreneur's own resources, friends and possible collateral, do not allow these businesses to make a good start. Furthermore, traditional debt is not appropriate, mainly owing to the fragility and risk of failure of these enterprises. Traditional venture capital is equally inapplicable, since these enterprises offer neither a sufficient growth potential, nor a good perspective for exit at maturity (who would buy them?). It is for these companies that the financing challenge is most difficult, and requires innovative policies.

³¹ This is a cautious assumption, leaving enough other companies as 'unclassifiable' or hybrid types.

6 Concluding remarks and policy implications

The analyses in this chapter highlight the socio-economic significance of SMEs on the one hand, and the complexities of a SME-friendly environment on the other. Furthermore, they show some of the peculiarities within the South African context as far as financing is concerned, and the need for policies that would cater for the specific realities of the country.

This being said, although it is tempting to reduce the problem of SMEs in South Africa to the issue of finance and access to capital, this would be misleading and, from a policy point of view, counterproductive. SMEs are such an important component of the national socio-economic context that they merit a well-considered and systemically coherent strategic framework.

In view of the generic requirements of SMEs, it may be argued that the overriding concern should be to ensure that the policy and regulatory framework are right. Only then would the institutional set-up have meaning and significance. However, a policy of easing access to financial markets and services would only be fruitful if it takes place in an appropriate setting and is accompanied by suitable non-financial actions.

Referring to the legal framework, Wilkinson argues: *'On the legal side, South Africa can benefit from removal of obstacles to small business lending. These include the Usury Act, opening of legislation to enable a wide variety of financial institutions, and increasing transparency of bank reporting on their lending to SMMEs. An assessment of the legal requirements for opening up a window in the JSE for penny stocks may be useful. Work on collateral legislation and related registry services will be important and should proceed soon. Finally, laws governing debt recovery and administration of justice can be made simpler'*³².

³² Wilkinson, B., Small Business Policy: Options for Finance, Taxation, Labour, and Government Procurement; Expanding Local Options Using Emerging Principles and International Experience: A Review of Recent Literature, SEGA South Africa Project, September 2000, p.11.

CHAPTER 2

SMEs' ACCESS TO EQUITY-BASED FINANCE

1 Introduction

Small businesses, but particularly micro businesses, often do not fulfil the criteria to obtain the required amount of debt finance for longer-term growth. Typical problems are the lack of appropriate collateral, excessive outstanding debt and lack of proven business skills. For business people to obtain an unsecured loan solely on the strength of their character, requires a major leap of faith on the part of the creditor. Usually, such unsecured credit is forthcoming only after some time has passed and against a proven track record of successfully operating one or more small-scale business undertakings for the business person's own account.

At the earliest development stages, the finance of micro and small enterprises is critically dependent on the owners and individuals close to them. As successful SMEs develop, they soon outgrow sources of internal equity and graduate to external capital, including venture capital, corporate investment and bank debt.

In South Africa, as in so many other countries, there is a false perception that an ample supply of debt financing to SMEs will overcome most of their development problems. In practice SMEs with a proven track record hardly ever experience a shortage of debt financing. In the UK, the Cruickshank Commission emphasised the implied consequence thereof, namely that Government interventions in the past to stimulate the provision of debt finance had been misdirected. Public-policy interventions should be reoriented, away from debt-oriented interventions, to emphasise initiatives that support or facilitate the provision of equity to SMEs. Government should therefore support the expansion and/or establishment of venture capital funds.

Differences in the structure of the financial sector and in the profile of the SME universe may require verifying whether these conclusions apply to South Africa (see Chapter 1); i.e. there *may be* insufficient debt finance available to small enterprises.¹ Even then, however, there is a strong presumption that equity finance needs to be promoted.

The Cruickshank Commission found that there was market failure in the provision of small-scale equity finance to SMEs with high potential. The result of this market failure is evident in: (i) insufficient small-scale risk capital being available to SMEs (in particular to high-growth potential SMEs); and (ii) illiquid equity markets for small firms. Cruickshank saw these shortcomings in the equity market as being more significant than access to debt and other financial services. Accordingly, a number of recommendations were made regarding the establishment and/or support of national and regional venture capital funds for SMEs.

2 Principles and issues to be considered in equity finance

This section concentrates on the principles, problems and required incentive structures to promote equity finance for small and micro enterprises.

2.1 The SME target group for equity finance

In terms of the lifecycles and funding cycles of companies and estimates of the proportion of South African SMEs in each category, as described in Chapter 1, Section 5, there are two subgroups of possible 'candidates' for venture capital finance:

- A small group of 'high potential and attractive' enterprises, which are believed to number about 60 000 to 95 000 – possibly up to 150 000 – in South Africa. This category is internationally recognised as attractive for the providers of venture capital or private equity. This is a relatively small number though, with obvious implications for scale and structure for the

¹ Noting though that the enterprises in this category are generally significantly smaller than their UK counterparts.

financiers or venture capital structures wishing to provide finance to this segment. These businesses, however, could contribute significantly to output and productivity growth, and therefore warrant attention which may be out of all proportion to the number of entities involved.

- Besides these high-potential first-world enterprises, in South Africa there is a very large layer of low-growth enterprises, which are under-capitalised and do not currently qualify for debt finance because of their too-low resources. They probably number more than one million, and they require a new type of equity capital because of their particular risk.

2.2 Advantages and disadvantages of equity finance for the SME

The owner-manager of an SME should be fully aware of the characteristics of equity finance and the problems inherent in it. Likewise, if equity finance is the only major source of finance available for small businesses, it is important to create the right incentives to stimulate this form of finance for potentially attractive businesses.

Equity finance, like any other form of external finance, has specific advantages and disadvantages. The major advantages of equity finance are the following:

- Dividends only have to be paid on profits and only to the extent that the company's shareholders decide to distribute dividends, implying that the enterprise is not impairing its cash flow during the initial 'take-off' phase or during cyclical 'downs'.
- The holders of equity are business partners who not only help with funding aspects, but also with financial, corporate governance and management issues in a broader sense.
- The equity capital submitted by shareholders is long-term funding that need not be repaid.²

² It can be repaid, though, in the form of dividends or share buybacks.

- The 'cushion' provided by equity capital augments the firm's ability to contract debt, i.e. it can be leveraged.

The following disadvantages of equity finance also have to be acknowledged:

- An issue of equity results in a dilution of the initial owner's business interests, meaning a smaller share of profits and a smaller percentage of the voting rights for important decisions.
- Shareholders may demand greater disclosure than the owner is willing to make (often for competitive reasons).
- Shareholders may start to interfere in the day-to-day activities of the company.
- Unlike interest, dividends are not deductible from tax.
- If the business is really successful, it might be difficult to buy back the shares of other shareholders or to launch a general share-buyback scheme.

If the enterprise turns out to be successful, the entrepreneur may be tempted to regard the initial equity finance as having been an expensive alternative, although there would have been few or no other choices available at the time. But if the venture fails, the equity route would have been cheap – at least seen from the point of view of the entrepreneur. As a general rule, the riskier the business, the more attractive the equity financing. Only after the business has proven its success over time can it slowly switch to debt finance.

2.3 Advantages of equity finance for the financier

From the point of view of the financier, debt finance for high-risk, high-return business propositions is inappropriate owing to difficulties in assessing the implicit business risk. In practice, the higher interest rate charged does not

easily compensate for these business risks. For example, the initial external financier of an SME takes the risk at the start-up phase and prices for it in the interest rate charged. Those SMEs that are successful, however, will continually assess the cost of this form of finance; eventually they will settle the debt facilities granted by an initial financier and progress towards cheaper finance with the more risk-averse financier. The initial risk-taking financier is therefore not fully rewarded for the risk taken during the start-up phase.³ Because of its long-term binding character, which prevents 'success stories' from leaving too early, equity resolves this problem. Therefore, small amounts of external equity are one of the most appropriate sources of finance for firms wishing to fund high-risk, high-return propositions.

2.4 Transaction cost problem with the provision of small amounts of equity to SMEs

Another important factor, emphasised in the Cruickshank Report because of its aggravating impact on the 'equity gap', is the problem of transaction costs resulting from equity transactions. This problem has mainly the following roots:⁴

- The transaction and administration costs of operating a venture capital fund are largely fixed, irrespective of the amount of the equity required.
- The fixed costs for small amounts of equity constitute a high proportion of the total costs, including the actual cost of the finance.
- To be successful, the fixed costs and the finance costs both have to be paid from the returns earned on the investment.

Therefore, on average, in order to provide the same return to investors, activities that require small amounts of equity need to be capable of delivering higher rates of return than the equity provided in large amounts to

³ See Cruickshank Report, paragraph 6.5 to 6.8, being a systematic analysis of the problems with debt finance granted to high-risk ventures.

⁴ Cruickshank, *Op.Cit.*, paragraph 6.14 and 6.15.

larger firms with a similar risk profile. This, in turn, impacts on the venture capital market, particularly for SMEs that want to raise less than R5 million.

3 'Business-angel' risk capital

3.1 The concept of a business angel

Private investors who invest directly in private unlisted companies, in return for an equity stake, and who perhaps take a seat on the company's board, are often referred to as 'business angels'.⁵ The concept of a business angel is unknown in a fiscal sense in South Africa. Overseas, business-angel risk capital is defined as financial investments made by private persons (individually or in small groups, but not an institution) directly in SMEs. So the term business angel does not apply to the entrepreneur as such, the employees of the company or existing investors or partners. The companies concerned are often of a high-tech and high-risk nature, and the tax incentives are designed to support such entrepreneurial companies. Obviously, these schemes are designed to appeal to high net worth individuals as investors.

The risk capital provided by a business angel plays an important intermediary role in the finance market for SMEs. In essence, business-angel risk capital forms a bridge between internal finance and access to formal venture capital and is often cheaper and more readily available than venture capital, given the lower transaction and due diligence costs involved in individual investments of this type. Business angels have clear industry preferences; they invest in industries that they understand and, usually, operate locally in view of the requirement for local knowledge.⁶

Compared to professional investors, business angels present the following potential drawbacks:

⁵ Two websites that can be accessed are: www.nationalbusangels.org and www.matchco.org.

⁶ In the UK, business angels invest some £650 million annually in around 1,3 million SMEs. This is significantly larger than the investments made by formal venture capital funds in seed, start-up and early-stage enterprises.

- Less time and possibly less experience/systematic procedures for providing management support and for building capacity.
- In most of the cases, probably less diversification of the risks taken.

3.2 International best practices to promote business angels

Tax and other incentives were created in the UK, because it was usually very difficult for companies to raise venture capital for amounts of less than £500 000. The typical investment amount by any one individual is £50 000. The average amount raised by individual companies in this way, however, is around £265 000. The reason for this apparent contradiction is that, often, a group of individuals will come together to provide £50 000 each to a company wishing to raise sums in excess of this amount. The individuals may or may not know one another. Several co-ordinating agencies in the market effectively act as brokers. In effect, a borrower will approach a broker with a request for, say, £300 000. Similarly, individual investors will approach the broker to offer amounts of, say, £50 000. The broker will assemble the package.

Business angels in the UK obtain tax incentives from the Government through the 'Enterprise Investment Scheme' (EIS). The UK Government established the EIS to replace the Business Expansion Scheme and to encourage business angels to invest in certain types of smaller unquoted UK companies.⁷ The EIS is appropriate for individuals (and trustees of certain trusts) who wish to invest in **higher risk small companies**. An investor can benefit from capital gains tax relief by investing sequentially in unquoted companies.⁸

The tax incentives work broadly as follows. On each individual's tax form there is a box to indicate whether the taxpayer is investing in an EIS. If the investor is investing risk capital in a qualifying company (main qualification is

⁷ For further details of 'business angels' in the UK see: www.eisa.org.uk

⁸ The precise rules concerning which companies qualify and what prevents an individual from obtaining EIS relief are complicated. For further details of tax issues see the UK Inland Revenue's website, at www.inlandrevenue.gov.uk/pdfs/ir137.htm .

that it is unlisted) and provided that the investment is held for five years or more, (i) no tax is paid on any dividends received, and (ii) there will be no capital gains tax when the holding is sold. The holding can be repaid in one of the following ways: (i) the investor can sell the stake to another investor; (ii) the company might float itself on the stock market, (iii) the company might buy back the shares itself; or (iv) the company might be bought by another company. In any one of these ways, the investor might make a capital gain on which no tax is paid.⁹

The current assessment is that the EIS scheme has had limited success, though more growth is anticipated in future. The obvious problem is that this is high-risk investment and the information problems and search costs for the investor are high. Even then, though, the total amount of funding for SMEs through business angels is reported to be substantially higher than the SME funding provided by formal venture capital funds.

Besides tax incentives, governments could also assist business angels by providing information-gathering services. For example, in Australia and the UK, there are extensive databases on the Internet for business angels.¹⁰ These systems match the various business criteria – such as skills, capital requirements, or growth potential per sector – between the SMEs and the business angels. The matchmaking service is often a non-profit organisation, which enables business angels to advertise anonymously, access a large database, become involved with managers and consultants and receive regular updates on new company developments. Setting up such an infrastructure for matchmaking may be too expensive for small business,

⁹ More specifically there are four types of EIS tax relief:

An investor can **reduce his/her income-tax liability** by an amount equal to 20 per cent of his/her share subscription. The minimum subscription is £500 per company, and the maximum per investor is £150 000 per annum.

Deferral of gains realised on a different asset, where disposal of that asset occurred less than 36 months before the EIS investment or less than 12 months after the investment (i.e. deferral relief).

No capital gains tax payable on disposal of shares **after three years**, provided that the initial EIS income-tax relief was given and not withdrawn.

If EIS shares are disposed of at any time at a loss, such loss can be offset against the investor's capital gains or income in the year of disposal.

¹⁰ For further details see, for instance, www.businessangels.com.au; www.venturesite.co.uk; or www.venturenetwork.oracle.com.

since the returns on such a project are of a more public nature. Accordingly, the creation of an 'innovation capital' hub for private investors to find business opportunities and business partners could be a government-sponsored initiative, with long-term benefits for the community that would greatly exceed the costs of such initiative.¹¹

3.3 The situation in South Africa

Compared to other developing countries, South Africa has the advantage of having a number of 'high net worth individuals', some of them with the potential of acting as business angels. This gives business angels a true responsibility to make up for the scarce savings available to financial institutions, and therefore fill a gap.

In practice, it is reported that a number of business angels have invested in small companies on an *ad hoc* basis, and a few platforms have been created, in the form of NGOs or private companies, to advertise investment opportunities among them (in Cape Town, Omegamatch, Matchmakers or Promethium). In spite of these initiatives, very little information is available about the number of active business angels, the amount and nature of their investments and the functioning of their networks.

However, there are apparently the following problems:

- Business angels do not receive any form of fiscal support in South Africa. As mentioned above, special tax incentives are available to business angels in the UK.
- Access to an 'innovation capital' hub advertising business opportunities could be improved. South African non-profit matchmaking services for small companies seeking equity finance and business-angel investors, such as those in Australia and the UK, should be supported.

¹¹ In the UK and other European Union states there has also been frequent criticism of these interventions, and in certain countries they were discontinued. Scrutiny of the arguments put forward may shed light on the appropriate course of action in the South African environment.

- Although business angels usually decide about their investment mainly on the basis of the technology, the idea, and the skills of the entrepreneur, it is probable that, in the particular context of South Africa, they would also consider financing factors. However, business angels may find the cost of access to the private-sector credit bureaux in South Africa prohibitive, in relation to the relevance of the information such bureaux contain. Note that credit bureau information in South Africa is aimed primarily at the extension of consumer credit to individuals and may therefore exclude most of the information relevant to SME risk. Furthermore, the business information kept by credit bureaux is not well developed.¹²
- Business angels find it difficult to sell their investments in SMEs to larger investors if the business is successful, because the venture capital market is not fully developed in this respect in South Africa.

Undoubtedly, the introduction of incentive schemes such as those described above would facilitate the provision of capital through business angels. As to further actions to protect the investors against the risk they are taking, the future will tell whether this is necessary and in what form.

4 Venture-capital market and relevance of the regulatory environment

4.1 International experience with venture capital

This section describes the evolution of venture-capital investments, and the supportive effect that has resulted, in many countries, from a more conducive IPO environment.

¹² For comparison, access to information is much easier in developed countries. In Europe, France has one of the most far-reaching requirements, obliging even private companies fulfilling certain criteria, to deliver their annual accounts to the Tribunal du Commerce, from where they are in the public domain. In the United States, too, many agencies pool credit-scoring information about SMEs, such as the 'Risk Management Association' (RMA).

4.1.1 The development of venture-capital investments

For South African venture capital, it is probable that European experiences provide, in many respects, a more suitable basis for comparison than the US market which is 'unique'. Likewise the Israeli venture capital development could also be of interest, as it appears that Israel has, to an extent, a similar situation as South Africa, with a narrow upper end of the market and few possibilities for domestic exits.

The main highlights of the evolution of European venture capital were as follows in 2000:¹³

- Funds raised reached an all-time high at ?48 billion, i.e. up by 89 per cent.
- A new record was set for investments, which totalled ?35 billion, i.e. up by 39 per cent.
- European investment portfolio now stands at ?94 billion.
- Pension funds overtook banks as the largest source of capital (more than doubling their contribution from the previous year).
- Domestic sources raised over half of the venture capital, and almost 70 per cent of the funds raised were from independent investors.
- Substantially more funds were raised for high-tech and buy-out investments. Start-up investments, however, more than doubled to ?5,8 billion.
- Nearly 80 per cent of the companies invested in, employ fewer than 100 people.

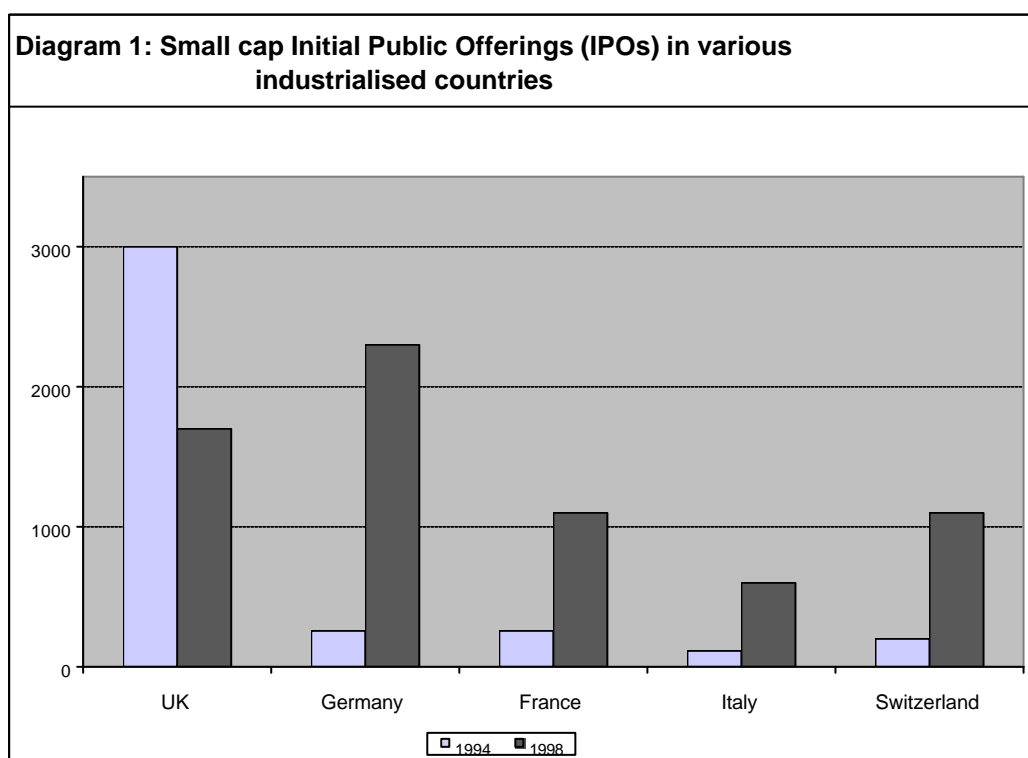
It is interesting, at this stage, to consider the likely effect of this growth on the quality of management support granted to investors. Start-up entrepreneurs are often commercially inexperienced. In giving managerial advice, venture capitalists can enhance the success of innovative but highly risky ventures. The supply of experienced venture capitalists is not easily increased, however. When the rate of business formation accelerates, the incumbent venture capitalists tend to include more firms in their portfolio, and this dilutes the quality of advice, and also makes project risks excessively high in the

¹³ Source: European Venture Capital Association, Yearbook 2001, pp.39-47.

short term. Through appropriate qualification and incentive measures, though, the supply of advisory capacity may eventually become elastic, as new venture capitalists are attracted to the industry. Company portfolios would in such a case again tend to become more focused, the quality of advice would be restored and the risk of business failure would decline.

4.1.2 *New securities exchange regulations have opened exit opportunities to venture capitalists*

The regulatory framework for equity markets can support or stifle access to SME capital. For example, in the UK market, small-capital initial public offerings (IPOs) decreased from 3 000 in 1994 to 1 700 in 1998, suggesting a slowdown of the market. In Germany, Switzerland, France and Italy, however, such offerings all showed remarkable increases, from 800 in 1994 to a total of 5 100 in 1998 (see Diagram 1).



Likewise, the US markets are better able to raise capital for innovative, high-return projects than the UK, as reflected for example in the Nasdaq's success in attracting investors to fund the continued growth of venture-backed

enterprises. Between 1992 and 1997, there were 1 200 venture-backed IPOs in the US, as opposed to 244 in the UK and only 156 in the rest of Europe.¹⁴

- In 1997 the Neuer Markt was established in Germany to create an opportunity for innovative growth companies to access the capital markets. The key reform was to allow companies with only two years of financials to list. A committee that could determine the suitability of the company oversaw the listing process. To make up for a shorter financial history, companies had to be highly transparent, compliant with either the US or the international accounting standards, hold annual analyst meetings and publish quarterly reports. One of the key objectives (other than to imitate the Nasdaq) was to create exit opportunities for the venture-capital industry.

The IPO market in the remaining countries of Continental Europe also benefited from changes to the equity culture. For example, mutual funds were able to participate very profitably in the IPOs and were also keen to invest in these 'new economy' stocks.

Up to 1999, the IPO experience was fairly encouraging in Europe and the US:

- The combination of less history and more disclosure seems to have been successful from the perspective of market development, and investors do not seem to have suffered.
- The market benefited greatly from the change in equity culture within Europe.

The recent worldwide collapse of technology markets and venture capital securities obliges one to avoid naïve optimism. In particular, the latest statistics of the EVCA show that, in 2000:

- although the number of companies divested by venture capital funds by way of IPOs increased from 149 to 249,
- the proceeds of IPOs declined 36 per cent to ?573 million,

¹⁴ Cruickshank Report, paragraph 6.19.

- it strongly suggests that the performance of IPOs has been much poorer than in 1999.

However, it may simply be a sign that, with their particular systemic risk ($\beta > 1$), SME and technology shares are volatile and have a more cyclical pattern than the average.

4.1.3 The problems of increasing deal size

For Europe, the latest EVCA statistics point to a dramatic increase of deal size, as shown in Table 1.

Table 1: Venture capital: amount invested and number of investments in 1999/2000							
	1999			2000			Increase in average amount
	Amount	Number	Average amount per investment	Amount	Number	Average amount per investment	
	Euro m		Euro m	Euro m		Euro m	(%)
UK	11501	2309	4.98	13180	1980	6.66	33.6
France	2817	2545	1.11	5304	2994	1.77	60.0
Germany	3159	2081	1.52	4767	3012	1.58	4.3
Italy	1779	390	4.56	2969	646	4.60	0.8
Sweden	1277	819	1.56	2300	702	3.28	110.1
Netherland	1710	872	1.96	1916	789	2.43	23.8
Other	2873	2237	1.28	4550	2984	1.52	18.7
Europe total	25116	11253	2.23	34986	13107	2.67	19.6

The increase in deal size is problematic for the financing of start-up and very small enterprises, as it means that early-stage finance is decreasing while development capital and management buy-outs or buy-ins (i.e. the so-called MBO-MBI deals) become more important. The Cruickshank Commission came to the following general conclusion about venture capital in the UK: *'Commercial trends in the UK are tending to raise the average deal size, increasing the number of companies who may be adversely affected by the equity gap market failure between bank and business angel finance on the one hand and formal venture capital on the other. This is precisely the market in which venture funds consistently and for good economic reasons find it difficult to make sustainable returns. The market failure occurs because the*

transaction and running costs of funds aiming to provide around £500 000 of equity are higher than the recipient firms can reasonably support. The US market, where the Small Business Administration has been instrumental in developing small scale venture capital for the past 40 years, shows that long term commitment to public-private financing is necessary.'

4.1.4 Conclusion: does the supply of venture capital match demand?

In the euphoria of the previous few years of the development of venture capital in Europe, it may be said that, for the first time, there seems to be more venture capital than venture opportunities in Europe. Such a statement, though, should be considered with caution, and the following counter-arguments could be raised:

- Venture capitalists are only now starting to develop 'deal-generating networks' in order to better seize the opportunities of the markets. To date, the deals that came to fruition were only a fraction of those that could have been realised.
- Companies focusing on start-up and early-stage investments tend to satisfy only a tiny proportion of the requests for finance they receive (and this, without investing too much into their marketing network). As an example, Sofinnova Partners¹⁵ indicate that they receive approximately 2 000 venture opportunities a year and serve only six. This suggests an extremely low realisation rate.

It is therefore important to be aware of the extremely small capacity of venture capital firms. Having neither the dimension, refinancing facilities, the retail network nor the staff of a commercial bank, these firms will always be constrained in their financing and in their management capacity. To remove the equity gap, even in a region like Europe where the needs by far do not reach the South African demand, a huge structural transformation would be required.

¹⁵ One of the leading venture capital firms in France.

4.2 The South African experience with venture capital

4.2.1 *Compared to its GDP, South Africa has one of the largest venture-capital markets*

Looking at the formal venture-capital markets in South Africa, the lay person can find several pleasant surprises:

- Compared to the size of the economy, the South African venture-capital sector is one of the most developed, with 4,2 per cent of GDP or R33,1 billion under management. This compares to only 2,3 per cent of GDP in the UK or 1,3 per cent in the Netherlands. Only in Israel (with VC funds under management amounting to 12,1 per cent of GDP) and the USA (4,9 per cent) is the venture capital market relatively more significant than in South Africa.¹⁶
- Fortunately, although deal size is also increasing, the worldwide shifting of funds towards later-stage investments is not dominant in South Africa, with as much as 25 per cent of the investments in 2000 being done in seed, start-up and early-stage capital. In previous years, however, the share of seed, start-up and early-stage investment was much lower, with 6 per cent of cumulative investments until 1999.
- There may be measurement differences, but the performance of SA venture capital funds is healthy and in line with international rates of return (from 14 funds reporting to KPMG/SAVCA, ten stated an internal rate of return exceeding 15 per cent, and six even exceeded 40 per cent).
- Although there is no known value or estimate of the management advice provided by venture capitalists to their invested companies, it is probable that the 'skill improvement' effect of venture capital was a significant additional benefit.

Positive though these figures may be, it is clear that the R3,4 billion remains limited compared to the extent of the needs. Though positive, venture-capital

¹⁶ See KPMG and SAVCA's joint 2000 Private Equity Survey, published in April 2001 and downloadable on www.kpmg.co.za

funds make a limited contribution to the equity gap problem in this country. Even more alarming is the fact that the growth of the market seems to be slowing down, for probably two reasons:

- The weakness of exit possibilities for venture-capital funds (see 4.2.2 below).
- The lack of incentives for third parties to invest in venture-capital funds (see 4.2.3 below).

4.2.2 Exit possibilities remain narrow

A venture-capital fund has generally two options for selling its participation in a company: through an initial public offering (IPO) or a private sale (trade sale).

Private sales are merger and acquisition (M&A) transactions, in which one buyer (or, in some cases, several buyers) purchase the venture capitalist's shares in a company. If they are to succeed, however, it is important to have a certain liquidity in the market for private companies. According to Ernst & Young's findings in their annual survey on M&A activity in South Africa, the high growth of M&A transactions recorded between 1995 and 1998 (at an average annual rate of 93 per cent) is now slowing down (average increase of 8,7 per cent between 1998 and 2000). It is hoped that a steeper upward trend will reappear.

The situation appears to be even more difficult for a public sale. Recognising the need to encourage the growth of small to medium-sized businesses, the JSE Securities Exchange South Africa (JSE) created the Development Capital Market (DCM) in 1984, and added the Venture Capital Market (VCM) in 1989. The DCM requires somewhat more capital, quality and evidence of sustainability than the VCM, and the concept is that the VCM ranks above the DCM in the progression from owner through to the main board of the stock exchange.

It is expected that DCM companies will use the capital raised to expand to a level at which they meet the requirements for a listing on the main board,

whereas the VCM is designed to assist companies specialising in venture-capital projects (venture-capital conglomerates) or single-venture companies.

The listing requirements for companies on the VCM and DCM boards are significantly less onerous than for those that aspire to the main board, as shown in Table 2.¹⁷

Table 2: Listing requirements for the VCM and DCM		
	VCM	DCM
Subscribed capital, excluding revaluations of assets	At least R500 000, in the form of not less than one million shares in issue.	At least R1 million, in the form of not less than one million shares in issue.
Entrepreneurs' commitment	The entrepreneur to remain financially committed to the venture and JSE will not list securities held by the entrepreneurs of the company amounting to 75% of their shareholding for at least two years subsequent to the listing being granted.	No restriction. Owner can liquidate his/her shareholding at any time
Profit history	No profit history is required, but the venture capital company should indicate, in its analysis of future earnings, credible returns on capital, which on a time-weighted basis are above average.	A satisfactory profit history for the preceding two years (or, in exceptional circumstances, a lesser period), the last of which reported an audited profit level of at least R500 000 before taxation (mineral companies are exempt from this requirement).
Public holding of shares	Minimum of 5% of each class of shares is to be held by the public.	A minimum of 10% of each class of equity shares in issue to be held by the public.
Number of shareholders	A minimum of 75 public shareholders is required for the equity shares.	
Issue price	The minimum initial price of the shares is to be not less than 50 cents per share.	

In spite of the relatively relaxed requirements for the DCM and the VCM, the markets have not been successful. Only 63 companies are currently listed on the VCM and DCM boards of the JSE (19 on the DCM and 44 on the VCM), representing a market capitalisation of R2 billion (DCM R0,6 billion and VCM R1,4 billion). Migration from the DCM to the main board has been disappointing over the years.

A number of factors impede the development of the VCM and the DCM in South Africa:

¹⁷ Information on listing requirements supplied by the JSE Securities Exchange SA.

- The transparency criteria of the VCM and the DCM are far less onerous than those used abroad. This has led to inferior quality listings, subsequent poor performance of these stocks and, ultimately, to a lack of confidence in and credibility for the venture capital sector of the JSE.
- Restrictions are imposed on pension funds and insurance companies, as they may not invest more than 5 per cent of their portfolio in private companies.
- Liquidity on the VCM and the DCM is very low, and the VCM has turned over just R500 000 a day and the DCM around R50 000 a day, on average, during the past six months. There are long periods of no turnover whatsoever on the DCM and also days of inactivity on the VCM. Investors are naturally less inclined to invest where they cannot vary and reduce their exposures to particular counters, so they prefer to stay away from these markets.
- The venture-capital market has a poor image in the eyes of the investor community. This is partly due to the inevitable higher risk of these markets. What is needed, however, is for investors to develop the ability to price the market accurately for the risk inherent therein. Another reason for the poor perceptions of the VCM/DCM markets is the expectation, not always valid, that the corporate governance of the companies listed there is not of the same standard as of the companies listed on the main board.

The VCM could be stimulated by the following measures:

- Educating the investment community about the true value and risks to be found in venture-capital companies could improve investors' appetite for such investments.
- Possibly, the introduction of markets that focus on illiquid, small capitalisation stocks (not necessarily only DCM and VCM stocks, but also stocks on the main board with a longer track record, but still qualifying as small companies) could help to stimulate the market. The question could

be asked whether the same trading system that works for relatively liquid stocks (that is, the top forty index companies and the other more liquid stocks on the main board) would be effective for the less liquid counters, including the DCM/VCM stocks. Perhaps a somewhat less sophisticated auction-based system, which concentrates liquidity within a short time window each day, might serve the purposes of these stocks more effectively.

- The market should also be made readily and cheaply available to a broad cross-section of investors. Internet technology would be the ideal medium to achieve this goal. The speed of transaction needed for highly liquid stocks is not required for an auction-based system that would suit the small-cap stocks. Despite its limitations in South Africa today, the Internet still provides a sufficiently rapid channel for the trading of small-cap stocks. Although South Africa does not have the bandwidths to provide the speed of data transmission obtainable in countries such as the UK and the United States, technology is changing rapidly.¹⁸ The regulatory authorities should keep an open mind about the application of Internet technology by existing and yet-to-be-established financial and stock exchanges.
- A different taxation regime could be permitted for investors in DCM and VCM companies listed on recognised exchanges for such companies.

4.2.3 Lack of incentives for third parties to invest in venture capital

When comparing the sources of third-party funding of the venture-capital industry in South Africa, Europe and the USA, it is clear that though pension funds, banks and insurance companies provide 67 per cent of all third-party funds (more than in Europe and USA), South Africa is particularly weak in attracting contributions from individuals or corporates (see Table 3).

¹⁸ Low level geo-stationary satellites and the proliferation of fibre-optic cabling will produce bandwidth and data-transmission speeds that will eventually compete with those of the dedicated lines needed for trade in liquid instruments in South Africa.

In percentages	South Africa (2000)	Europe (1999)	USA (1999)
Pension and endowment	28	19	47
Banks and insurance companies	39	42	14
Government and aid agencies	6	5	0
Private individuals	4	6	23
Fund of funds	8	4	0
Other, including corporates	15	24	16

A campaign promoting the social benefits of venture-capital investments could contribute to widening this source of capital, especially as far as high-income individuals are concerned. For the protection of small savings and lower-income population layers, it should be explained, however, that venture capital is a risky investment not appropriate for 'uneducated investors'.

Lastly, SMEs could be assisted powerfully if the prudential regulations of institutional investors were to allow for these types of high-risk high-return investment. Currently, institutional investors in South Africa have a very limited choice regarding the full risk/return spectrum. Provided high-risk high-return investments are a relatively small part of the overall portfolio of institutional investors, there is a definite place for them. Considering the importance of SMEs in the overall economy, this market segment should not be ignored from a prudential viewpoint.

4.2.4 Venture capital for low-resource low-growth enterprises

There is a large group of low-resource emerging enterprises, which represent a high employment potential, but do not have the growth potential that venture-capital investors generally expect. Those enterprises can neither afford traditional venture capital (owing to their modest growth), nor debt (which would over-leverage their balance sheets). Even business-angel capital is not likely to help them, since they often need more systematic management support than a business angel is likely to provide to them.

¹⁹ Source: KPMG/SAVCA Private Equity Survey 2000 – The US figures, which are from NVCA, do not separately measure contributions from fund of funds and government institutions and aid agencies.

What type of finance can be made available to them remains a difficult question, but if these enterprises are to be supported, then an 'innovative form of venture capital' appears to be an interesting proposition.

The initiative of Greenfields Venture Capital, Cape Town, deserves attention. Recognising the potential of those 'low-resource low-growth enterprises', this venture capital company is currently launching a new fund that will provide to such companies the equity capital they need and intensive management support. Typically, such businesses would be franchise outlets, coffee shops, restaurants or service stations.²⁰

Briefly, it was envisaged that the fund would be subject to the following investment criteria:

- *Stage of investment*: the business must have a trading history of at least one year.
- *Investment range*: between R100 000 and R2 million.
- *Type of investment*: equity only of between 25 per cent and 49 per cent.
- *IRR required*: at least 10 per cent p.a.

Since these firms do not, by themselves, generate the value creation that venture capital funds need to cover their costs of capital, Greenfields is asking the Western Cape government to support a pilot project, in order to remunerate the investors for their contribution to the transition of these enterprises to a formal and businesslike sector. This appears to be a promising new trend in the quest for SMME financing. The government should support this and similar initiatives, at least on a 'pilot test' basis.

5 Limitations on equity finance

Except for the above-mentioned initiative that remains marginal, only companies of some minimum size (say, around R2 million in turnover) have access to the venture-capital/private equity market. Therefore alternative

²⁰ Ganief Galiel, Director of Greenfields Venture Capital, terms these enterprises 'lifestyle' opportunities.

sources of equity finance remain crucial for the vast majority of SMEs in South Africa.

As in the UK, South Africa should start to develop a business-angel culture, which in turn would encourage private investors to finance small or micro businesses directly. Fiscal assistance may therefore be required to encourage such investment more meaningfully. Moreover, the appropriate balance between equity and debt finance is not easily solved for SMEs. Cruickshank makes the following important remarks about the limitations of debt finance in this context:

*'So for firms wishing to fund high risk, high return propositions, small amounts of external equity are often the most appropriate source of finance. But there are well known and long established problems in the private provision of small-scale risk capital in the UK and elsewhere. These problems have at their heart the information asymmetry between investors and the firms, the degree of risk involved in financing relatively fragile firms, and the costs for the investor in obtaining information and structuring finance accordingly.'*²¹

Accordingly, the important role of equity-based financing for SMEs and, therefore, the possible role of business angels and the venture-capital markets in such financing should not be underestimated.

6 Incentive structures to overcome local problems with equity finance

In order to develop SMEs in South Africa, it is vital to support the creation of a local business-angel culture. At the same time, the venture-capital market on the JSE and, possibly, on the Internet has to be revived. The private and the public sector both have an important role to play in this regard.

²¹ Cruickshank, paragraph 6.5 – 6.8

6.1 Summary of current problems

In South Africa, as noted above, business angels are still an unknown fiscal concept, and the venture-capital market is still poorly developed on the JSE. Generally, entrepreneurs are more willing to make direct investments in SMEs if they have sufficient information to make a considered risk assessment of the SME and if at least some of this risk can be shared with the government.²² The main reasons for the lack of equity financing have been mentioned, but can be summarised as follows:

- Insufficient recognition of the business angel (fiscal treatment, information and networking support).
- Perceptions of venture companies remain poor in South Africa and a proper public relations exercise could enhance the profile of this sector.

6.2 Private-sector initiatives to support business angels and the venture- capital markets

Private-sector initiatives flow mainly from the banking sector, since banks are *de facto* not only the major creditors in the country, but also the major securities firms on the JSE. Banks could help business angels in the following ways:²³

- Facilitate or legislate greater information sharing by banks and other credit providers on SME debt profile and repayment performance.
- Support growth of the business-angel concept by providing local or regional low-cost Internet-based bulletin boards or electronic meeting rooms, where venture-capital firms and business angels could be introduced to one another electronically (if they are not already in place).
- At a later stage, when a sustainable venture-capital culture is established among corporates and private persons, support the venture-capital

²² Particularly if public policy wants a specific SME development to take place, for example, in areas where unemployment is high.

²³ Provided of course that the regulatory authorities ensure that the banks do not manipulate the information and access thereto for competitive reasons.

market by establishing an Internet exchange specialising in trade in venture capital.

6.3 Public sector initiatives to support business angels and the venture-capital markets

In the public sector the major players able to give *equity-based* support to SMEs are the Department of Trade and Industry and the National Treasury.

The Department of Trade and Industry

The following issues need to be addressed:

- Incentives should be given to create a non-profit matchmaking service for business-angel investors
- Government support for a forum to link SME-related parties would be desirable.²⁴
- In the regulatory environment for credit bureaux, consideration should be given to the extent to which credit bureaux meet the information needs that would facilitate greater SME lending.

The National Treasury

- Fiscal support for business angels. The tax incentives given in the UK could be used as an example in this context.
- Recognition for the creation of venture capital as an accepted form of prudential investment for institutional investors, within certain limits.
- Linking the freeing of blocked rand investments with business-angel capital.
- Establishment of a public financial information agency and/or improvement of accessibility of small enterprises' financials to interested parties, as soon as possible.

²⁴ For example, similar to the Oracle Venture Network

CHAPTER 3

SMEs' ACCESS TO BANKING SERVICES

1 Introduction

Although it is generally accepted that most SMEs lack sufficient **equity finance**, it is not certain whether there is a similar lack of **debt finance** for SMEs. For example, the Task Group found no indication that the quantum of debt finance available to SMEs that have a turnover of more than R2 million is insufficient,¹ and although there is a presumption that such debt finance might be skewed towards too-short maturities, there is still a need to produce evidence on this.

The problem is not so much the availability of debt finance as such, but inefficiencies in terms of product range, the cost of debt finance and the service provided to SMEs. The reasons for these inefficiencies relate mainly to competitive factors, to barriers to the entry of potential new providers of financial services and to SMEs' need for non-financial services.

A crucial thrust of this chapter is the recognition that, for SMEs, access to debt cannot be separated from the broader topic of access to banking services. This is not peculiar to South Africa; developed countries are also discussing the connection between money-transmission facilities and access to loans.² However, the complexity in South Africa is increased by the

¹ For micro enterprises the picture is very different as this market segment is better financed with equity capital – rather than debt finance.

² The Cruickshank Commission found in the UK: *'Banks are able to continue to exercise market power because current account services and term loans are generally sold in a bundle. There are good reasons for doing this. The bank is able to price the risk of a loan more accurately when it has a long transaction history. Empirical evidence suggests that this advantage is real: SMEs tend to get relatively better loan rates the longer they remain with a bank. The overall effect of bundling therefore may give some individual SMEs a relative advantage, but it also means that a small number of banks can collectively exercise market power over the SME population as a whole.'*

confusion between enterprise and personal (owner's) finance, which is presumably greater than in developed countries.

This chapter will therefore embrace the following three interrelated markets:

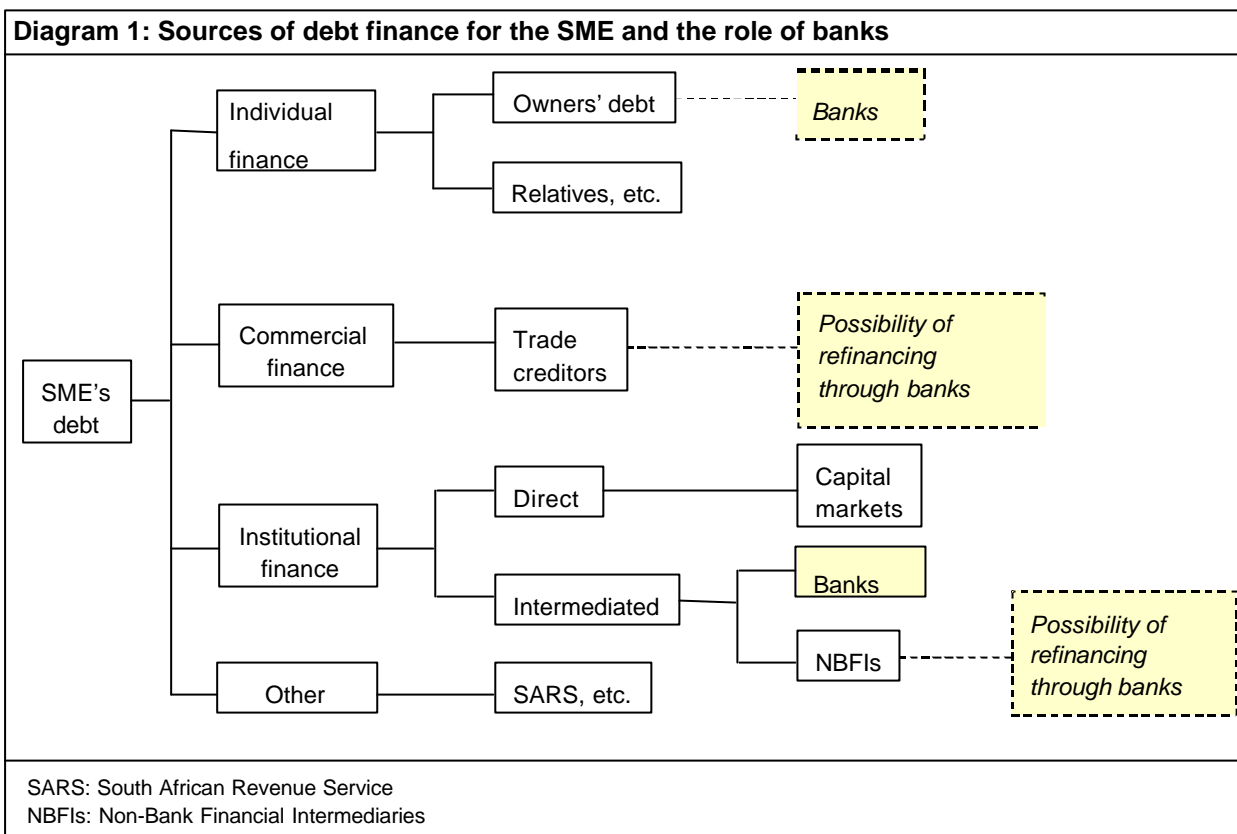
- Money transmission. This is the flow of money between firms, individuals and Government through the national (and international) payment systems. The main methods of money transmission include ATMs, credit cards and debit cards, cheques, direct debits and standing orders, as well as high-value payments and specific procedures for international transfers.
- Services to personal customers. The main services here are current accounts, savings products, personal loans, mortgages, debit cards and credit cards.
- Services to SMEs. These entail mainly current accounts, deposit facilities, and external finance.

The contents of this chapter can be outlined as follows: Section 2 reviews the various topics related to debt finance to SMEs and the role of banks in a multi-player scheme. Section 3 examines more specifically the costs and quality of banking services and structural measures that could lead to improved competition in the market, as well as to redressing issues. Section 4 considers the particular role to be played by the Postbank. Section 5 is a summary of recommendations.

2 The role of banks in providing debt finance to SMEs

2.1 The bank as part of a multi-player scheme

Contrary to a common perception, a bank is by far not the only source of debt finance for SMEs. In fact, using a tree-chart structure as depicted in Diagram 1, the multiplicity of options and players in the provision of debt finance to SMEs can be represented (though this is not an exhaustive scheme):

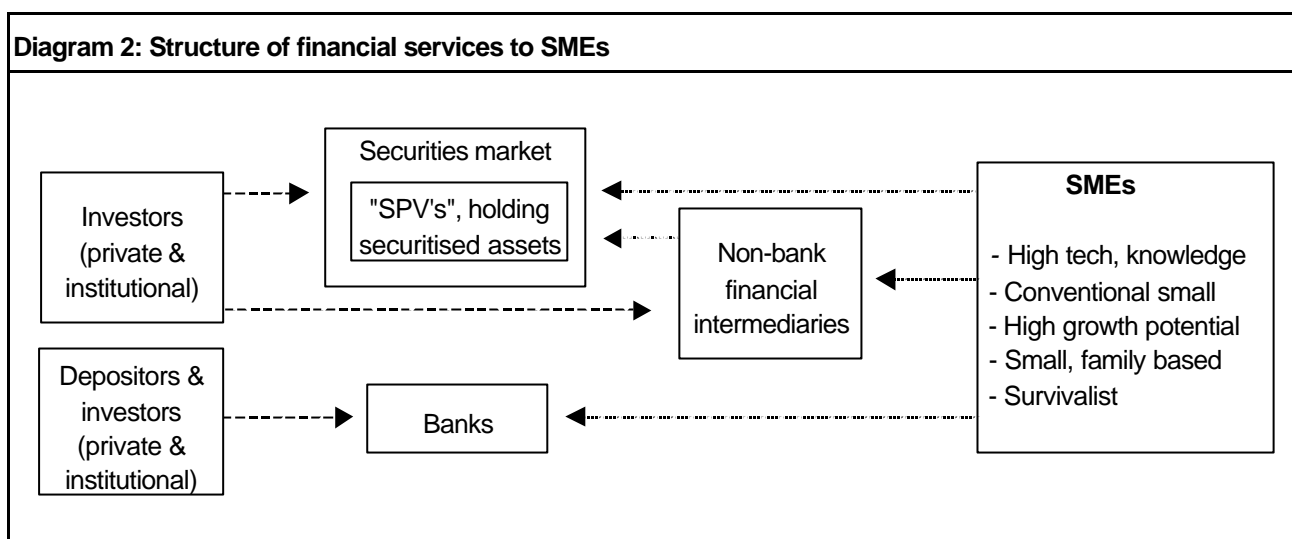


The following sections describe in more detail the impact of the following issues on SME finance: (a) owner's access to credit, (b) direct access to capital markets, (c) bank products themselves and (d) non-bank intermediation. Though trade credit would also be a sensitive issue, it will not be treated separately in this Report, but since trade creditors are often SMEs themselves, every direct or indirect contribution of banks to the financing of SMEs stimulates the provision of trade credit.

2.1.1 Business owner's access to credit

Since the largest proportion of SME finance is internal (particularly during the start-up phase), the provision of finance for micro- and small enterprises is intrinsically linked to access to **personal finance** in the banking sector and micro-lending industries. Nearly all micro- and small enterprises, and even the majority of medium-sized enterprises, have to access debt finance in the names of the owners (i.e. in their personal capacities).

2.1.2 Direct financing of SMEs on the capital markets



In principle, any SME looking for debt finance can either approach investors **directly** in the capital market (for example, in the securitised-asset market) or approach ultimate investors **indirectly**, through a financial intermediary (usually a bank, but also, say, an insurer). Even if SMEs are relatively small, they can in principle still utilise the capital markets. In such a case, they have to bundle their specific requirements with those of other SMEs and thus effectively operate as a type of co-operative in the capital markets³.

Likewise, investors willing to invest in SMEs can do so **directly** by buying, for instance, the equity or debt of a specific SME, or **indirectly** by investment instruments in, for example, a collateralised loan-obligation fund (discussed in detail in Chapter 5).

The various options in using the securities market for SME finance, as well as the potential structure of debt-finance services to SMEs of different sizes, risks and collateral profiles is illustrated in Diagram 2.

2.1.3 Bank products for SME financing

By contrast to investors in financial markets, bank depositors do not make any focused or direct investments in SMEs, but, instead, rely on their legal

³ There is some debate on the extent to which the SME market in South Africa has reached a level of sophistication that would allow participation on structures of this type.

obligations with the bank. These stipulate the repayment of the principal at face value plus interest at the end of the investment or deposit horizon. Since the credit-risk profile of SMEs may be too high, banks can risk only a relatively small percentage of their depositors' money in SMEs. They do, however, provide a number of important debt products:

- Bank-overdraft facilities.
- Bank loans.
- Factoring and invoice discounting.
- Asset finance (including commercial mortgages).
- Equity finance (see Chapter 2).

Banks currently provide most of these products very effectively. Nonetheless, many emerging small entrepreneurs find it difficult to separate their personal finances from those related to their business. This creates management problems, to the detriment of their businesses. Therefore the issue of appropriate non-financial support remains critical.

2.1.4 Non-bank financial intermediaries

Within the South African context, access to credit supplied by non-banks (such as retailers and micro-lenders) is an important class of intermediated debt finance. Chapter 4 concentrates on the financial services rendered through non-bank financial intermediaries (NBFIs). It is worth mentioning upfront, however, the particular role of banks as partners of NBFIs. International evidence shows that a great weakness of sub-Saharan African countries, compared to emerging Asian countries, lies in the traditional 'schism' between both arenas. Whereas in Taiwan, banks provide refinancing and saving facilities to informal lenders, this is barely the case in Africa, resulting in market fragmentation and inefficiencies.⁴ The current formalisation of the micro-lending industry, however, seems to open much potential for a strengthening of ties between bank and non-bank

⁴ See Nissanke, M. and E. Aryeetey, *Institutional Analysis of Financial Market Fragmentation in Sub-Saharan Africa - Risk-Cost Configuration Approach*, presented at the 3rd Annual Conference of the International Society for New Institutional Economics, Washington D.C., September 16-18, 1999, available also at <http://www.soas.ac.uk/Economics/staff/staflist.html>.

intermediaries. A new line of thinking seems to be developing in the banking sector,⁵ with promising possibilities.

2.2 Commercial banks' experience in providing finance to SMEs

It is not easy to report about commercial banks' involvement and experience in providing finance to SMEs, as they tend to be fairly discreet about their practices in this regard. However, a few estimations exist about the size of their SME credit portfolios. Also, there is some evidence as to the credit-rating techniques that they utilise. After a brief general outline, examples can be provided from the Standard Bank Group's experience.

2.2.1 Estimates of the size of commercial banks' SME credit exposure

The engagement of commercial banks in the SME sector, although it has been existing for a long time as far as traditional (white) enterprises are concerned, is currently taking a new turn. As a consequence, statistics are not yet in place. The following table, though, provides an order of magnitude.

	Standard Bank	Nedbank	Absa	FNB**	Total
SME clients	360 000	N/a	170 000	N/a	
<i>Non-borrowers</i>	<i>226 800</i>	<i>N/a</i>	<i>N/a</i>	<i>N/a</i>	370000
<i>Borrowers</i>	<i>133 200</i>	<i>N/a</i>	<i>N/a</i>	<i>N/a</i>	
Total book***	R5 bn	R 5-8 bn	R3-7 bn	R2-4 bn	R20 bn
Average loan size	R39 039	N/a	R47 058	N/a	R54 000
Market share	34%	33%	20%		100%
<p>* Source: Presentations to the Parliament Portfolio Committee for Trade and Industry on the role of banks in financing SMMEs (June, 2000) and South African Banking Council – (figures computed by MFRC).</p> <p>** Figures for FNB are pure guesstimates. FNB, according to South African Banking Council, was not required to present to the Committee.</p> <p>*** This is the most hazardous of all guesses as nearly all commercial banks have various definitions of what constitutes an SME.</p>					

⁵ See South African Banking Council, Submission to the Portfolio Committee for Trade and Industry on "The role of banks in financing SMMEs", 6 June 2000.

Table 1 raises the following comments:

- R20 billion in SME exposure approximates to 5 per cent of total bank exposure (excluding mortgages and credit cards).⁶
- Khula guarantee exposure to commercial banks is approximately R168 million⁷ (i.e. 0,8 per cent of aggregate commercial bank SME exposure).⁸
- On the other hand, 370 000 SME borrowers represent between 16 per cent and 40 per cent of the estimated number of SMMEs in the country (see Chapter 1 for various indicators on the number of SMMEs).
- Although these statistics show an average loan size of R54 000, it is believed that, of the 370 000 borrowers, only 18 per cent (i.e. some 66 600) borrow above R50 000.
- In terms of loan usage (by overall SME loan exposure), approximately:
 - 61 per cent of the amount comes from installment sale finance;
 - 27 per cent is (short-term) overdraft facilities;
 - 11 per cent comes from term/revolving loan facilities;
 - 1 per cent is other forms of financing (factoring, discounting finance, etc.).

Standard Bank has the most accurate statistics and is believed to be leading the market with a significant presence in the lower-end segment. Nedbank, with its subsidiary Peoples' Bank and its small business division NedEnterprise, is probably in second place with a relatively visible offer. The remaining two large banks, Absa and FNB, seem to be actively developing their market share.

⁶ See South African Banking Council, *The South African Banking Review*, 1999, p.21.

⁷ Khula, *Annual Report*, 2000.

⁸ It should be stated that banks would only seek a Khula guarantee if, at a sound business plan meeting, all other requirements is considered. The Khula guarantee would only be sought to cover for a lack of collateral under such circumstances.

2.2.2 Credit decision mechanisms and credit performance

There is little evidence that methods for risk assessment and credit decision are adequate, and a lot of research is required to improve knowledge in this important regard. A survey conducted among several Western Cape institutions involved in SME finance⁹ gives some indication that, compared to the average of institutions with an exposure to SMEs, commercial banks (i) strongly rely on the existence of collateral, but also (ii) use the greatest variety of means to assess their risk. They are also the strongest users of automatic or semi-automatic credit-scoring systems.

A thorough analysis of the performance of banks' loans to SMEs would be required to improve the quality of statistics available. However, extrapolating the information presented by Absa Bank, Standard Bank and Nedbank to the Parliament Portfolio Committee for Trade and Industry, it would appear that the performance is roughly as follows: non-performing loans 18 per cent; bad debt 4 per cent.

2.2.3 The example of the Standard Bank Group

The innovative experience of Standard Bank with respect to lending to emerging enterprises is informative. After having launched the E-bank in 1993, (which was later merged with Standard Bank and renamed 'E-plan'), as a strategy using electronic resources to bundle services needed by the urban poor,¹⁰ Standard Bank started extending the concept to include small loans (originally, less than R500).

The key to this lending concept lies in the utilisation of past account balance information (electronically available within the bank) as a credit check. A restrictive consequence of such practice is that it gives a strong preference to 'long-term clients' over start-ups and 'external firms'. However, in the

⁹ Von Blottnitz, M., University of Cape Town, June 2001 – unpublished working paper

¹⁰ For a description of the E-Bank / E-Plan concept and its evolution and success, refer to J.A. Paulson and J. MacAndrews, "Financial Services for the Urban Poor – South Africa's E Plan", World Bank's *Policy Research Working Paper No 2016*, the Financing Sector Development Department, World Bank, November 1998 (downloadable from www.worldbank.org).

meantime, the large portfolio that Standard Bank has been able to constitute seems to indicate a significant outreach of this concept.

2.3 Recommendations

This section calls for the following remarks on strengths and weaknesses of banks' involvement with SME debt financing:

- Banks are not the sole actors able to provide debt finance to SMEs. However, through their particular refinancing capacities, their potential to affect the volume and quality of SME finance goes beyond the direct granting of SME loans. Providing a back-up line to non-bank financial intermediaries, for example, or to business owners in their individual quality, may indirectly loosen the knot for a number of enterprises.
- The long tradition of fragmentation between banks and non-bank lenders seems to be slowly improving with the emergence of a 'middle class' of formal, registered and better-administered small lenders, which banks will hopefully be more prepared to refinance. Changes may be required in the regulatory environment to give impetus to such developments.
- As far as direct loan support to SMEs is concerned, banks are increasing their involvement but remaining discreet about it. There is a need for better research on the exact extent of their involvement, and better disclosure from their side. Possible fears of banks on the consequences of transparency about their exposures should be addressed pragmatically.
- However, even with these problems resolved, the costs of administering loans and granting borrowers the necessary business support, remain a massive challenge. It seems that mentorship schemes are still not efficient enough to be generalised on a long-term basis. Innovative mentorship schemes with students or 'community champions' may provide the potential for large-scale business support (see Epilogue).

3 Access to other banking services and their cost

This section aims to explore the cost of banking services to SMEs and the incidence of market structures (in particular, the concentration of the banking sector) on the cost and quality of service to SMEs. The possible need to promote new entrants to the banking sector is questioned. The perspectives of enterprises and banks on the right level of bank charges are considered. Later, the issue of access to redress is reviewed. Finally, some recommendations are made.

3.1 A banking sector with little competition

The number of banks in South Africa active in the SME financing market is still relatively limited. While the banking sector in South Africa has grown substantially since 1994, the fact is that all foreign banks are active at the upper end of the market and not at the more risky retail end. The negative implications for SME finance from the already high level of concentration in the South African banking sector, is aggravated given that SMEs tend to be even less able to benefit from the competition between banks than the average bank client. This has three reasons: the preference for local banks, the structure of the system itself, and the lack of information on SMEs.

3.1.1 *The preference for local banks*

Both internationally and in South Africa, the market for providing current account services and bank debt to SMEs exhibits strong **local** characteristics. Access to banking services is crucially important for SMEs, particularly access to money-transmission facilities. SMEs cannot afford to be serviced by financial intermediaries that are located far away. Locality is effectively enforced by the following characteristics of the market:

- For SMEs with a high volume of cash and cheque transactions, access to a local money-transmission facility is simply essential.
- SMEs tend to use local financial providers, whether a bank or non-bank supplier. Also, in South Africa, most small businesses use the closest provider of their main source of finance (including non-bank debt).

- The price of credit and banking services may vary significantly in different areas.
- Local knowledge of the SME business environment is important for lending decisions. Lenders can reduce their risk by understanding local economic conditions and the impact that these are likely to have on the success or failure of individual projects. This seems to underline the importance of participation of non-bank financial intermediaries in the provision of SME finance, given the local presence of these institutions.
- Many emerging small entrepreneurs have a very tight cash-flow. Travel and other costs of utilising facilities far removed from the business are often prohibitive.
- Many entrepreneurs start businesses that require their physical presence on the shop floor. The concept of owner-manager is critical to the success of small business, and entrepreneurs do not want to spend lengthy periods of time away from their businesses.

3.1.2 Bank monopoly versus agency system in money-transmission services

If banks have an effective monopoly on money-transmission services, they can engage in monopolistic pricing strategies (i.e. they base their pricing strategies on average rather than marginal costs). The monopolistic 'surplus profit' may in turn be used to subsidise the debt provided to SMEs (when banks face competition from non-bank service providers).¹¹ For these reasons, the **participation of core banks (see Section 3.4.2.1 below) in money-transmission services, particularly at the local level, is of crucial**

¹¹ For the UK example, see the Executive Summary of the Cruickshank Report, for instance paragraph 5.35 - 5.40: '*Banks are able to sustain undue price discrimination within classes of SMEs that have the same economic characteristics.*' Or paragraph 5.41: '*Research suggests that larger banks with greater market share charge more for loans of equivalent risk, and demand more collateral.*' And, again, in paragraph 5.45: '*At institutional level, the firms principally concerned in SME banking markets have together made cumulative returns for their shareholders in excess of nearly all other sectors of the UK stock market. This finding holds true for a number of periods of time, all including the economic downturn of the early 1990s.*' Paragraph 5.46 notes: '*The Review's analysis confirms the old saw that 'banks make more money than their small business customers'.*'

importance to addressing inherent market shortcomings.¹² Moreover, the tendency of banks in South Africa to close rural, unprofitable branches emphasises this point even more strongly.

The Cruickshank Commission observed that in the US, where there is far less concentration in the SME banking markets, agency arrangements for money-transmission facilities are commonplace. **These arrangements reduce the barriers to entry and facilitate competition among different financial service providers for SME clients.** This has benefits both in respect of the cost at which SMEs can access such services and in terms of the range of products available to SMEs (as a result of higher levels of innovation).

3.1.3 Lack of information on SMEs

Making more information about SMEs available could help to make the market more efficient and improve competition in this market segment. This would help to reduce entry barriers to credit markets by making it easier for new entrants to identify potential clients, market their services to such clients and assess the risk of new applicants by, for instance, constructing appropriate credit-scoring models.

Since the existing bank of an SME has the benefit of information about client behaviour, usually built up over years, for several years the SME owner may find it difficult to switch his or her accounts to another institution. The information problems and barriers preventing SMEs from switching between financial service providers imply that the risk profile of SMEs applying for new finance tends to be higher than average. Breaking down these barriers to information would increase the competition for SME clients, lower the cost of SME finance and improve product innovation in this market segment. These observations imply that a bank has little incentive to lower the cost to its

¹² Whether such business can be done profitably, is for the private sector to decide. The regulatory authorities should not decide on a priority for this issue, as for instance technology changes the cost of banking services continuously.

established SME clients, since: (i) the client is unlikely to 'shop around', and (ii) its competitor banks are unlikely to market their services to these clients.¹³

3.2 Two perspectives on the level of bank charges

If the lowering of entry barriers is to have a positive impact on competition, service quality and banking costs, it is necessary that the market of providing bank services to SMEs should be attractive, i.e. profitable. If this is the case, increased competition is likely to push bank charges down to a level acceptable to both suppliers and buyers of such services. If the activity is not profitable, however, alternative solutions must be found. Against this background, this section investigates SMEs' perspective on the level of bank charges, and banks' profitability on the SME segment.

3.2.1 The burden of bank charges for SMEs

Although their voice is seldom heard, SMEs do complain about the high levels of bank charges for basic financial services such as money transmissions. With a limited turnover and the need to keep margins low to compete with large enterprises, they need to be efficient and keep administrative costs low to maintain sufficient profitability. In this context, high bank fees can represent a significant burden.

There is, however, little statistical evidence to document the importance of the cost burden. Table 2 indicates some preliminary findings on the review of 16 very small to medium enterprises in the Cape Town area which relates bank charges to the SMEs' income.

¹³ Since early 2000 banks have begun to compete more aggressively for attractive SME deals. There is substantial political and economic pressure on banks to finance small business. Nonetheless banks find that sustainable SME deals are few. The problem of lack of access to finance is still manifested when entrepreneurs are unable to meet the criteria of banks as a result of a lack of non-core skills and a lack of collateral.

	Bank charges to turnover (%)	Bank charges to gross margin (%)	Bank charges to 'free margin' (after payment of rent and employees)
Lowest	0,2%	0,6%	1,1%
Highest	1,4%	4,4%	8,6%
Average	0,8%	1,9%	3.3%

* Von Blottnitz, M., "Some preliminary indicators on the importance of the bank charges burden for SMEs in the Cape Town area", unpublished working paper, University of Cape Town, October 2001.

3.2.2 The profitability of the SME segment for the banks

As mentioned, three interrelated markets are of particular importance in the provision of debt-finance to SMEs:

- Money transmission. This is the flow of money between firms, individuals and Government through the national payment systems.
- Services to personal customers. The main services here are current accounts, savings products, personal loans, mortgages, debit cards and credit cards.
- Services to SMEs. These entail mainly current accounts and external finance.

In all three of these markets, banks play a dominating role. The profitability of supplying SME finance may differ materially in different countries. In the UK, it is highly profitable according to the Cruickshank Commission, but in South Africa it seems to be less so. In fact, compared with other countries, the return on equity of South African banks is not particularly high. As indicated in Table 3 below, the top six banks in South Africa had an average risk return on equity of some 6 per cent, compared with more than 18 per cent in the UK and about 12 per cent in the USA and Australia. The reasons for this lower profitability level in South Africa still have to be investigated in detail.

Moreover, the risk returns depicted in Table 3 should also reflect the risk premiums on the loan book of the banking industry. A study conducted by KPMG in 1999, states that this risk premium should be between 4 and 6 per

cent in South Africa. Nevertheless, despite the inherent limitations of the analysis done in Table 3, the analysis indicates that banks in South Africa cannot be compared directly with those in industrial countries, or even other developing countries.

Country	Nominal return on equity	Risk-free return	Risk return
South Africa			
Absa Bank	18,49%	14,58%	3,91%
Standard Bank	22,00%	14,58%	7,42%
Nedcor Bank	25,30%	14,58%	10,72%
FirstRand Bank	24,50%	14,58%	9,92%
Investec Bank	18,80%	14,58%	4,22%
BOE Bank	12,00%	14,58%	-2,58%
African countries			
Ghana	62,58%	26,36%	36,22%
Kenya	12,07%	13,29%	-1,22%
Nigeria	30,60%	18,00%	12,60%
Botswana	38,70%	11,70%	27,00%
Namibia	34,22%	13,27%	20,95%
Mauritius	18,13%	11,76%	6,37%
Zimbabwe	57,33%	50,00%	7,33%
Developed countries			
UK	23,60%	5,34%	18,26%
Canada	12,50%	5,13%	7,37%
USA supra-regional banks	16,80%	4,81%	11,99%
Australia	18,00%	5,02%	12,98%
Source: KPMG International Banking Surveys			

As in many other countries, banks in South Africa are among the largest institutions in the economy. For example, in 1999 the top six banks in South Africa made an aggregated profit of R9,4 billion (after interest payments and exceptionals, but before corporate tax). Unfortunately, more detailed information on the sources of banks' profits are not easily available in South Africa. For example, as far as the largest banks are concerned, their segment reportings do allocate the total profit to their broad activities, but not to the various client groups served. **In addition, the relationship between (i) banks' activities, (ii) dedicated regulatory capital and (iii) the profitability on these activities is not gathered by the South Africa Reserve Bank in its official returns.** Banks themselves have only fragmentary information in this respect for internal planning purposes, and

this information is not made public. Accordingly, it is not possible to be accurate in this important area of research.

The Banking Council South Africa is currently gathering data on banks' profitability from the top six banks for the period from 1990 to 2000. This information will be in line with the information gathered by the Cruickshank Commission (see Appendix 3), and probably available towards the end of 2002. However, as already mentioned, the split between personal and SME finance is not always clear in South Africa, since these two activities are so closely interlinked. Since finance to SMEs and the lower end of the personal market do not appear to be too profitable for banks in South Africa, competition among banks in this field is also limited.

Clearly, it will be important to investigate the profitability of banks' operations regarding SMEs in greater detail, as this will determine the probability of new entrants into the market. Much of the meaningfulness of policies on market structure depends on the answer to this question.

3.3 Improved access to redress

One of the most important objectives of the Banking Council South Africa in 1999 was the redrafting of the Code of Banking Practice, in order to address the needs of customers. The importance of the Code lies in the fact that the banks have committed themselves to dealing with their customers in accordance with the principles set out in the Code. It is also of importance that the rulings given by the independent Adjudicator for the banking industry are not based only on what is legal, but on what is 'fair and just'.

The draft Code was negotiated to the point of acceptance by member banks, the Government and consumer bodies, and released to the public for comments in March 1999. Amendments were subsequently made to the Code, which became effective in April 2000. An independent steering committee was established to determine the status and terms of reference of an independent Adjudicator's office. The Adjudicator now reports to an independent board, consisting of representatives from Government, the

South African Reserve Bank, the Financial Services Board, consumers and the banking sector. The banking sector has minimum representation on this board. As banks have no effective veto in compiling the code or in rulings made by the Adjudicator, this code is in line with international best practice.

3.4 Recommendations

Despite the obvious differences between the UK and South Africa in the markets for SME finance, the conclusions of the Cruickshank Commission is of such significance for SME finance that the validity thereof for the South African market has to be further investigated. The Cruickshank Commission came to the following conclusions on banking services supplied to SMEs:

- There was no effective competition between banks in providing finance to SMEs.
- Consumers perceived significant barriers to switching their current accounts.
- Few consumers were aware of the terms and conditions of the products that they held, pointing to significant disclosure problems.
- Consumers had inadequate representation and redress.
- The markets supplying these services were extremely concentrated, and barriers to entry were high.
- In the absence of government intervention, the prospects for effective competition in these markets were remote.¹⁴

The Task Group could not confirm these statements by means of available banking statistics in South Africa and could not do so within the allotted timeframe. But even if the statements were to be false, no harm would be done if they were to be confronted as **potential threats** in the South African

¹⁴ *Cruickshank Report*, Executive Summary, p. 17.

context in years to come. **The regulatory reply to these potential threats should primarily be to encourage more competition in the debt-finance markets for SMEs and more information disclosure to and about SMEs.** These responses are discussed in greater detail in Sections 3.4.1 and 3.4.2 below.

3.4.1 Improved competition among banks by better disclosure

Knowledgeable consumers provide the best incentive to effective competition. Provided sufficient and appropriate information is available, such consumers can take responsibility for their own financial well-being, can shop around and can exert the pressures on suppliers that drive a competitive and innovative market. **Government could take a number of actions to improve information conditions in retail markets. The potential gains from catalysing competition would be large if this can be implemented in a manner that contains the cost of information provision.**

Furthermore, some groups of consumers need more help to make choices than others – specifically, small businesses and those that are currently excluded from financial services. Resources devoted to consumer awareness should accommodate the information problems experienced by SMEs, and by people with a low income, especially those currently excluded from banking services.

SME clients generally do not have sufficient or appropriate information with which to compare the cost of services offered by different financial-service providers. A number of reasons can be mentioned:

- Transaction and/or product risk profiles are non-standard, making comparison difficult.
- Owing to weak disclosure, SMEs are frequently ill-informed about the cost of their existing financial services (for example, arbitrage between transaction fees and interest rates makes evaluation of actual cost very difficult).
- The price of different services utilised by the SME client are linked (for example, an SME may fear that by switching from one service to another

for cheaper debt finance, it may pay higher transaction costs).¹⁵ SMEs, therefore, generally do not shop around.

In order to enable SMEs to make informed choices, the regulatory authorities could provide guidelines to banks to simplify their tariff structures and improve their information flows to consumers about applicable rates. Alternatively, these authorities could themselves supply more detailed information about banking services or aggregated credit exposures of consumers to the market.¹⁶ **SMEs could exercise a significant competitive leverage on financial institutions – but only if SMEs were to be provided with appropriate information.**

In addition to information on tariffs practised by banks, another disclosure issue concerns financial and credit information on SMEs. Better disclosure in this regard would not only enhance competition in the financial sector, but also powerfully support business angels in their equity allocation to deserving SMEs and/or non-bank creditors evaluating the merits of new debt finance to specific businesses.

Moreover, banks and/or the regulatory authorities could give more specific information, not so much to current banking clients as to potentially new competitors, who in turn could judge, based on this information, whether it would be worthwhile to enter the banking market. In this context, the following disclosure incentives could be considered.

¹⁵ The rules and practices relating to the release of collateral may be another big factor. Paragraph 5.67 of the Cruickshank Report refers to one such arrangement (i.e. 'floating charge over assets').

¹⁶ Privacy is important however. Accordingly, credit information may be disclosed only if the debtor consents.

3.4.1.1. *Public disclosure of profit contributions per main banking activity*

Since banks operate as large financial conglomerates, their return on equity (ROE) is a mixture of fundamentally different activities, such as investment banking, insurance, fund management, personal finance and SME finance. The profit profile of these various activities are obscure to outside competitors, since banks do not publish, for example, how much of their equity is allocated to specific activities and what the internal rate of return on these investments is. For competition to work properly, it is not enough simply to publish the banks' total profitability, since this total may well be made up of extremes that offset one another. **Better disclosure will have the impact of creating efficiencies in the market through increased competition, both at the overall bank level and through competition between competitors and specific service lines within the bank.**

The current disclosure level makes it nearly impossible to judge to what extent SME finance is profitable. This lack of disclosure may result in significantly lower levels of competition than would otherwise be the case. High profitability in some specific bank activities may be a magnet for other financial service providers. This type of information on profits has to be shared in public – at least if competition is to function properly.

In order to ensure the disclosure of the profitability of various banking activities, the Registrar of Banks could in future gather this information for public distribution. If for systemic reasons full information could not be published immediately, it should be made available to the public after a reasonable time delay. The type of information and statistics that the South African regulatory authorities should look for are similar to those collected by the Cruickshank Commission. See Appendix 3 for further details of this aspect.

3.4.1.2. *Disclosure of the cost of a basic banking service*

For SMEs it is often impossible to determine *a priori* the total cost of a basic banking service, owing to the fundamentally different pricing strategies of banks. The regulatory authorities could help SMEs and other bank

consumers in this regard, by insisting on better disclosure of the total price of a basic banking service for both personal and SME finance. It should be a task of the business conduct regulator (currently the FSB) to gather the appropriate price information of banks and to present this input to consumers in an acceptable form. The aim of the information provided should be competitive price disclosure which, in turn, would encourage the competitive purchase of financial services by clients. To this end, the regulatory authorities could develop price-quotation models (as used for instance on the Internet by cellular telephone companies; e.g. see mtn.co.za/products).

Two basic banking-service packages should be presented to consumers over the Internet, namely one for personal banking services and the other for SME banking services. The definition of the standard products and the way in which the total average cost per basic banking product is calculated are currently being investigated by the Banking Council South Africa. This analysis is likely to be completed towards the end of 2001.

3.4.1.3. Disclosure of the costs of a basic banking service by foreign suppliers

No country operates in total isolation. Accordingly, the prices of local services have to be compared with the costs of similar financial services abroad. An example of such a comparison is shown in Appendix 4.

The publication of this type of international competitive information has three important advantages. Firstly, significant differences in local and foreign prices may give the regulatory authorities an indication of the global competitiveness of the local financial industry, which, in turn, will impact on broad regulatory strategy. Secondly, international price comparisons give consumer bodies an initial rough indication of whether local pricing strategies in banking ought to be investigated in greater detail. Thirdly, financial institutions are given the opportunity to indicate that their various services are not 'excessively expensive', at least compared to other countries offering similar services.

Appendix 4 gives an overview of how such an international comparison could be done. According to the Banking Council South Africa, a similar study cannot be completed before 2003.

3.4.2 Improved competition in banking by lowering the entry barriers

Two issues are addressed in this section: the initial capital requirement for banks and access to the national payment system.

3.4.2.1. Lower initial capital requirements for core banks

Entry barriers to banking could be reduced by establishing different types of banks, with different initial capital requirements, in terms of the Banks Act. South Africa has a long history of distinguishing between different kinds of banks for regulatory purposes. The regulatory requirements for banks, building societies and discount houses were equalised only in 1990. Although there were solid economic reasons at the time for pursuing a uniform regulatory approach for all deposit-taking institutions,¹⁷ this consolidation, from a consumer's point of view implied a significant reduction in competition in banking – particularly after the disappearance of building societies. For example, building societies served the retail market very well and their money-transmission services were competitive with those of the banks. Moreover, building societies served the consumer not only from their own

¹⁷ The first Currency and Banking Act of the Union (Act No. 31 of 1920) referred to banks only in general (being a company 'receiving or accepting deposits of money, subject to withdrawal by cheque, draft or order'). In the Banking Act of 1942 a people's bank was defined as 'an association established for the purpose of promoting thrift among its members and of making loans to its members', and a loan bank meant 'a person (other than a people's bank) which carries on the business of accepting deposits of money and of granting small loans'. A deposit-receiving institution was simply seen as a residual, that is, a person accepting deposits, but not being a commercial bank or a people's bank or a loan bank. The retail-banking character of the people's and loan banks was clearly enforced by the Act (section 20), since it restricted these banks to lending a maximum amount of £100 to any one person, whereas the maximum they could owe to any person was limited to £4 000.

The Banks Act of 1965 subjected all classes of banking institution (except discount houses) to the same financial requirements. Moreover, new classifications of banking institution were introduced, namely commercial, savings, hire purchase and general banks, based on the relative importance of the banking business conducted.

The rapid development and diversification of banking services offered by any one bank during the 1970s made the classification of banking institutions, as stated in the Banks Act, increasingly difficult in practice. The difference between hire purchase, savings and general banks became so vague that the Registrar – through the Financial Institutions Amendment Act, No. 103 of 1979 – reclassified the first two types as general banks. The Financial Institutions Amendment Act, No. 106 of 1985, repealed the distinction between commercial banks, general banks and merchant banks, and all banks, except discount houses, were classified as banks. The Deposit-taking Institutions Act, No. 94 of 1990, consolidated and revised its predecessors, the Banks Act, 1965 (Act 24 of 1965), and the Building Societies Act, 1986 (Act 82 of 1986), and finally, also repealed the distinction between banks, discount houses and equity building societies. In 1993, the Deposit-taking Institutions Act was renamed the Banks Act, No. 94 of 1990.

branch networks, but also from their sub-branches in, for example, various real-estate agencies and supermarkets. For the consumer, these sub-branches were convenient, since shopping and banking could easily be combined.

In terms of the proposed Basel Capital Accord (2005), the capital requirement for an internationally active bank should be at least 8 per cent of its risk-weighted exposure of assets (i.e. mainly market, credit and operating risks). Currently, the minimum capital requirement for any bank, except a mutual bank, in South Africa is R250 million or 10 per cent of the risk-weighted exposure, whichever is the higher.

Mutual banks are no more than a remnant of the past, since they represent some of the old mutual building societies. Their initial capital requirement is R50 million. Together, mutual banks account for 0,1 per cent of the total assets of the banking sector. Given their foundation structure, mutual banks are unlikely ever to be a competitive force against the large commercial banks.

Although the current capital requirement of a 10 per cent risk-weighted exposure is unlikely to be a problem for any new participant in the banking industry,¹⁸ the initial minimum capital of R250 million is a major entry barrier – at least to those *types of banks*¹⁹ that want to limit themselves solely to money-transmission services or limited lines of financial services. As illustration: a core bank effectively operates like a money-market fund for small depositors (rather than for investors). A core bank eliminates all exposures to credit risk by investing all its assets in short-term money-market instruments, it has no currency risks and may, perhaps, run a smallish interest-rate gap exposure (because its assets and liabilities are unlikely to be perfectly matched). Accordingly, the profits of a core bank are largely

¹⁸ Generally speaking, the success of new small banks entering the market has been mixed in South Africa during the past twenty years. Although there were the success stories of Rand Merchant Bank Limited and Investec Bank Limited there were also the big failures of Cape Investment Bank Limited and The Business Bank Limited.

¹⁹ E.g. core banks.

determined by the interest spread between money-market rates and retail-deposit rates.

In order to ensure competition in the banking sector, the regulatory authorities could consider a significantly lower initial capital requirement for such core banks²⁰. In fact, the initial capital requirement could be reduced for any type of bank that is legally constrained in its risk taking (for example, co-operative or core banks). By lowering the entry barriers to banking in this specific way, competition in banking could be increased without necessarily creating or increasing systemic risks.

3.4.2.2. Granting core banks access to the national payment system

Firms that may be interested in establishing a core bank are for instance telephone and IT companies, supermarkets and large retail stores. Supermarkets already handle large volumes of cash and could engage, without too much trouble, more intensively in money-transmission services. Obviously, from a regulatory perspective, such core-bank activities would have to be fully ring-fenced from the non-banking activities of such a firm.

However, in order to ensure the 'fair and correct' pricing of their money-transmission services, such core banks should have equal access to the Automated Clearing Bureau (ACB) and the South African Multiple Option Settlement System (SAMOS).²¹ Ensuring fair access to the national payment system for smaller banks may, however, become a thorny issue for the major banks, as well as for the competition and regulatory authorities.

In essence, the existing four major clearing banks in South Africa have paid for the existing clearing system among banks (i.e. the ACB system) and the

clearing and settlement systems of the securities exchanges (i.e. STRATE, UNEXOR, and SAFCOM). These investments by the big four banks are valued at some R0,5 billion. Since the country cannot yet afford a competing

²⁰ Or other "second-tier" banks.

²¹ There are currently 25 participants that have settlement accounts with the central bank.

'financial wiring system',²² the four major clearing banks, in aggregate, *de facto* provide a public service under license.²³

The four largest clearing banks in South Africa handle nearly all money transmissions and square off with the central bank at the end of each working day. These big four banks are the 'direct clearers' for most high-volume, low-value transactions in the domestic payment system, while they also clear for several other banks on a 'sponsored basis'.²⁴ Core banks should have the right to become at least a 'sponsored clearer' in the retail payment streams. Alternatively the central bank could give core banks direct access to SAMOS which, in contrast to the retail payment system, currently concentrates on low-volume, high-value transactions based on gross settlement for its 25 participating banks.

Obviously, the four major clearing banks are in keen competition with one another. Moreover, foreign banks operating in South Africa ensure contestability in the corporate-banking sector. Nonetheless, the four major clearing banks would be in a strong position to eliminate any possible competition from new core banks if they were to insist that all the transactions of core banks had to be cleared through the clearing banks and at the prices determined by the clearing banks.

In order for competition to work properly²⁵ in the personal and SME banking markets it is crucial that the money-transmission services (covering automated teller machines, credit and debit cards, standing orders, cheque

²² The Internet may well start to challenge existing money-transmission systems in years to come.

²³ Natural monopolies, such as the railways, the electricity grid and telephone landlines, are quite natural in a free-market economy. By their nature, such natural monopolies attract additional regulation, particularly in respect of their pricing policies and access to their systems by new participants.

²⁴ In contrast, the large international banks support the local foreign-exchange market. These foreign banks also own the international clearing and settlement systems.

²⁵ Whether the four major clearing banks in South Africa are operating as a 'complex monopoly' (as defined in Cruickshank) in respect of their networks is a complex question, which is not addressed in this Report. In the UK, however, the Competition Commission came to that very conclusion in 2001 about the big four British clearing banks, and the Cruickshank Commission already recommended in 2000 that the banks' payment system be declared a licensed activity (implying that the Treasury would issue licences to secure price transparency and fairness). For further details, see Appendix 5.

clearing, etc.) be provided at 'fair and correct' prices to all existing and new participants.

In view of the large concentration of economic power that the existing major clearing banks have in the national payment system, the regulatory authorities in South Africa should investigate the competitive conditions in this market and the regulatory implications thereof.

4 Positioning the Postbank as a competitive force

There is universal acceptance of the advantages of a government-owned postal bank, which competes on a level playing field with commercial banks. In the South African context, the advantages of the Postbank are the following:

- The Postbank, as a participant in the national payment system, would give the Government insights into retail banking that would be difficult to obtain if the Postbank were to remain a market outsider.
- The branches of the Postbank are well distributed across the country and can service even the smallest communities, where commercial banks would be hesitant to operate. Through the Postbank, financial services can be provided to communities that privately owned banks see as unprofitable.²⁶ Wallis notes that *'Obliging financial institutions to subsidise some activities through "community service obligations" compromises their efficiency and is unlikely to prove sustainable in a competitive market'*.²⁷ If there is a 'social need' for the provision of certain financial services that the market cannot profitably provide, Government has to

²⁶ Wallis also notes that the experience of the Post Bank in Australia indicated that this type of institution could provide, through specialisation in certain services lines, a network through which other financial service providers could access customers who were located in rural areas or low population-density areas.

²⁷ Wallis, *Op.cit.*, p.176.

recognise this and has to fund the provision of such services on the same basis as that for the provision of other social services.²⁸

- Some people prefer, for ideological reasons, to undertake their financial services through a Government institution, rather than a private-sector institution, even if the cost or level of service being provided is less favourable.²⁹

Basically, the Postbank has four broad options open to it in the next few years:

- It could continue doing business along existing lines by being involved in the money-transmission process on a very limited scale. In view of the privatisation policies of Government and the commercialisation of some of Telkom's core operations, however, this policy option would become increasingly difficult to execute.
- The Postbank could become a separate public-sector corporation, with its own legal statutes. The Minister of Finance and the Registrar of Banks would frown upon this option, however, particularly should the Postbank develop, over time, into a fully-fledged bank. In fact, Cabinet has already indicated that it is not in favour of this particular policy option because of the inherent conflicts that would arise with other banks. This option could still be considered, however, if the intention were to utilise the Postbank

²⁸ *'If there is a social concern about imposing the real cost of financial services on certain groups, this is more efficiently dealt with through direct government funding, transfer payments or provision of services. This approach is used to fund most other goods and services required by disadvantaged groups. If access to financial services is as important as access to transport or medicines, this should be recognised explicitly and funded in the same way'. (Ibid., p.196).*

²⁹ The disadvantages of a post bank should not, however, be ignored either. The following may be of importance:

- As a public-sector institution, the Postbank is far closer to the country's party politics, which has its own dynamics, unrelated to day-to-day financial business. For example, the tendency to cross-subsidise is stronger in the public sector than in the private sector, which may distort 'fair and correct' pricing strategies.
- As a public-sector institution, the Postbank may be undercapitalised, as it is dependent on the Government rather than the stock market for its capital.
- 'Bureaucrats in business' have failed to build up an impressive track record over the past decades. Accordingly, credit policy is likely to be a major problem.
- Being a public-sector institution, with very different 'hire and fire' rules, the Postbank's civil servants' syndromes of inertia and 'cannot be bothered' would require hardened bank customers who could take some mental pain.

as a vehicle for socio-economic delivery. Such use could then be identified by statute, and the Postbank's operations could be governed accordingly. This would provide certainty to banks and other private-sector institutions in their dealings with the Postbank.

- The Postbank could be established as a normal bank under the Banks Act. This option has the disadvantage that the minimal initial capital would have to exceed R250 million, which the Postbank currently does not have.
- The Postbank could be established as a core bank after being appropriately capitalised by the Government. This would require that the Banks Act should differentiate between fully-fledged banks and core banks, and that the latter category would require a significantly lower initial capital requirement.

On balance, it seems that it would be best for the Postbank to be fully recapitalised by the Government and to be developed into a core bank, specialising in providing deposit and transmission facilities nationally, but with a special focus on rural and other low population-density or commercially unattractive areas. If the Postbank were to operate solely as a core bank, it could contribute to greater competition in the national payment system,³⁰ as well as to the greater mobilisation of savings and 'financial-sector deepening'.

5 Summary and conclusion

The key recommendations of this Chapter may be summarised as follows:

- Banks should be encouraged to build up their refinancing ties with non-bank lenders.
- As far as direct bank loans to SMEs are concerned, transparency should be increased about the exact extent of banks' involvement and the performance and profitability of this activity.

³⁰ Which would include a SAMOS account at the central bank.

CHAPTER 4

SMEs' ACCESS TO FINANCIAL SERVICES THROUGH NON-BANK FINANCIAL INTERMEDIARIES

1 Introduction

Extending the *range of financial products* available to SMEs and the *gross amount of finance being provided* to the SME sector would require increased innovation and risk taking by all financial service providers. Apart from increasing the competition between banks,¹ which was considered in the previous chapter, there is also a need to increase the number of financial institutions that find the granting of finance to SMEs profitable.² This, in turn, should lead to increased innovation and an increase in the volume and range of enterprises being financed³. Such a development would be most likely to take place in a market characterised by:

- Low barriers to entry for new financial service providers.
- Effective competition between new entrants and existing players.

As the SME market matures, different financial-service leaders are likely to evolve in South Africa. During the last decade, major changes have already taken place in the market for personal finance and the market for low-cost housing finance, especially for middle- and low-income earners. For example, the exemption of small loans from the provisions of the Usury Act allowed a number of small lenders to innovate and grow in this market

¹ Wallis notes that '***the key to getting the full range of improvements lies in more intense competition in all parts of the market***' (see Wallis, S., *Final Report of the Financial System Inquiry*, Canberra, 1997, p. 212). The International Finance Corporation makes a related point by stating that '*[It is an] important aim to increase the number of financial institutions that find lending to SMEs profitable*' (see IFC, *A Market-Oriented Strategy for Small and Medium Scale Enterprises, Discussion Paper*, World Bank, Washington, May 2000, p.12).

² IFC, *Op. cit.*, p. 12.

³ This is particularly true if the SME definition is extended to include micro-enterprises, to which the banks tend to be reluctant to lend.

segment. By 1999, not only had a large number of small lenders entered this market segment, but consolidation had also started taking place. This phase included the entry of a number of banks into the micro-finance market for the first time.

Only once the technology had been proven and profitable business models had been developed did commercial banks follow the more innovative and less risk-averse approach of non-bank lenders to the market segment.⁴ Of course, such (conservative) market behaviour is to be expected of banks, as their asset/liability profile does not allow for major risk taking. Nonetheless, there are factors that still limit the level of innovation and risk taking by these credit institutions in the market for SME finance.

By contrast, niche banks or non-bank financial intermediaries (NBFIs)⁵ entered the market for SME finance in an innovative and pioneering way. For such a pattern of financial development to be possible, **it is critical for the regulatory environment to be conducive to the participation of non-bank institutions in financial-service delivery and in SME-finance provision in particular**. This point is addressed in more detail in the next sections.

The pattern of innovation and market development described above is confirmed by international literature and experience. In his analysis of the transformation of micro-finance across a number of countries in Latin America, Robert Christen⁶ emphasises three aspects:

⁴ See also R. Christen, *Commercialisation and Mission Drift: The Transformation of Micro-Finance in Latin America*, CGAP, World Bank, December 2000, p. 35, for a related argument.

⁵ For example, African Bank Limited was a non-bank financial intermediary until only a few years ago. It established itself as a major financial intermediary in a new sector *while not being a bank*. Though it did not wish to access retail deposits as such, it could not access sufficient amounts of wholesale funding as a non-bank. Access to funding was one of the primary drivers in becoming a bank. Capitec Bank Limited that was formed from the consolidation of a large number of short-term cash lenders in 2001 is another example in this context. This bank demonstrates a market focus that is unique in South Africa: it intends establishing low-cost, limited service branches in the townships, in South Africa, to an extent that no other bank has yet done. Both cases demonstrate the extent to which innovation takes place outside the mainstream banking sector. Capitec Bank also demonstrated the extent to which initial capital requirements of R250 million are an obstacle to bank formation and to the conversion of NBFIs into banks.

⁶ See Christen, *Op. Cit.*

- The demonstration effect of the success of non-bank lenders in the micro-enterprise finance market caused banks to enter this market segment.
- The extent to which non-bank lenders can evolve into fully-fledged banks.
- The extent to which this resulted in banks across Chile, Bolivia, Brazil and Ecuador (to name but a few) becoming involved in micro-enterprise lending⁷ as part of their core banking business.

Therefore, the development of profitable SME lending by non-bank lenders could have a multiplier effect that could attract banks into the market to the benefit of SMEs.

2 Principles and international precedent

International precedent seems to indicate that, in respect of SME finance at least, innovation and financial risk taking is more common outside the banking sector. Only once technology has been proven do banks enter this market segment. This does not necessarily indicate weaknesses in the banking system, but does reflect, in some ways, the particular role that banks play in a modern economy.

The key principles that are addressed in this section are the role of non-bank financial intermediaries, the importance of competitive neutrality, a free market interest-rate regime, access to information and the need to create a 'public infrastructure' in certain areas.

⁷ Christen's analysis focused on micro-enterprise lending. The rationale, however, is also true for the SME lender.

2.1 Role of non-bank financial intermediaries (NBFIs) in extending finance to SMEs

Increasing international competition implies that banks will continue to eliminate 'unprofitable' product lines and reduce their retail branch network. This is particularly true for banks that operate in market segments in which they are in direct competition with international banks. As noted in the Wallis Report: *'The process of rationalisation, including closure of bank branches, is likely to occur irrespective of regulatory changes, since it is driven by the fundamental competitive forces unleashed by new technologies and other factors.'*⁸ Wallis further notes that, even in the more homogenous Australian market, there is recognition that, as a result of international competition and the elimination of internal cross-subsidisation, *'certain services may become unaffordable for some sections of the community, including low-income groups or those in remote areas.'*⁹ **It is improbable that the leading retail banks in South Africa would provide SME finance at a meaningful scale, unless they could do so profitably.**

Recent statistics confirm the above statement, since access to finance in the lower income segments of the South African population is decreasing (see Table 1 below). For example, between 1998 and 2000, access to bank accounts has *decreased* for people in the lower income brackets (i.e. the income categories LSM 2 to LSM 4 in Table 1).

Table 1: Bank accounts and living standards			
LSM	Average annual h/h income	Any bank account	Any bank account
	2000	1998	2000
1	R 8 952,00	0%	3%
2	R 10 428,00	16%	11%
3	R 12 432,00	18%	17%
4	R 17 628,00	30%	29%
5	R 25 344,00	34%	43%
6	R 42 792,00	44%	62%
7	R 87 540,00	74%	78%
8	R 157 300,00	94%	98%

Source: IMI Consumer Scopes for 1998 and 2000
LSM = living standard measure

⁸ Wallis, *Op. cit.*, p. 149.

⁹ Wallis, *Op. cit.* p.144.

In the years ahead NBFIs, even those that come from roots outside the 'traditional financial-services sector', will probably play an increasingly important role in many sectors of the SMME finance market. This statement is based on current international trends in financial-service provision. NBFIs are often better placed to provide certain of the services from which banks are withdrawing.¹⁰ Generally, the major banks in South Africa, as the 'caretaker of the nation's money-transmission system', operate within corporate cultures that are hardly the most fertile breeding ground for the level of innovation and of risk taking that is required for the development of effective finance products for SMEs. The history of South African banks' involvement in small business finance indicates the resistance of South African banks to becoming involved in SME finance, which is likely to hold true until non-banks lead the way into this sector.¹¹ This fact has to be recognised and accommodated in the regulation of the financial-services sector.

An enabling regulatory environment may lead to the provision of financial services to SMEs by any number of different (bank and non-bank) entities, depending only on the potential for profitable financial service delivery given the particular entity's interface with SMEs. Section 3.5.3 below indicates the extent to which micro-lenders view SME finance as a potential area of growth. Examples of areas from which increased financial service provision may originate are:

- Increased finance or better terms to agricultural SMEs from agricultural equipment suppliers.
- Lower interest rates or longer-term loans provided to SMEs by the suppliers of trading stock.

¹⁰ If the Australian finding that a substantial section of retail transaction accounts is unprofitable is also valid in South Africa, this trend will probably increase, rather than be reversed. (See also Wallis, *Op. cit.*, p.147).

¹¹ The Standard Bank of South Africa Limited has arguably been the leader in the small business field. It is notable, however, that its high-profile entry into this market segment at the beginning of the 1990s was followed by a largely unheralded 'refocusing' away from small business finance and the disbanding of the small business finance unit. Every indication is that the Standard Bank is focusing on providing transaction services to small business, preferring to avoid or minimise the provision of loan finance.

- Micro-lenders in certain towns providing working capital or investment finance to SMEs, where the owners of such micro-lenders could personally evaluate the risk and manage the financial relationship.
- Micro-lenders providing guarantees for SMEs for purchases from large retailers.¹²

NBFIs are well placed to play an important financing role during the initial stages of SME development, particularly when such small businesses rely heavily on short-term debt.¹³ The Latin American experience demonstrated the role that consumer-finance companies can play in expanding access to enterprise finance.¹⁴ For example, in Paraguay small finance companies dominated the commercialisation of micro (enterprise) credit, and anecdotal evidence suggests that there is a considerable crossover from consumer finance into micro (enterprise) credit. Therefore it is important to remove as far as possible the obstacles to increased participation in SME finance by NBFIs.

2.2 Competitive neutrality

Competitive neutrality implies, *inter alia*, that similar financial functions, products or services have to be regulated similarly across different types of institutions.¹⁵ More specifically, competitive neutrality requires that the regulatory burden applying to a particular financial commitment (or promise) should apply equally to all that make such commitments. It requires therefore:¹⁶

- Minimal barriers to entry and exit from markets and products.
- No undue restrictions on institutions or the products they offer.
- Markets to be open to the widest possible range of participants.

¹² Quatro Finance, a subsidiary of African Bank, is already a leader in this area.

¹³ OECD, *Small Businesses, Job Creation and Growth: Facts, Obstacles and Best Practices*, Paris, p.18.

¹⁴ Christen, *Op. cit.*, p. 16.

¹⁵ Wallis, *Op. cit.*, p. 173.

¹⁶ Wallis, *Op. cit.*, p. 197

If there is not adherence to these principles, the implication is that the existing (frequently large) market participants would discourage new entrants to compete away their clients or their existing product lines. Such ‘discouragement’ could occur through any number of measures through which the cost and/or risk for new entrants could be raised. Banks in particular have every reason to wish to ‘discourage’ any competitor or potential competitor from offering financial services to existing clients of the bank. **Inappropriate regulation may either (i) tolerate such behaviour, or (ii) even directly contribute to the higher cost and/or risk of new entrants or potential competitors.**

An example of competitive neutrality is the extent to which supermarket branches and other providers of “in-store banking” have allowed a reduction in the cost per distribution outlet in certain areas of retail banking. The regulatory authorities have to reconsider any regulatory barriers that could obstruct the formation of alliances or any other innovations that could bring similar benefits to SME finance.¹⁷ **At present (as shown in the section below), the regulatory environment is not neutral between banks and NBFIs, and this has a strongly negative impact on the participation of NBFIs in SME finance.** There are also inconsistencies between the regulation of different types of credit, which, in turn, introduce further regulatory bias and have potentially negative consequences for SME finance.

2.3 Competition

The Wallis Report emphasises that ‘... *the key to getting the full range of improvements lies in more intense competition in all parts of the market. This makes it all the more important to examine the possible anti-competitive effects in banking caused by unwarranted access and ownership restrictions, implicit community service obligations and overly strict privacy regulations.*’¹⁸ A lack of competition in credit markets may cause banks to focus on larger, more profitable clients¹⁹ and would remove the pressure on banks to develop

¹⁷ Wallis, *Op. cit.*, p. 210

¹⁸ Wallis, *Op. cit.*, p. 212

¹⁹ IFC, *Op. cit.*, p. 7.

their lending to smaller clients.²⁰ The requirements for competitive neutrality would also include that NBFIs should be able to compete on an equal footing with banks in the supply of credit.

2.4 Barriers to entry

To increase SME finance, it is important to increase the number of institutions that find lending to SMEs profitable. It is therefore important to reduce the entry barriers into banking and credit business. Currently, such barriers (in terms of banking) include capital adequacy, and a range of other prudential requirements (including what constitutes “banking business” in terms of the Banks Act).²¹ It should similarly be easy for an entity to provide finance to SMEs, whether as a new service line in an existing business, as a dedicated finance company or as expansion of existing SME finance activities.

Low barriers to entry in this context would imply:

- It should be relatively easy for new NBFIs to start providing finance to SMEs.
- There should be no obstacles to the growth of such NBFIs.
- It should be possible for such entities to ‘evolve’, for example, to convert into full service banks if that forms part of their business strategy and does not endanger the financial system or the interests of depositors.²²

²⁰ IFC, *Op. cit.*, p. 11.

²¹ IFC, *Op. cit.*, p. 12

²² There is ample evidence that lack of access to loan capital during a high-growth phase has forced non-bank lenders in South Africa to become subsidiaries of banks. Such ‘forced marriages’ are obviously also part of a normal cycle of business growth, but the South African situation does not seem to fit such a definition. There is evidence that barriers to access to capital have forced NBFIs to register as banks, even where such entities do not wish to have access to retail deposits. African Bank is a prime example of such a case.

2.5 Interest-rate control

Usury laws may prevent lenders from charging interest rates that would cover the high cost and/or risk of lending to small firms, and ensure that they refrain from engaging in such lending.²³ However, there is substantial evidence that, at least for the smallest of SMMEs, access to credit is often more important than the cost of such credit.²⁴

Even in OECD countries, financial institutions charge higher interest rates to SMEs than to bigger companies in order to compensate for (i) the higher costs of information collection, (ii) the smaller volume of external financing and (iii) the greater risk of failure.²⁵ This is equally true in the South African market. As long as interest-rate control exists, banks and NBFIs will both refrain from any lending on which they cannot charge the interest rate required to cover the transaction cost and provide an acceptable return (given the level of risk)²⁶.

The non-enforcement of interest-rate controls and avoidance of such controls are common occurrences in dispensations where there are interest-rate controls.²⁷ Such controls generally lead either to credit rationing or avoidance of the regulations.²⁸ An environment with high levels of avoidance obviously also has implications for the profile of active providers of credit. Credit providers with higher 'compliance standards' would tend to avoid market places in which the avoidance of regulation is a business imperative.²⁹

²³ IFC, *Op. cit.*, p. 7.

²⁴ IFC, *Op. cit.*, pp. 11-12.

²⁵ OECD, *Op. cit.*, p. 17. Note, however, that higher rates do not necessarily solve the problem, since these may well crowd out low-risk SMEs from borrowing.

²⁶ I.e. where the required interest rate is above the maximum rate allowed by statute.

²⁷ *Feeding the loan sharks: the Usury Act in South Africa*, Research Report by The Law Review Project and commissioned by the Friedrich-Naumann Stiftung, 1997, pp. 36-40, gives a number of examples of application of usury laws in other countries. The report also indicates the extent to which the Usury Act leads either to credit rationing or to avoidance and a credit cost higher than it would have been in an uncapped-interest environment.

²⁸ In the latter instance, the cost of such avoidance would add to the cost of credit and make it higher than it would be in an uncapped environment.

²⁹ It is illustrative in this context that the entry of banks into the micro-lending business occurred only after a 'credible' regulatory regime had been established.

The existing structure of and limits contained in the Usury Act and Credit Agreements Act in South Africa are major obstacles to increased SME lending. This is addressed more in detail in Section 5.1. below.

2.6 Access to information

A common theme running through the literature on increased provision of SME finance, is the importance of access to information. This theme is given prominence in most of the leading analyses on SME finance and financial sector regulation, including the Wallis Report in Australia, the Cruickshank Report in the UK, the International Finance Corporation's report on SME finance and various OECD studies on SME finance.

The key problem in credit markets is the difficulty of obtaining information on the creditworthiness of potential SME clients. If lenders perceive the risk of lending to a particular client or group of clients as greater than what it actually is, they will charge higher interest rates or will refrain completely from lending to that client or group of clients.³⁰ Cruickshank³¹ emphasises two points in this respect, which are probably also valid in South Africa:

- **Firstly, there is a lack of detailed information about past performance of enterprises in the SME sector.** Such information would help new entrants to build up credit-scoring systems. The ability to obtain credit-scoring information in the UK compares unfavourably with that in the US or France (and is probably even worse in South Africa). In the US, banks can buy into the 'Fair-Isaacs' credit-scoring system, established with information pooled by several major banks. In France, a great deal of financial information about SMEs is available through the Banque de France or agencies such as Euridile.

³⁰ IFC, *Op. cit.*, p. 8.

³¹ Cruickshank Report, *Competition in Banking*, London: The Stationery Office Oriel Bookshop, March 2000, Chapter 5, p. 160.

- **Secondly, there are high costs involved in accessing information about the financial characteristics of local small firms.** As a consequence, lenders tend to accord privileges to the clients they have known for a long time, substituting experience for a desk analysis of the company's potential, and hence disadvantaging start-ups or 'switchers'. This is particularly important, since the main reason that SMEs give for switching their current account supplier is that they have been refused credit. The pool of switchers is therefore likely, at least initially, to be riskier on average than the SME population as a whole.

Cruickshank also draws attention to the level of development of direct debt financing in the US and Canadian SME loan markets. The higher level in North America is attributed to the early adoption of *credit scoring*, which enables quick approval of loans by large banks (sometimes within 15 minutes). Credit scoring furthermore allows the delivery of SME finance through low-cost distribution channels, such as applications for a term loan through the Internet.³² These benefits cannot be realised in an environment where credit information is not generally shared among financial service providers or where big financial service providers refuse to share large amounts of important credit information. Section 5.4 discusses the dearth of information sharing in South Africa, and it is argued that this is an important contributing factor to the lack of access to SME finance.

The Wallis Report³³ adds the following dimension, echoing the concerns in South Africa about privacy and access to information:

- 'The Attorney-General should establish a working party to assess the costs and benefits of positive credit reporting. Extension of the privacy regime should include striking an appropriate balance between consumer protection, consumer choice and the effective and efficient delivery of financial services.'

³² Cruickshank, *Op. cit.*, paragraph 50.

³³ Wallis, *Op. cit.*, pp. 478 and 520.

- ‘The absence of positive credit reporting may deny access to finance to customers who should obtain it. Positive credit reporting is widely used in the United States and Canada and is being used increasingly in several European countries. This practice may contribute to greater competition by enabling consumers with a good record of meeting their commitments to obtain finance more readily from institutions with which they do not have an existing banking relationship. Enabling institutions to assess credit risk more accurately may reduce the number of consumers defaulting and reduce interest rates.’

This is an area in which public intervention may be necessary, since it requires a **trade-off between the public benefits of increasing the effectiveness of the financial markets versus the commercial interests of individual firms**. Individual firms (and banks in particular) with significant market share may wish to deny competitors or potential competitors access to information about the track record and liabilities of their existing personal and SME clients. This would prevent such competitors from being able to assess the risk of such SMEs or owner-managed businesses. There is a further reason for public-policy intervention in this area: improving the access to information about SMEs and their owners requires a **trade-off between the individual’s constitutionally protected right to privacy versus the efficient market’s requirement for access to information**.

In short, access to information is a significant factor in:

- Enabling greater access to SME finance, by enabling credit providers to improve their risk assessment.
- Lowering the cost of finance by enabling the lenders to improve their risk analysis and assessment, thus enabling lenders to price more accurately for risk and to avoid unnecessary losses.
- Reducing the bias against start-ups and bank switchers by reducing the importance of the lender/borrower relationship in assessing a company’s creditworthiness.

- Lowering the cost of finance as a result of increased competition between existing financial service providers and new market entrants.
- ***Lowering the cost of small and micro-enterprise finance by lowering the loan appraisal and risk-assessment cost.*** The cost of traditional on-site loan appraisal is prohibitive for small loans and adds significantly to the cost of delivering such finance.

The ability (i) to access comprehensive information about SME exposures and repayment profiles and (ii) to access such information through an electronic interface has the potential to make a significant impact on the volume of SME finance being provided, as well as various categories of SMEs that may gain access to finance and the cost of such finance. Existing financial-service providers in general, and banks in particular, can manipulate or use access to information as a barrier to avoid competition with other banks and with NBFIs in the provision of finance to SMEs (see also Section 5.4).

2.7 Creating the ‘public infrastructure’ that will facilitate increased access to SME finance

It is a public-sector responsibility to engage in ‘market-completing’ interventions, i.e. interventions that will enable the market to function effectively.³⁴ These would include interventions such as the following:

- **Credit bureaux:** South Africa has well-established private-sector credit bureaux.³⁵ Although they are active in the enterprise information market, the bureaux are primarily geared towards providing information about private individuals. As a result, their access to information is limited and they have virtually no technical ability to implement the more complex database structures required for enterprises. Rather than duplicate the

³⁴ IFC, *Op. cit.*, p. 8.

³⁵ A model similar to that of the US and the UK. In many European countries, credit bureaux are government run.

existing infrastructure, the need for information related to SME finance seems to be in the following areas:

- Encouraging and incentivising information agencies to improve their technical capacity to handle more complex enterprise data and cope with more multidimensional requests.
 - Better regulation of private-sector credit bureaux in order to increase their credibility among the SME community and the public at large.
 - Facilitation or legislation to ensure that important SME-related information is provided to the bureaux.
-
- **SME database:** improvement in electronically accessible (non-credit-risk) information about the SME sector, such as statistics on turnover and profitability by geographical area and subsector.
 - **Register of pledges or of collateral:** countries such as Canada benefited greatly from the establishment of a register of pledges, thus enabling central, electronic verification of the collateral being offered by SMEs that were applying for finance.
 - **Legal enforcement of claims against SMEs and of the security offered by defaulting SMEs:** improving the accessibility and efficiency of the public infrastructure in this area would reduce the risk of and eventual loss resulting from an SME defaulting on debt or other obligations. It would therefore facilitate increased lending to SMEs. In addition, access to specialised courts to act against SMEs that default on loan obligations could also facilitate SME finance.

3 Historical development and role of NBFIs (including micro-lenders) in South Africa

3.1 NBFi development prior to the 1990s

Micro-lending and SME lending are by no means a new phenomenon in South Africa. Formal micro-lending³⁶ operations were practised by a small number of operators in the 1980s, most probably in contravention of the Usury Act, and perhaps even the Banks Act. The lenders included non-profit organisations (NGOs) whose primary aim was to assist the poor, as well as provincial and national development agencies and a small number of commercial companies that were involved in micro-lending and SME lending. Some of the most notable operations were the Small Business Development Corporation (SBDC), the Sugar Association's Financial Aid Fund (FAF)³⁷ and the KwaZulu Finance Corporation (KFC). Although most of these entities were very small and not sustainable, this was by no means true for the whole group. NBFIs such as the SBDC, KFC and FAF had SME loan portfolios that were significant even by international standards.

Outside medium-enterprise finance,³⁸ banks' involvement in SME finance has been limited. Particularly in small and micro-enterprise finance, bank lending has never gone beyond the 'experimental' or 'pilot' phase, and none of the banks have even vaguely approached the scale of involvement that has become common in Latin America over the past decade.³⁹ Only since the late 1990s has banks' exposure to micro-lending (not necessarily SME lending, mostly personal lending) started increasing, and a number of banks have acquired shareholding in specialised non-bank micro-lenders, whereas certain micro-lenders have converted to banks. The primary motivation for

³⁶ No strict distinction between SME, consumer and housing lending is made in the historical overview. The focus is on the context and the factors that shaped this section of financial-sector development.

³⁷ FAF provided finance to small-scale sugar producers.

³⁸ This is not to say that banks are or were meeting the demand for even medium-enterprise loans.

³⁹ See Christen, *Op. cit.*

banks' involvement in non-bank lenders has clearly been the profits that could be earned in the development phase of large-scale consumer lending. It also seems, however, that the most significant product development, in particular for small and micro-enterprise finance, is taking place outside of the mainstream banks.⁴⁰

3.2 NBF development in the 1990s: partial liberalisation

The establishment of the Independent Development Trust (IDT) in 1990 and the passing of an exemption notice to the Usury Act in 1992 were major milestones in the formation of the micro-lending industry as it is known today. The IDT's management was instrumental in persuading the government to promulgate a regulatory exemption from the maximum interest rates specified by the Usury Act for loans below R6 000. The motivation for this exemption was that the operating costs of a typical micro-lender exceeded the interest income (assuming adherence to the Usury Act limits) by a wide margin. This exemption was promulgated in December 1992 and was extensively used by the Independent Development Trust – Finance Company (IDTFC) and the retail lending entities (RLEs) which it financed to do on-lending.

The second main obstacle to the expansion of finance encountered by the IDTFC was the lack of access to funding for NBFIs. The NBFIs were far less successful in persuading the authorities to respond to this challenge, and ***the lack of access to funding remains a major obstacle to the delivery of finance to this day.***

3.2.1 1992 Usury Act Exemption Notice

The first Usury Act Exemption Notice was passed in 1992 and consisted of a full exemption from the Usury Act for all loans under R6 000. The exemption recognised that the provision of small loans was expensive and of high risk,

⁴⁰ For instance, this has been true for Absa Bank Limited with its Nu-Bank initiative and for the experimentation in micro-enterprise lending of Unibank Limited (another Absa subsidiary) through its joint venture with an international development agency in the North West Province. Other banks that are leading the innovation charge are African Bank and Capitec Bank, both of which were NBFIs until recently.

and that lenders would have to charge interest at rates higher than those permitted by the Usury Act to recover the cost on such small loans. The exemption thus 'legalised' the high rates that NGOs found were inevitable in providing micro-loans on a non-subsidised basis.

Possibly unintentionally, the exemption notice also led to the development of the cash loan industry (i.e. the provision of small cash loans⁴¹ for consumption and emergency finance). The huge growth in this industry, to annual loan disbursements of close to R15 billion by 1999, illustrates the extent to which the financial-service needs of the poor in South Africa were not being met by the banking sector.

By 1999, the micro-lending industry had therefore evolved into the following broad subcategories:

- Four banks were specialising in providing micro-loans.⁴² Loans averaged between R3 000 and R6 000, with average interest rates of around 60 per cent per annum and repayment terms of between 12 months and three years. A large majority of these loans were repaid through payroll deductions. The origins of these loans were in housing lending, but by 1999 the boundaries between housing and consumption lending had all but disappeared.
- A great number of 'cash lenders' were established, operating from formal shop fronts and, frequently, as part of franchise groups. These entities provided very small loans, repayable in single payments at month-end, at interest rates of 30 per cent per month (i.e. about 360 per cent per year). The loans were utilised mainly for emergency and consumption purposes.
- Roughly 30 NGOs were focusing on micro-enterprise lending with a smaller group doing housing lending. These non-government 'development lenders' generally provided loans of between R500 and

⁴¹ With an average loan amount of about R500 and a normal repayment term of one month.

⁴² The 'pure' micro-lenders are Cashbank, African Bank, Unibank and Saambou Bank Limited. Their common mandate may be described as serving the financial needs of the low and emerging middle-class, with product offerings evolving to meet the developing financial needs of this segment.

R3 000, repayable over nine to 18 months, at rates varying from 40 per cent to about 60 per cent per annum.

3.2.2 1999 Usury Act Exemption Notice and the establishment of the Micro Finance Regulatory Council (MFRC)

In June 1999, a revised Usury Act Exemption Notice⁴³ was passed. This made the exemption from the Usury Act conditional on registration with the MFRC and on adherence to certain basic disclosure and consumer-protection requirements.⁴⁴

The most notable impact of this more ‘formal’ regulation of the industry was the large-scale entry of new entities into financial-service delivery to low-/middle-income South Africans. It resulted in changes to the industry structure and greater competition,⁴⁵ product development, development of new delivery channels and significant investment in the application of new technology in this sector.

Among the ensuing changes in industry structure, the following are particularly important:

- The entry of banks into micro-lending increased, with large banks increasing their stakes (and, in certain cases, taking controlling stakes) in micro-lenders and micro-lending banks. In certain cases, leading retail banks added micro-lending products to their core banking products. The micro-lending products are delivered through their national branch distribution networks with a number of ‘joint ventures’ between banks, micro-lenders and also retail groups.

⁴³ *Government Gazette* No. 713 of June 1999

⁴⁴ The Exemption Notice included a prohibition on the practice of retaining clients’ bank cards and personal identification numbers and an interest-rate cap of ten times the prime rate. After a challenge in the High Court, the interest-rate cap was set aside.

⁴⁵ Interest rates on term loans have decreased by 20 per cent and more. Interest rates on short-term (one-month) loans have not yet decreased significantly, but there are indications that downward pressure on interest rates is taking effect.

- Another significant development is the entry of consumer-goods retailers (for example, furniture and clothing retailers) into money-lending and the offering of money loans to their customer base. Other entrants into this market include a leading insurance company, retirement-fund administrators and a number of employers that wished to offer 'better-priced loan products' to their employee base.
- Among the short-term lenders, the new regulations resulted in considerable consolidation and a few large groups being formed through the takeover of small, short-term micro-lending offices. This consolidation includes a bank being formed from more than 300 short-term micro-lending offices. The consolidation is far from complete and, despite the pressure on the smaller micro-lenders, there is a continuous stream of new registration of small micro-lenders with the MFRC.

3.2.3 Current trends

Client-service and product offerings are changing rapidly. There are indications that banks and non-bank lenders view the relationship with a micro-lending client as long term, potentially as the beginning of creating a long-term financial-services relationship with an emerging middle class. Product development reflects this trend, but there are indications that the existing regulatory environment is an impediment to the evolution of financial products that would meet the demands of the client base.

Of particular interest are the following features of the micro-lending industry as it exists today:

- More than 1 300 lenders (registered with the MFRC and including nine banks, nine other listed companies and a number of large private companies) have made a substantial commitment to providing financial services to the low-/middle-income market.

- Small- and micro-enterprise finance⁴⁶ remains minor in the loan portfolios of most micro-lenders,⁴⁷ but a significant number of these entities have identified this as being a strategically important development market.
- The market change is consistent with international experience and economic theory. As payroll-based consumer lending becomes increasingly ‘commoditised’ and keenly competitive, the lenders seek areas that are under-serviced where they could take the lead.
- Small- and micro-enterprise finance is obviously also seen as being an extension of the existing client base – leveraging of (i) the involvement of the clients with whom they have existing relationships in small- and micro-enterprises and (ii) the applicability of their existing expertise⁴⁸ in understanding the needs of the small- and micro-enterprise sector.
- Increased entry of NBFIs into SME finance is currently hampered by a number of significant regulatory and other obstacles. This is addressed in more detail in later sections of this chapter.

The micro-lending sector is a significant part of the NBFI group, deserving attention in its own right for the potential role in increased SME finance provision. The evolution of the micro-lending sector and present obstacles to the growth of the sector highlight the inefficiencies in the regulatory environment and are preventing NBFIs from evolving in response to the financial services needs that are currently not being met.⁴⁹

⁴⁶ Also low-cost housing, but this falls beyond the ambit of this report.

⁴⁷ See Table 3 on page 23.

⁴⁸ The knowledge of the low- and middle-income consumer group.

⁴⁹ Many of these obstacles are related to the overly dominant role of banks, and a small group of large banks in particular. The existing financial services regulations and regulatory arrangements prevent non-bank competitors from entering the financial services market or competing on an equal footing with banks. Appropriate regulatory reform should enable any entity wishing to provide financial services (but excluding deposit taking) to SMEs, to do so.

3.3 Micro-lenders' access to wholesale funding

Existing regulations hamper access to finance and have a negative impact on the development of the South African financial markets. Unfortunately, negligible progress has been made in this area during the past decade. **In contrast to the progressive developments in the loosening of interest-rate control, the position of access to funding by RLEs (i.e. “retail lending entities”) has probably deteriorated.**

By late 1994, the aggregate of the book debts of all NBFIs was in excess of R200 million and showed an insatiable demand for increasing wholesale funding, which the IDTFC was not in a position to provide. The CHIPs bond⁵⁰ was frowned upon by the Registrar of Banks and could not be utilised by the IDTFC to finance RLEs. The inability of the IDTFC to continue to meet the funding demands of its RLEs left a major vacuum. Banks were not interested in becoming involved as wholesale funders – a situation that has not changed to this day. The first wholesale loan of about R5 million to King Finance was provided only in 1995.

The lack of access to wholesale funding for housing was extensively debated during 1993/4 and led to the establishment of the National Housing Finance Corporation⁵¹ (NHFC) in 1995 and the establishment of Khula Enterprise Finance Limited in 1996. Through these two institutions, the government intended to increase access to ‘wholesale funding’ for on-lending by banks and NBFIs for housing and enterprise finance, respectively. However, the existing regulations hampering the financial markets from responding to the demand for capital have largely been left unchanged (see also Section 4.2).

⁵⁰ This bond raised funding for the IDTFC’s retail lending enterprises.

⁵¹ The NHFC took over the book debts of the IDTFC and continued slowly to grow its loan advances to RLEs and other approved lenders. The aggregate of its book debt today is about R600 million.

3.4 Impact of interest-rate regulation

The level at which the interest-rate cap in the Usury Act has been set prevents cost recovery on small loans. The Usury Act Exemption Notice exempts loans of less than R10 000 from this cap. The amount of R10 000, however, falls substantially short of the finance required by most small enterprises, implying that such finance is still provided only on a very limited scale. **As a consequence, the regulatory environment that has been created (within the small loan segment), has a bias against the provision of larger loans (R10 000-50 000), repayable over longer terms, and a bias in favour of the provision of short-term consumption loans.**

This encouraged the predominance of short term, consumption debt amongst low- and middle-income South Africans.⁵² The regulatory environment, through both the Usury Act and the Banks Act, encourages small, short-term (and therefore consumption) lending, while preventing the provision of larger, long-term investment finance.

3.5 Relevance of developments in micro-lending for SME finance

3.5.1 *Current status of micro-lending*

The statistics on the actual utilisation of micro-loans are generally unreliable. The statistics derived from the returns that micro-lenders submit to the MFRC indicate that roughly 5 per cent of all loans, or 450 000 loans with a total value of approximately R700 million, are utilised to finance businesses. This percentage, however, is thought to be grossly understated. Given the fungibility of money, many researchers believe a much higher percentage of

⁵² The majority of the South African population do not have access to larger longer-term debt, such as for investment in housing or enterprises. Non-bank lenders are inhibited from providing such finance by the interest cap on loans and by the limitation on access to finance, i.e. by their inability to fund larger, long-term loans. The only type of finance that is encouraged by regulation, and which consequently is widely available, is small short-term loans.

micro-loans is being used to fund enterprises. According to research by the MFRC, anything between 1 per cent and 13 per cent of the 'general purpose' loans taken from micro-lenders may in fact be used for business purposes (the corresponding range for housing is from 6 per cent to 45 per cent – the MFRC plans to obtain firmer statistics in the near future).

3.5.2 Impact of micro-lending on demand for SME output

Micro-lenders *disburse cash* to middle- and low-income South Africans. The only other form of credit to which these income groups have had access in the past was consumer credit, namely the credit facilities provided by the suppliers of consumer goods for the acquisition of such goods. Prior to the entry of micro-lenders, the major providers of finance to low-/middle-income South Africans were large corporates, which provided such credit facilities to stimulate the demand for their own output of consumer goods. The entry of micro-lenders meant that, for the first time, finance was also available to finance purchases *other than those from large retail groups*. For the first time, the consumer could also access finance to buy goods or services from a small- or micro-enterprise.

The different categories of consumer credit are unequally regulated at present, and **micro-lending is far more strictly regulated than any other category of finance being provided**. This creates a bias of consumer spending away from SME output.

3.5.3 Potential of SME finance provision by micro-lenders

The MFRC conducted a snap survey among the 80 biggest registered micro-lenders in order to assess the importance of SME finance in the strategic plans of these lenders. Some of the key findings of this survey are presented in Table 2 below.

Table 2: Survey on micro-lenders' finance to SMEs			
Although 60 per cent of respondents had less than 20 per cent of their loan portfolio devoted to SME lending, 76 per cent regarded SME lending as either important or very important in their current business strategy, and over 90 per cent regarded it as important or very important within the next three years.			
Over 60 per cent of lenders found that existing demand for SME finance from borrowers was greater than they were capable of or willing to provide.			
The greatest challenges facing lenders in providing SME finance were identified as: <ul style="list-style-type: none"> ▪ Understanding all the risks associated with SME lending. ▪ Obtaining quick and meaningful borrower information for making an informed decision about SME loans. ▪ Obtaining wholesale funding to provide SME loans to end-users. ▪ Limitations to the Usury Act and Exemption Notice, which made the offering of SME loans above the exemption limit of R10 000 restrictive and mostly unprofitable.¹ 			
Over 80 per cent of respondents said there would be some impact or a significant impact on their business if the National Loans Register ² could be expanded to include an SME database.			
Given an accommodating/enabling regulatory environment, the lowest estimate of the number of SME loans that would be provided in terms of the strategic plans of these lenders was about 555 000 (see table below) ³ .			
	Lowest	Average	Highest
Number of loans	555 000	851 000	1 142 000
Rand value	R734 million	R1,48 billion	R1,98 billion
<p>¹. This indicates the existence of a SME 'credit gap' of between R10 000 and R50 000, where the latter amount becomes an average starting point for most commercial banks to extend loan facilities to creditworthy SME borrowers. Indeed, the Banking Council South Africa recognises the existence of this gap. It has initiated a joint venture with South Africa's four major banks to provide increased financial access to this sector. To date, the impact of this initiative has been insignificant – 56 applications, amounting to a total of R1,9 million have been approved. The council concedes, however, that much still has to be done and acknowledges that '<i>... banks are under pressure to expand their delivery of financial services to the poor</i>' (see Banking Council, <i>Annual Report</i>, Johannesburg, 1999, pp. 28-29).</p> <p>². The National Loans Register is a 'credit bureau' of micro-loans that has been established by the MFRC, and the management of the register has been outsourced to the two major credit bureaux. The primary purpose of this step is to combat predatory lending and over-indebtedness by compelling lenders to assess a borrower's existing debt commitments before advancing any new loans.</p> <p>³. This snap survey did not make use of a large sample of lenders to reach its conclusions. The supply side, for instance, does not end with statistics on Khula and MFRC; Business Partners do substantial SME lending as do commercial banks although their statistics are not well publicised. Other development agencies have had limited SME impact. Clearly, much more detailed research should be undertaken in this area.</p> <ul style="list-style-type: none"> • Some of the other activity in SME finance includes the following: the Land Bank has a significant micro-credit rural programme of about 50 000 clients but there are no criteria to indicate whether these are necessarily SME loans, or possibly just consumption loans. Other institutions, such as Ithala, do have small-business loan programmes. The DBSA also has a financing scheme for women who are building contractors. One of African Bank's subsidiaries has a building-contractor loan book estimated at R210 million. 			

In short, micro-lenders appear to be willing to increase their involvement in SME finance, provided the legislative and regulatory obstacles are removed.

4 Legal environment for NBFIs

This section summarises the existing legal and regulatory dispensation for NBFIs,⁵³ focusing on interest-rate control and access to funding. The next section assesses the implications and limitations imposed by the existing dispensation(s).

4.1 Usury Act: price control on loan finance

South Africa has price control on credit, embodied in interest-rate limitations on all money-lending transactions, credit transactions and leasing transactions. This restriction is imposed in terms of section 2 of the Usury Act (No. 73 of 1968). The Usury Act furthermore allows for different limits to be set for different types and categories of transaction and also for certain types or categories of transaction to be exempted from such interest-rate limits.⁵⁴

The following exemptions should be noted:

- The Land Bank is exempted from the conditions of the Usury Act.
- Loans below R10 000 are exempted if the lender is registered with the MFRC and the transactions comply with the conditions of the exemption notice referred to in Section 3.2.2 above. Rather than being an unconditional exemption from regulation, the said exemption notice creates a simplified set of rules with which exempted loans have to

⁵³ Note that the Usury Act limitations also apply to banks. The limitations discussed in this section therefore also inhibit lending by banks to SMEs.

⁵⁴ Currently, the limits are 22 per cent for transactions over R10 000 and 25 per cent for transactions under R10 000. These limits are set by the Minister of Trade and Industry and are published in the *Government Gazette*.

comply and places the obligation on the MFRC to monitor compliance and enforce these rules.⁵⁵

This framework allows lenders to recover a higher interest rate from borrowers for loans of less than R10 000. Through the exemption notice, recognition is given to the fact that the cost and risk of small loans cannot be recovered within the interest-rate limit of the Usury Act. Section 5.1 argues that this volume limitation and the level of the Usury Act limits still place an effective prohibition on the majority of potential SME lending. The level of contravention of the Usury Act is supposedly still high.⁵⁶

4.2 Banks Act and access to funding

The Banks Act regulates banking business, defined as the acceptance of deposits from the general public and the employment of such funds to grant loans, make investments or provide finance to any person for any other business activity. More specifically, the 'business of a bank' is defined in Section 1 of the Banks Act as follows:

- Acceptance of deposits from the general public (including persons in the employ of the person so accepting deposits) as a regular feature of the business in question.
- Soliciting of or advertising for deposits.
- Utilisation of money, or of the interest or other income earned on money, accepted by way of deposit as contemplated in paragraph (a).⁵⁷

⁵⁵ The Usury Act Exemption Notice meets most, if not all, requirements for the regulation of consumer-credit transactions, as contained in the relevant European Union Directive, and is also consistent with the requirements of the regulation of 'pay-day lending', as contained in the United States. It creates a dispensation of 'functional' rather than 'institutional' regulation, as all transactions falling within the ambit of the regulation are required to register with the MFRC. Entities that do register, submit themselves to oversight only in respect of the transactions being regulated.

⁵⁶ Refer 'Feeding the Loan Sharks?', *Op. cit.*, pp. 30- 31.

⁵⁷ Paragraph (a) includes the following stipulations on the utilisation of such money: (1) the granting by any person, acting as a lender in his/her own name or through the medium of a trust or a nominee, **of loans to other persons**; (2) **investment by any person**, acting as investor in his/her own name or through the medium of a trust or a nominee; or (3) the financing, wholly or to any material extent, **by any person of any other business activity** conducted by him/her in his/her own name or through the medium of a trust or a nominee.

In this way the Banks Act governs the activities of all entities that raise deposits from the general public. The initial capital requirement for registration as a bank has been set at R250 million, whereas for a mutual bank the initial capital requirement is set at R50 million. For NBFIs wishing to become a bank (even for those with very limited business operations), this is a very high entry barrier indeed.

4.2.1 Access to finance by issuing commercial paper

The current restrictions on the issue of commercial paper should be evaluated against the background that, for instance, South Africa's company law is badly outdated (e.g. in respect of public debenture issues) and that there is still no equivalent along the lines of a Financial Services Act or a Collective Investment Schemes Act (as enacted in the UK as long ago as in the 1980s). The drafting of improved legislation in this area has been in progress for many years now but, in the interim, greater reliance had to be placed on the Banks Act to protect the investing public against fraud. Accordingly, South African banking legislation is far more restrictive than US or EU legislation.

The commercial-paper exemption from the provisions of the Banks Act has been created to enable entities that are not banks to access funding by issuing commercial paper directly to investors.⁵⁸ This is accessible, however, only to listed companies with net assets exceeding R100 million, *'provided the money so accepted is not used, in the case of such acceptance of money by a person other than a bank, for the granting of money loans or credit (other than customary credit in respect of the sale of goods or provision of services by the issuer of such financial instruments).'*⁵⁹ This effectively ensures that NBFIs cannot access funding from private investors for on-lending to SMEs and cannot access funding from private investors or any other type of client.

⁵⁸ Defined as 'debentures, bills of exchange, promissory notes or other similar financial instruments' (see Banks Act).

⁵⁹ Paragraph (ee) under the definition of "the business of a bank".

Through the definitions of a deposit and of banking business, as well as the various exemptions from the provisions of the Banks Act, the said Act has been structured to define, as the sole mandate of entities registered as banks, both the acceptance of deposits from the general public **and** the granting of money loans even if such loans are funded from sources other than retail deposits. The Banks Act ensures that only banks may be engaged in the extension of money loans, despite the stated intention of the Act to regulate deposit taking only. Furthermore, through the limitation on the commercial-paper exemption (discussed above), neither is this avenue available to NBFIs to raise money for on-lending.

4.2.2 Special dispensations under the Banks Act

A number of institutions are exempted from the provisions of the Banks Act. These include the Land Bank, the Post Bank, the Development Bank of Southern Africa, the Industrial Development Corporation of South Africa Limited and the National Housing Finance Corporation Limited.⁶⁰ The level of contravention of the Banks Act is reported as being quite high.⁶¹

In the past, the number of exemptions from the Banks Act was much higher, but there has been a move to abolish many of these exemptions. This has affected institutions such as development finance corporations and Teba (which has since been registered as a bank).

There is a further group of exemptions, namely the 'common bond exemption'. Through an exemption notice, credit unions, savings and credit co-operatives, and *stokvels* are exempted from the Banks Act. The conditions are that (i) there has to be a 'common bond' between the members of institutions; (ii) the institutions must be members of a recognised self-regulatory body; and (iii) they have to comply with certain other conditions.

⁶⁰ Khula Enterprise Finance is not exempted from the Banks Act, and most of Khula's clients are therefore technically in breach of the Banks Act.

⁶¹ Stassen, S., Regulation and Supervision of Micro-finance Institutions in South Africa, *GTZ Discussion Paper*, 1999, p. 9.

The regulatory logic is that the members of these institutions (whether savers or borrowers) would ensure, through 'peer pressure', that such institutions are soundly managed, that borrowers do not generally default and that savers' funds are safeguarded. Also relevant is the fact that these institutions are small and that the 'failure' of one or many of them would not pose a systemic risk.

Village financial services co-operatives, commonly known as village banks, are similarly exempted from the provisions of the Banks Act, subject to certain conditions.

5 Obstacles to greater provision of SME finance by NBFIs

5.1 Interest-rate control through the Usury Act

Through the Usury Act, a maximum interest limit is set to all money-lending, credit and leasing transactions. The Usury Act Exemption Notice exempts transactions up to R10 000 from this interest-rate limit. Obviously, to the extent that the level of the interest-rate cap prevents financial service providers from charging interest rates that are high enough to cover the risk and cost, and to provide for an acceptable return on their loans, the Usury Act prevents such loans from being provided.

The structure and levels of the existing interest-rate limits appear to be a major disincentive to the provision of SME loans in the range between R10 000 and approximately R300 000. The fact that there is no interest-rate limit in the exemption notice has led to the increased provision of finance within the exemption notice parameters (that is, the increased provision of loans of less than R10 000).⁶² All indications are that at *the level* that the Usury Act interest caps are set, SME loans above R10 000 would generally

⁶² It is remarkable that many institutions are registering with the MFRC in order to gain the benefit of the exemption notice environment, despite the fact that it involves a not insubstantial annual registration fee and further compliance costs in the form of quarterly returns, auditors' compliance certificates and so forth.

not be viable. Only when the loan size is around R300 000 does this picture change.

The existing limits of the Usury Act, as well as the principle and structure of the price control that it embodies, need to be reconsidered, since they are major factors determining both the type and size of the SME finance being provided. Moreover, they discourage new potential financial service providers from entering the market. The R10 000 volume limit within the exemption notice is similarly problematic, since it is too low for most of the SME finance required. **A more accommodating approach would be to increase both the R10 000 and three-year repayment-term limits of the exemption notice, but only for SME and housing lending (probably with auditing requirements).** Such an exemption might well also be subject to an alternative interest cap (that is, it need not be totally 'uncapped'). This would allow a greater range of lending to take place within the parameters of the exemption notice, with the MFRC monitoring the compliance with the conditions.

Inconsistency between the requirements and level of enforcement of the Usury Act, the Credit Agreements Act and the Usury Act Exemption Notice may well be creating disincentives to the provision of relatively complex (and higher cost and risk) forms of finance such as SME loans, relative to consumer credit or payroll-based lending. It might facilitate increased SME lending if these different pieces of legislation were to be integrated into a consolidated Consumer Credit Act or Small Credit Act.⁶³ In the process, the complexity and cost of compliance could be reduced.

⁶³ The recent Financial Sector Assessment Program mission of the International Monetary Fund (IMF) recommended the enactment of a National Consumer Credit Act, with 'truth-in-lending' provisions, to replace the Usury Act, 1968, and its application to banks and registered micro-lenders. (Reported in the *Annual Report of the Bank Supervision Department*, Pretoria: SA Reserve Bank, 2000, p.15).

5.2 Access to capital

Together with the limits on interest rates, lack of access to loanable funds is commonly recognised as another big constraint on the increased provision of SME finance by NBFIs.⁶⁴ NBFIs' access to capital is constrained at the following levels:

- **Minimum capital and other requirements to establish a bank:** at R250 million, the initial minimum capital requirement to obtain a bank licence is high even by developed-country standards and very high relative to the standards of developing countries. This implies that the establishment of a bank is not a viable option, except for very large NBFIs. Therefore, these entities cannot gain access to the range of funding options open to a bank.⁶⁵
- **Mutual Banks Act:** at R50 million, this Act has a much lower initial capital requirement. The compliance requirements, however, are nearly as onerous as those of the Banks Act, and the mutual structure, in particular, makes this an unattractive option for NBFIs.
- **Commercial-paper exemption:** besides the onerous conditions for access to this exemption,⁶⁶ it specifically excludes entities that are in the business of providing loans.

⁶⁴ Ntsika Enterprise Promotion Agency, *National Small Business Regulatory Review*, June 1999, p. 37; and Staschen, *Op. cit.*, p. 9.

⁶⁵ The cost and other requirements of establishing an NBFi are much lower than those of establishing a bank. One of the results is that there is far keener competition in those segments of the financial markets to which NBFIs also have access.

⁶⁶ In particular, the restriction that it may be used only by listed companies with net assets exceeding R100 million (see Section 4.2.1 above).

- **‘Common-bond’ exemption:**⁶⁷ this exemption requires some type of ‘common bond’ among the members of the entity in order to qualify. This disqualifies most typical NBFIs.

Given the broad definition of a ‘deposit’ contained in the Banks Act, and the limitations in the alternative dispensations, the options available to NBFIs for raising external funding are extremely limited. **This inability of NBFIs to access capital has been identified as a major weakness in the South African financial system in numerous reports during the past few years**, including the report of the Financial Sector Assessment Program mission,⁶⁸ the Staschen Report,⁶⁹ the *National Small Business Regulatory Review*⁷⁰ and the report of the Strauss Commission.⁷¹ Although this weakness has been generally recognised, no concrete steps have yet been taken to remedy the weakness.

The above constraints have at least the following direct results:

- They limit the overall amount of finance being made available to SMEs through NBFIs.
- They increase the cost of finance being made available.
- They impact on the range of products being provided to SMEs by NBFIs, forcing NBFIs to provide shorter-term funding and smaller amounts of funding than would have been possible if access to funding were adequate.

⁶⁷ It is worth noting that the manner of regulation of credit unions in particular is increasingly being criticised for the lack of dynamic growth in these entities (note statements by Mr D de Jongh, Managing Director of the Savings and Credit Co-operative League of South Africa). The argument being presented is that the reliance on ‘self-regulation’ lacks credibility and that this undermines the trust of the public in these institutions. A similar argument may be made for, at least, recognition in law of a *stokvel* as a legal entity and the rights and obligations of its members. The massive scale on which *stokvels* exist seems sufficient cause for assessing the feasibility of such an approach. It may allow these entities to play a larger role in small business finance (and the role that they already play as ‘business angels for micro enterprises’ should not be underestimated).

⁶⁸ The mission of the IMF recommended that micro-lenders be supported by new sources of funds, such as commercial paper issued to institutional investors (Reported in the *Annual Report of the Bank Supervision Department*, *Op. cit.*, p. 15).

⁶⁹ Staschen, *Op. cit.*, p. 9.

⁷⁰ *National Small Business Regulatory Review*, *Op. cit.*, p.37.

⁷¹ Strauss Commission, *Final Report of the Commission of Inquiry into the Provision of Rural Financial Services*, Pretoria, September 1996.

5.3 Enhancing competitive neutrality between banks and other financial service providers

South Africa's banking sector is dominated by a small number of large banks. The four largest commercial banks account for over 75 per cent of the total assets of the banking sector, and the six biggest banks account for 90 per cent of the total assets of all registered banks.

The danger is that the dominant banks could use their market power to undermine the position of non-bank competitors in the credit markets, rather than attempting to compete with such institutions. A lack of sufficient local and international competition could result in lower levels of innovation, higher margins and higher costs to clients than in a competitive environment. This potential threat of a 'complex monopoly' is exaggerated in areas in which self-regulatory institutions play a role in regulation, such as is the case with the Payments Association of South Africa (PASA).

The concentration of market power in the major banks is likely to be a negative factor in the provision of finance to SMEs. In the following specific areas, the dominant position of the largest banks may detrimentally affect the provision of financial services to SMEs:

- Through banks' control over access to payments streams (exercised through PASA and a range of interbank agreements), niche banks and NBFIs are limited from participating in clearing and settlement in the national payment system, thus limiting the range of financial services that NBFIs can offer to SMEs.
- Through banks' control over information about credit exposures and repayment profiles, NBFIs are prevented from accurately assessing SMEs' creditworthiness, thus limiting competition.

- Through banks' ability to determine or influence the order in which different creditors are repaid, the risk profile for NBFIs providing finance to SMEs (when such SMEs are account holders with banks) is increased.

These factors limit NBFIs' ability and willingness to enter the market of financial-service provision to SMEs, and increase the risk and cost of finance for those that do provide finance to SMEs. It is important to reduce as far as possible the above-mentioned entry barriers to NBFIs (that is, without endangering the integrity of the national payment system) and so enhance effective competition in the financial markets.⁷²

5.3.1 Collection preferences

SME clients are nearly always account holders with banks, since SMEs need cheque and transmission facilities. The finance extended to an SME is nearly always repaid into a bank account. There have been many instances where the account-holding banks created mechanisms for making such banks preferred creditors.⁷³

These arrangements fall into the following broad categories⁷⁴:

- Placement of a hold (or partial hold) on a client's bank account until certain specified payments have been cleared. Repayments to certain lenders are in this manner given preference over payments to any other creditors.
- Creation of 'dummy accounts' next to the client's conventional bank account. Client payments are made into this account and 'preferred' loan payments are cleared from this account. Thereafter, the remaining

⁷² An enabling regulatory environment should give the means for the entry of new institutions to SME-finance provision and for evolution in different institutional forms. The latter could take place:

- either through larger institutions (including banks) taking over niche players and bringing the benefit of economies of scale and lower cost of capital to specific market segments, once the risk and operational requirements of such segments are sufficiently understood; or
- through new financial service providers developing within specific market niches.

⁷³ These preferential arrangements are frequently extended to other credit providers with which a bank may have special relationships.

⁷⁴ All of the above arrangements refer to transacting on accounts in the normal course of business and not to the prioritisation between creditors when a business is put in liquidation. In the latter case, the insolvency legislation determines prioritisation.

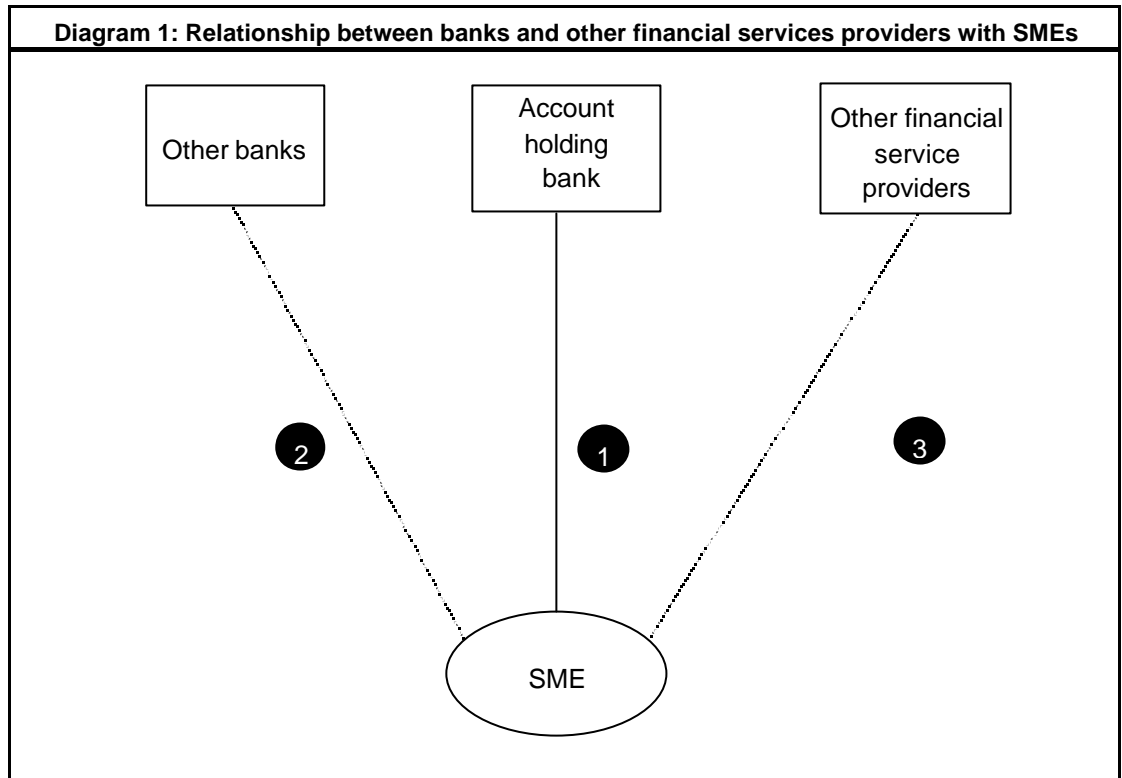
balance is passed through to the conventional bank account, on which normal debit orders are processed and to which the client has access. This mechanism therefore confers a preference to the bank that created such a 'dummy account', as well as to all other institutions that are allowed access to such a dummy account.

- Arrangements between creditors and the account-holding bank, in order to ensure the preferential processing of such a creditor's debit orders on borrowers. This typically implies manual or semi-manual intervention in the order of processing of debits. The arrangement could imply that a bank would process these debit orders – which may include debit orders relating to finance provided by the account-holding bank – on its account holders before any other debit orders are processed.

All these arrangements potentially have negative implications for consumer protection, as well as for the integrity and consistency of the payment systems. The fundamental objective of these banking arrangements is for certain lenders (typically including loans that have been made by the account-holding bank) to obtain a preference on collection of repayments from the client over other credit providers. It fundamentally compromises the neutrality of banks *vis-à-vis* the national payment system.⁷⁵

Accordingly, as shown in Diagram 1 on the next page, these various mechanisms create a significant disincentive to providing finance to an SME for categories 2 and 3. At any time during the course of its relationship with an SME client, the account-holding bank can undermine the legal rights of others by implementing a preferential collection arrangement in its own favour, for a new or existing debt (that is, relationship 1 in Diagram 1).

⁷⁵ Note that such practices are specifically regulated in other dispensations; see, for example, European Union Directive 87/598/eec: relating to electronic payment (relations between financial institutions, traders and service establishments, and consumers).



All these arrangements add extra layers of risk to SME lending by competing banks⁷⁶ and NBFIs⁷⁷ (that is, all institutions except the account-holding bank). They also create a significant disincentive for banks to market loan products to clients who hold their transaction accounts with competing banks. A major additional risk for any external financier (other than the account-holding bank) is that, after such a financier has provided the finance, the account-holding bank may implement one of the arrangements described in Diagram 1 above. This would give the account-holding bank, or an associated institution, a preferential claim to collect repayments. Consequently the current arrangement undermines innovation and investments in new products, particularly new products with different risk and term structures or different risk-assessment methodologies, as would be required for increased SME lending. The current arrangements, obviously, are also a major disincentive for such entities to provide large loans.

⁷⁶ That is, banks other than the bank with which the SME has its transaction accounts.

⁷⁷ When the SME approaches a bank other than that where it holds its bank accounts for finance.

5.3.2 Control over access to payment streams

The Payment Association of South Africa (PASA) oversees the management of and access to the payment streams. Payment streams include: (1) paper (mainly cheques) and (2) electronic fund transfer (EFT) debits and credits (including Saswitch and electronic debit orders). The governing committee of PASA consists of the five banks that are the largest users of the payments infrastructure, two representatives elected by the remaining banks and the South African Reserve Bank as a non-voting member. The payment streams are further regulated by a number of bilateral agreements between the different banks that are part of these streams.

This arrangement impacts directly upon transactions between NBFIs and their SME clients. Unless an SME repays a loan in cash to the NBFI, the repayment would have to be channelled through one of the payment streams. Through their control over PASA and over the different bilateral agreements, the major banks also have the ability to place obstacles in the path of the growth and development of NBFIs. They can achieve this by, for instance, denying access to a payment stream or by placing conditionality on such access.⁷⁸

5.4 Access to information: information on credit exposures and collateral

Usually, SME loans are small, the risk of default is high and the transaction cost is high. Lack of access to information and the cost of accessing information add considerably to the cost and risk of evaluating applications for finance from SMEs and also increase the cost of such finance.

⁷⁸ Over the past 24 months, this has been a continuous bone of contention between the short-term micro-lenders that are registered with the MFRC and the major banks. Prior to the prohibition in the Usury Act Exemption Notice, short-term micro-lenders typically recovered loan repayments by using their clients' bank cards and personal identification numbers to withdraw loan repayments directly from the clients' bank accounts. In order to respond to the prohibition, the micro-lenders required a facility that would allow the loan repayment to be transferred upon due date directly from a borrower's loan account to the account of the lender. The major banks have consistently refused to co-operate in the development of a 'payment stream' that would be appropriate for such transactions.

For a lender to assess the credit risk prior to making a loan and to manage this risk throughout the period of the loan, such lender would have to have access to comprehensive, accurate information about all the **financial commitments** of the applicant, about his/her **repayment record** and about the **collateral** that may be offered as security for the loan. In this context, the following issues are of particular importance for NBFIs:

- Access to information with which to confirm information already provided by an SME in an application for finance.
- Information with which to assess the SME's business plan and financial performance, as well as the prospects of the market segment in which the SME operates and the SME's position in the market segment.
- Information about the SME's existing financial obligations and liabilities.
- Information with which to assess the ownership and value of the security being offered by the SME.

Before making a loan, the credit provider requires such information to assess the 'creditworthiness' of the applicant, to assess the level of security that is required and to price the loan. If a credit provider incurs losses on finance as a result of factors that were unpredictable at the time of providing the finance – such as another credit provider creating a preference on the repayment stream – the first-mentioned credit provider would avoid such a category of applicant in future transactions. In case of default, a credit provider requires the capability of claiming against the security to the level initially offered. Accordingly, it has to be legally and socially possible to convert the security into cash, and no other credit provider should be able to pre-empt this claim.

The same considerations apply to a corporate application for finance. The sources of information, however, are more readily available and more reliable (for example, through an analysis of the applicant's annual financial

statements, or even the management accounts). For a variety of reasons,⁷⁹ the financial statements prepared by SMEs frequently have a less informative quality. In assessing the merit of an application for finance from a large enterprise, the financial statements would therefore play a much more important role than in the case of an SME, and would allow a significant saving in the cost of loan appraisal.

The level of fraud and corruption in South Africa further adds to the cost and complexity of doing SME risk assessments, for example through the added effort required to verify the validity of the documentation presented with loan applications. This adds another dimension in which access to information through a common infrastructure would mean a significant saving in the assessment of loan applications. Table 3 below contains a list of the types of information required, and the extent of its availability.

⁷⁹ In particular, the following reasons play a role:

- (a) the young age and dynamism of the enterprise (with the result that the annual financial statements are often outdated before they are published and audited);
- (b) the lack of skills, plus rather basic accounting systems in place, plus an inability to afford obtaining expensive accounting services;
- (c) the frequent difficulty with separating personal and business items, e.g. concerning premises and rental; and of course
- (d) the age-old technique of preparing one set of financial statements for the banker and another for the tax man.

Table 3: Information-sharing arrangements			
<i>Information requirement</i>	Businesses	Household of SME owner	Extent of access through credit bureaux or other information-sharing arrangements
▪ Rent for business premises / home	✓	✓	Not available
▪ Rent for machinery or office equipment	✓		Not available
▪ Lease payments & outstanding balance on machinery or equipment being leased	✓		Not shared
▪ Lease payments & outstanding balance on vehicles: business and personal	✓	✓	Not shared
▪ Nature of contract & extent of ownership of assets	✓	✓	Not available
▪ Municipal service payments (water, electricity, services, etc)	✓	✓	Not shared
▪ Recurring monthly expenses, for example, telephone and postage		✓	Credit bureaux (individuals only)
▪ Balances and repayments on bank accounts and bank loans	✓	✓	Information available to banks through interbank enquiry; this facility is <u>not available to non-banks</u>
▪ Credit cards: outstanding balances and monthly repayments	✓	✓	Information available to banks through interbank enquiry; This facility is <u>not available to non-banks</u>
▪ Mortgages and bonds over property (where owned) and notarial bonds	✓	✓	Shared among banks through interbank credit bureaux (amounts registered, not payments made)
▪ Liens or other encumbrances over business assets	✓		Not shared
▪ Factoring, invoice discounting or any other transfer of ownership of debtors	✓		Not shared
▪ Working capital / personal loans	✓		Not shared currently, position may change
▪ Term loans	✓	✓	Not shared currently, position may change
Note 1: Even when information is marked 'not available', it may still be shared within a group of banks and sometimes also with certain external parties with whom 'special arrangements' are made, such as when 'joint ventures' are entered into.			

The information-sharing arrangements described in Table 3 have the following implications:

- In categories to which a bank or banks have preferred access to information, such banks are better able to assess the risk. The risk for NBFIs and other banks is therefore always higher than it is for the account-holding bank, thus inhibiting such NBFIs or competing banks from providing finance to SMEs.
- A further risk to NBFIs is that, after an NBFIs has extended finance to a client, any bank may extend finance to the same client or may structure the transaction in such a way that the bank has a prior claim on the SME's cash flow.⁸⁰

A type of 'pecking order' is established in the following manner:

- The bank with which the SME has its personal and business accounts has the best information available, the lowest risk profile and the highest incentive to provide finance.
- Next in order is any party with which the bank may have a 'joint venture' or other special arrangement, whether for information sharing or for repayment collection.
- Then come any other banks.
- Only after that come the independent NBFIs.

If an NBFIs still considers providing finance in such circumstances, it would still need to assess the merits of the application. Since the information required to do such an assessment is not readily available, the implication is that a prospective financier would have to visit the SME's place of business (for small- and micro- businesses, frequently also the home of the owner) in order to collect information with which to identify and verify potential, undisclosed liabilities, financial commitments and the business's performance. Given the relatively small amounts for which SMEs tend to

⁸⁰ This process is described in the previous section.

apply, the cost of such an on-site investigation has a negative and significant impact on the cost of the finance being provided.

The information deficiencies therefore imply not only that access to finance is limited, but that the cost of finance to SMEs is substantially higher than it might have been with ready access to reliable information through public infrastructure.⁸¹

The implications of the above-mentioned arrangements are clear. NBFIs (and to some extent, even banks) would provide finance to SMEs only in cases in which they have made some kind of 'arrangement' for preferential access to information, or when they have a preferential claim on the SME's or its owner's cash flow.

⁸¹ Note that, in a number of countries, such public infrastructure is available for information exchange. The leading countries in this area are the US and Canada. Cruickshank (and a number of other observers) identified this information infrastructure as one of the important reasons for the greater availability of a range of financial products to SMEs. See Appendix E of the Cruickshank Report.

- The regulatory authorities should consider the licensing of core banks and other second tier banking institutions as a new competitive force in banking. Core banks (or “narrow banks”), with very limited risk exposures, should have significantly lower initial capital requirements than the current requirement of R250 million for fully-fledged banks.
- The Postbank may be better positioned as a supplier of banking services in the rural areas and/or for lower income groups. In its transformation, the Postbank should make a thorough assessment of these developments, including limited licensing and constraints on its access to the payment system.
- Core banks should have access to the national payment system on terms that ensure the ‘fair and correct’ pricing of money-transmission services.
- Information disclosure about banking fees and the costs of a basic banking service should be enhanced by means of pricing models (i.e. to be established and maintained by the regulatory authorities).
- The Registrar of Banks should publish aggregated information about the internal rate of return on the main banking activities, such as corporate finance, SME finance, personal finance and securities trading. To avoid possible systemic risks that might emanate from full disclosure, this information could be published for the industry as a whole and, perhaps, after a time delay.
- The regulatory authorities should compare the profit distribution of major bank activities with the international data, in order to promote information disclosure and, thus, encourage international participation and competition in the local markets.
- Last but not least, although effective and efficient co-operation between the banking sector, Government and the regulatory authorities is important and desirable, this should not in any way reduce the degree of

competition in the financial markets. The exchange of privileges for co-operation in policy making (referred to by Cruickshank as the 'old regulatory contract': see Appendix 5) should be avoided.

CHAPTER 5

SMEs' ACCESS TO THE CAPITAL MARKETS

1 Introduction

In general terms, the capital market (in which banks are the major participants) can, and should compete head-on with banks in the supply of debt finance to businesses, including SMEs. Any financial system that is built on the two pillars of banking and securities markets is stronger than a system that is built solely on banking credit. In contrast to banks, securities markets bring home the pains of recession and mismanagement immediately, making the recovery quicker and easier. The best-functioning economies are those that diversify their sources of finance, turning variously to banks and markets as conditions dictate. From a regulatory viewpoint it is essential that the competition between the banks and capital markets takes place on a level playing field¹.

In industrialised countries, securitisation is an accepted method of funding medium-sized or larger enterprises. In contrast to small- and micro-enterprises, medium-sized businesses often have a track record of some kind, indicate a higher degree of sustainability, and the owner-manager has built up an amount of equity in the business². The owners of medium-sized enterprises are able to supply some form of security (over collateralisation). They have acquired certain skills and have the ability and willingness to acquire more. Perhaps, such entrepreneurs are launching their own businesses in a field in which they have been operating for some time, and

¹ *The Economist*, "A survey of global equity markets", London, 5 May 2001, pp.36-37.

² This is not to say that securitisation cannot be instrumental in channelling debt funding from the securities markets to the micro-enterprise market; this, however, would usually be done indirectly through the microlending industry. Microlenders, whether lending to micro-enterprises or to individuals, are usually small- to medium enterprises themselves.

they have demonstrated the ability to migrate from employee to owner/operator status.

Debt-finance services offered by the securities markets fall into two main categories, namely:

- Direct loans to corporates.
- Loan finance based on asset securitisation.

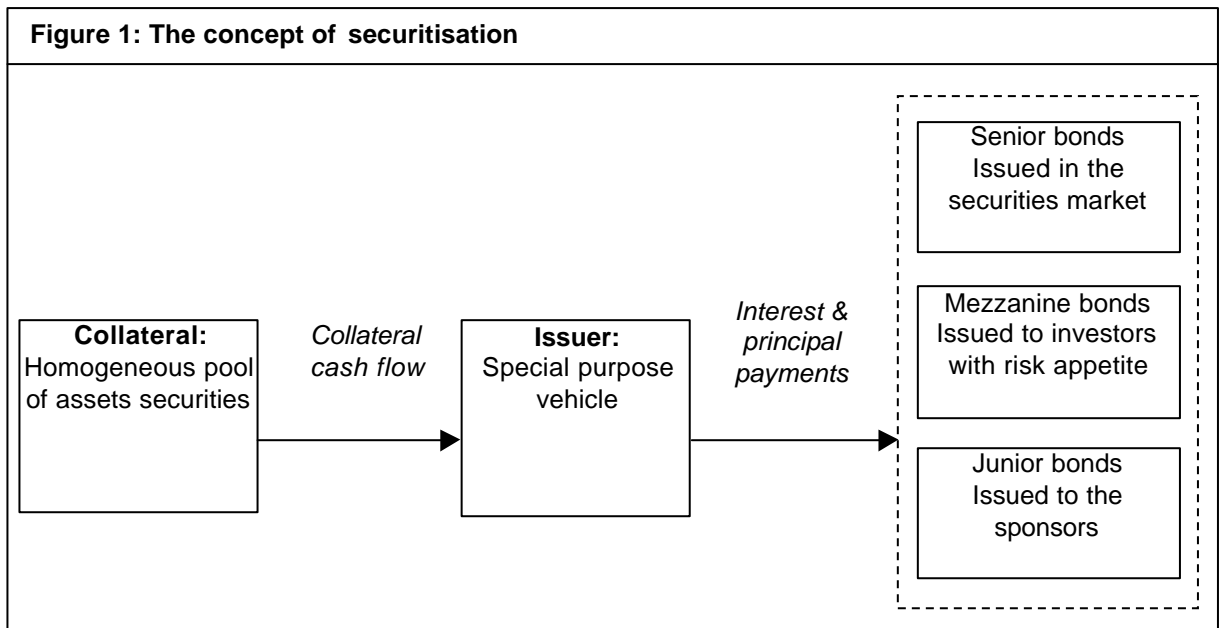
To be successful, a direct issue to the securities markets should be of a minimum size to attract a sufficiently wide spread of investors at a reasonable spread above the relevant benchmark (for example, government stock or other appropriate measure). No investor wishes to hold too great a proportion of a single issue, and a smaller issue into the securities markets will carry a size and liquidity premium that may be prohibitive. In South Africa the minimum size of an issue is generally accepted to be in the region of R1 billion. This clearly means that direct access to the securities markets in the company's own name tends to be confined to large companies.

It is worthwhile investigating, therefore, whether securitisation would be a more viable means for SMEs to access the securities markets for debt capital. The appropriateness of this alternative is assessed in this chapter.

2 Concept of securitised lending

2.1 Background

Securitisation is the issue of securities that are backed by a specific pool of homogenous assets (as illustrated in Figure 1). A common example of an asset-backed security would be a mortgage-backed instrument, whereby a number of individual mortgages are purchased from a bank, and a single security – a bond or a string of promissory notes, or some other debt security – is then issued to finance the purchase.

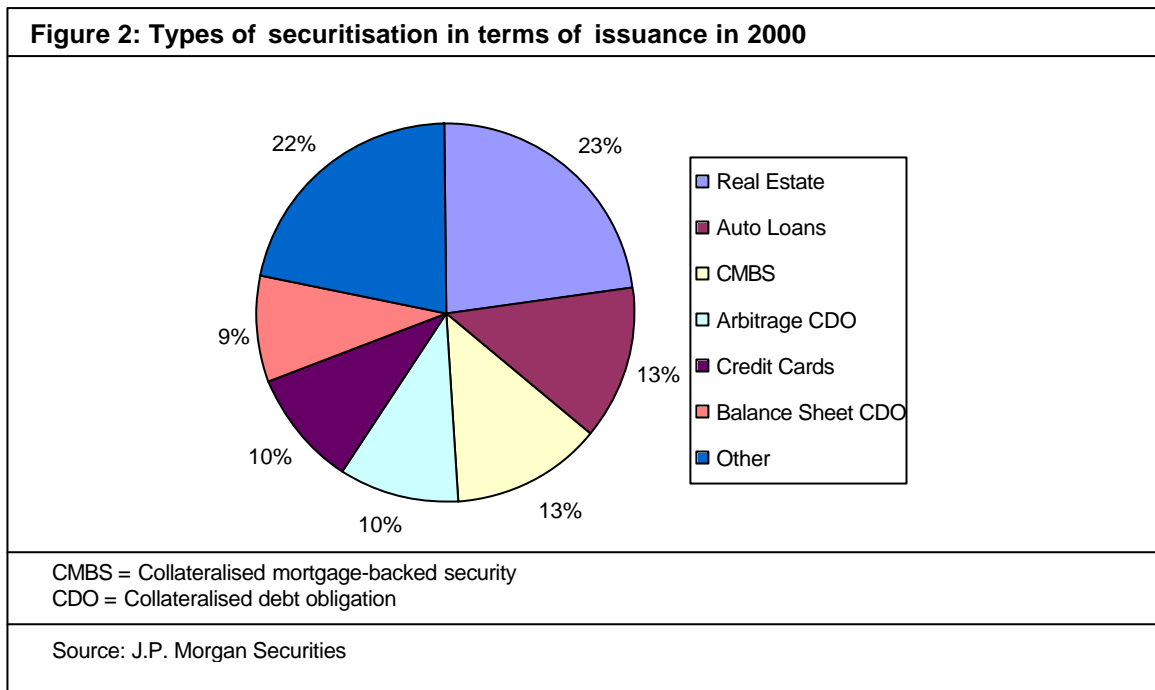


Securitisation is commonplace in developed economies and, in particular, in the United States. The total new issue of structured products and asset-backed securities amounted to US\$441 billion in 2000 (\$438 billion in 1999).³ In South Africa, where statistics on securitisation are somewhat anecdotal, the total issue to date has been in the order of \$10 billion⁴, which demonstrates that, despite having relatively sophisticated markets, South Africa's progress in the area of securitisation has been slow. No doubt, this phenomenon has in part been due to the restrictive legal environment for securitisation.

The assets pooled in securitisation schemes vary widely, and there seems to be little doubt that SME debt obligations would form suitable underlying instruments for a securitisation scheme. Figure 2 shows the makeup of the new issues of structured products and securitised issues in 1999 in the US.

³ Statistic provided by JP Morgan Securities.

⁴ Comments on the number and value of securitised issues in South Africa were provided by Fitch IBCA Duff and Phelps and Global Ratings (Pty) Ltd and relate to the total issuance up to the end of 1999.



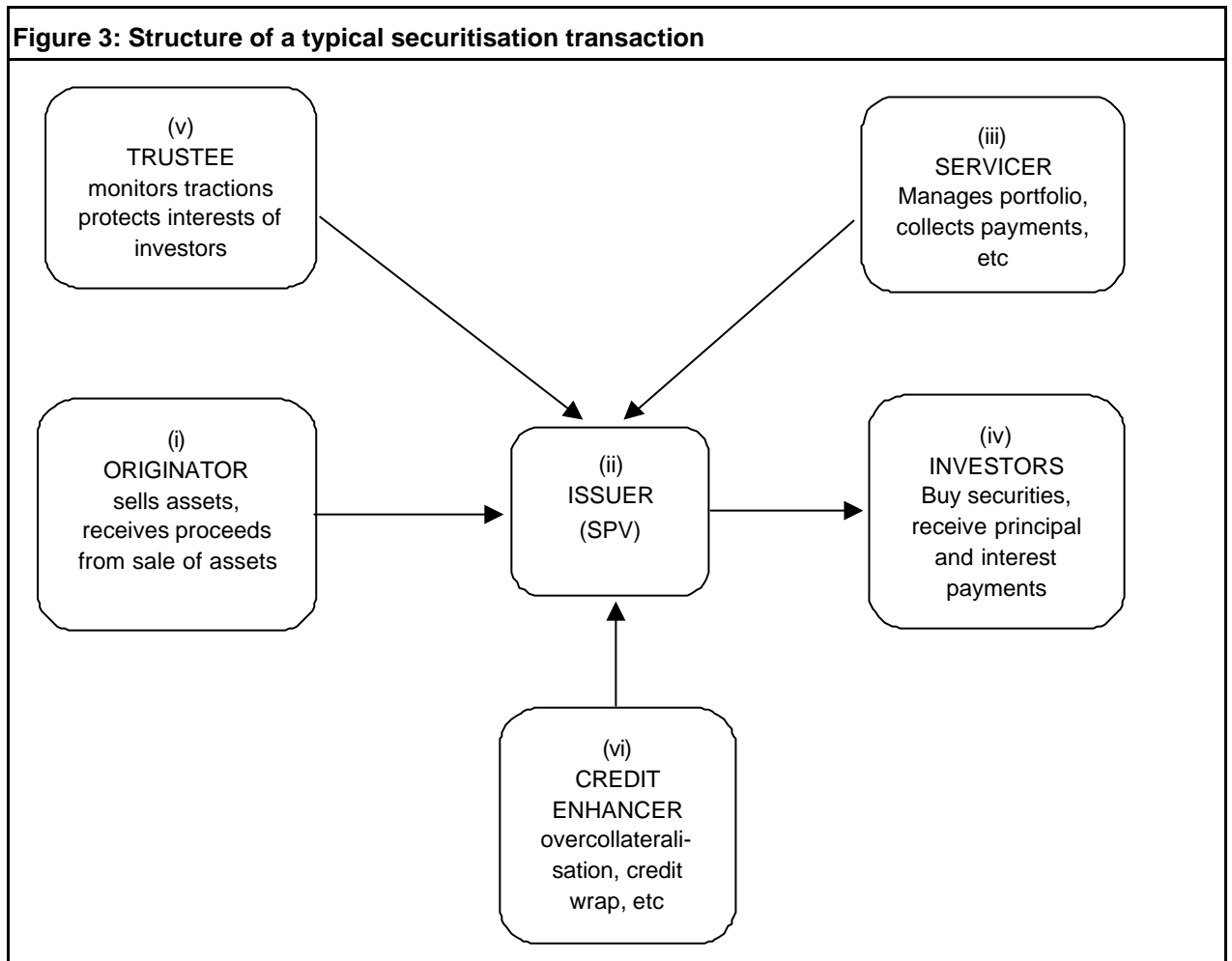
In August 2000, Kiwane⁵ launched the first collateralised debt obligation fund in an emerging market, raising R450 million in senior debt, in the securities market, in South Africa. (This securitisation is confined to investment-grade companies only, which would obviously not be the case for an SME securitisation.) It would appear that the appetite of the investment community in South Africa for these highly structured issues is increasing. In view of the reduced role of National Treasury in the capital market, as a result of the Government's success in reducing its budget deficit, a void has developed in the interest-bearing securities market. Accordingly, investors are keen to access new, relatively high-yielding types of debt instruments.

2.2 Structure of a typical securitisation transaction

The main objective of the intensive structuring and comprehensive documentation that go into securitisation is to ensure that the risks to the buyers of the securities issued by the SPV are minimised to the greatest possible extent. **Securitisation represents an advanced form of self-regulation, in that the structures typically build in significant checks**

⁵ Kiwane is a joint initiative of Gensec Bank Limited and Real Africa Durolink Holdings Limited.

and balances, which are intended to eliminate any undue influence from any particular party to the transaction. Figure 3 shows a typical securitisation transaction, and details the role that each entity plays in such a structure. It also illustrates the importance of self-regulation.



An essential function of the Banks Act is to protect the rights of depositors. Likewise, although a CLO should only be funded by educated and risk-aware investors, the elements involved in a well-constructed securitisation fund perform that function of investors protection to a very large extent. Securitisation is an innovative method of providing capital to borrowers that no longer want to be solely dependent on banks for external financial needs, while shielding investors against the risk of default of the underlying assets (other market risks resulting from the valuation of the obligation remain, though, as the security is subject to supply and demand).

2.3 Elements of a securitisation transaction

The parties that would usually be found in a securitisation transaction, and as set out in Figure 3, are the following:

- In most asset-backed securities (ABS), the originator will be a single entity, for example, a bank or a motor-vehicle finance company. The originator will sell assets into the SPV without recourse, in order to benefit from advantages in re-financing (leverage-effect; lower interest-rate)⁶. As such, the securitisation of assets is attractive to thinly capitalised companies.
- A special-purpose vehicle (“SPV”), which issues the securities and acquires the assets for collateralisation, is created. This is a legal entity with no equity, its balance sheet consisting only of the collateral assets and the securities issued as liabilities. An asset-backed securitisation separates the issuing vehicle from the other parties to the transaction in order to ensure that the vehicle is insolvency remote, that it is in no way answerable to any of the other entities involved in the transaction and that it is operated in the best interests of the investors. Insolvency remoteness of the SPV is vital. Under no circumstances should any stresses to which any other element may be subjected be transferred to the SPV and, thus, to the lenders. For example, the liquidator of the insolvent estate of the servicer or any of its shareholders should not be able to attack the SPV in any way.
- There is a need for a servicer to manage the portfolio of assets and liabilities on behalf of the SPV. The servicer monitors the collateral, controls the receipts and disbursements of interest and principal and, generally, runs the business of the SPV. There will be adequate arrangements in place to ensure the continuity of the servicer's functions in the event of any misadventure at the servicer level.

⁶ For certain categories of originators, in particular banks, a particular purpose of ABS is to ensure that the assets are in fact removed from its balance sheet for regulatory and accounting purposes.

- The investors are usually professional fund managers and not members of the public. If the issue is listed on a financial exchange or a stock exchange, the issuer is not bound to issue or transfer the securities in amounts greater than R1 million, in which case, the small private investor may buy and sell such securities. In the latter circumstance, however, the investor has the protection of the rules of the exchange.
- The originator, or other investors that have an appetite for risk, provide credit enhancement, which raises the credit standing of the securities issued to a level above that of the average asset in the portfolio. It has to be noted, however, that if the originator underwrites the risk in the SPV, the originator may lose the advantage of removing the assets from the originator's balance sheet entirely or in part.
- The trustee monitors the transaction and ensures that the activities of the servicer are in keeping with the laid-down terms of the transaction. These terms are bound up in a trust deed, which the trustee is bound to administer. The trustee's role is both ongoing and by exception, i.e. the trustee will monitor the continued compliance of the SPV with the terms of the trust deed and will be notified of any exceptional event. The trustee's role is vital in any securitisation, in that the trustee is in effect the self-regulator in the structure and, as for a bank's regulator; the trustee's primary function is to protect the investor. It is the trustee that will take possession of the assets of the fund and administer them to the benefit of the senior investors, as set out in the governing document. Since the trustee's integrity has to be above reproach, the trustee will usually be an accountant or lawyer of repute or a person of considerable standing in the financial community. In jurisdictions in which securitisation is commonplace, there are firms of professional trustees, whose business it is to administer these structures.

3 Possible securitisation structure for SMEs in South Africa

Each specific securitisation transaction has variations on the above basic theme. In some instances, these variations are significant, but, in every case, the variation should add to and not detract from the objective of strengthening the structure. No doubt, the structuring house (or houses) involved in the securitisation of SMEs and retail lending enterprises (RLEs) will seek to impose their own elements in order to provide a cost-effective and sound financial structure. The following is an example of a possible securitisation structure for SMEs and (RLEs) in South Africa.

The structure proposed here for an SME securitisation displays some elements that differ from the standard model outlined above.

- There are two options as to which institutions could be the originators of the securities. Firstly, the security could have multiple originators, consisting of individual SMEs grouping certain of their assets to serve as collateral. Such scheme would probably be complex though, since the pool of assets would be heterogeneous and their relevance for securitising purposes would have to be verified case by case. The second option, therefore, in which RLEs are originators and on-lend the amounts received to SMEs and private individuals, appears more realistic.
- In this second option, the SPV could be in the nature of a collateralised loan-obligation fund (or “CLO”), which is a specialised form of securitisation that has individual loans (that is, the loans of RLEs to SMEs or individuals) as its underlying instruments.
- Other elements of the structure, which are not described in the general structure above, but which would probably be needed in an SME securitisation, are:

- The sponsors, who would set up the securitisation transaction and have an interest in the servicer. The sponsors may provide over-collateralisation or other means of security for the structure. They would enjoy the benefit of the excess spread between the assets and the liabilities.
- The liquidity provider is a bank or other institution of acceptable credit quality, which would make a facility available to the CLO in order to bridge temporary cash shortages resulting from mismatches between receipts and disbursement of funds by the CLO.

Please refer to Figure 4 for a graphic overview on the proposed scheme.

As is common for all securitisations, an important condition is to ensure the maximum possible protection of the investors. In the traditional ABS transaction, the borrower or the originator is a substantial entity, which creates the structure for purposes of his own (balance-sheet restructuring, regulatory capital considerations, or arbitrage advantages) and which would not be in need of any form of protection. In the case of an SME securitisation, however, its very purpose is the nurturing of nascent businesses. Therefore, mechanisms would have to be in place to ensure the protection of the borrowers and the senior investors.

3.1 Borrower protection

Borrowers need to be protected against unfair practices and risks such as, excessively high interest rates, excessive fees, other unfair loan terms, midstream changes to the terms of the loan including early redemption, etc.

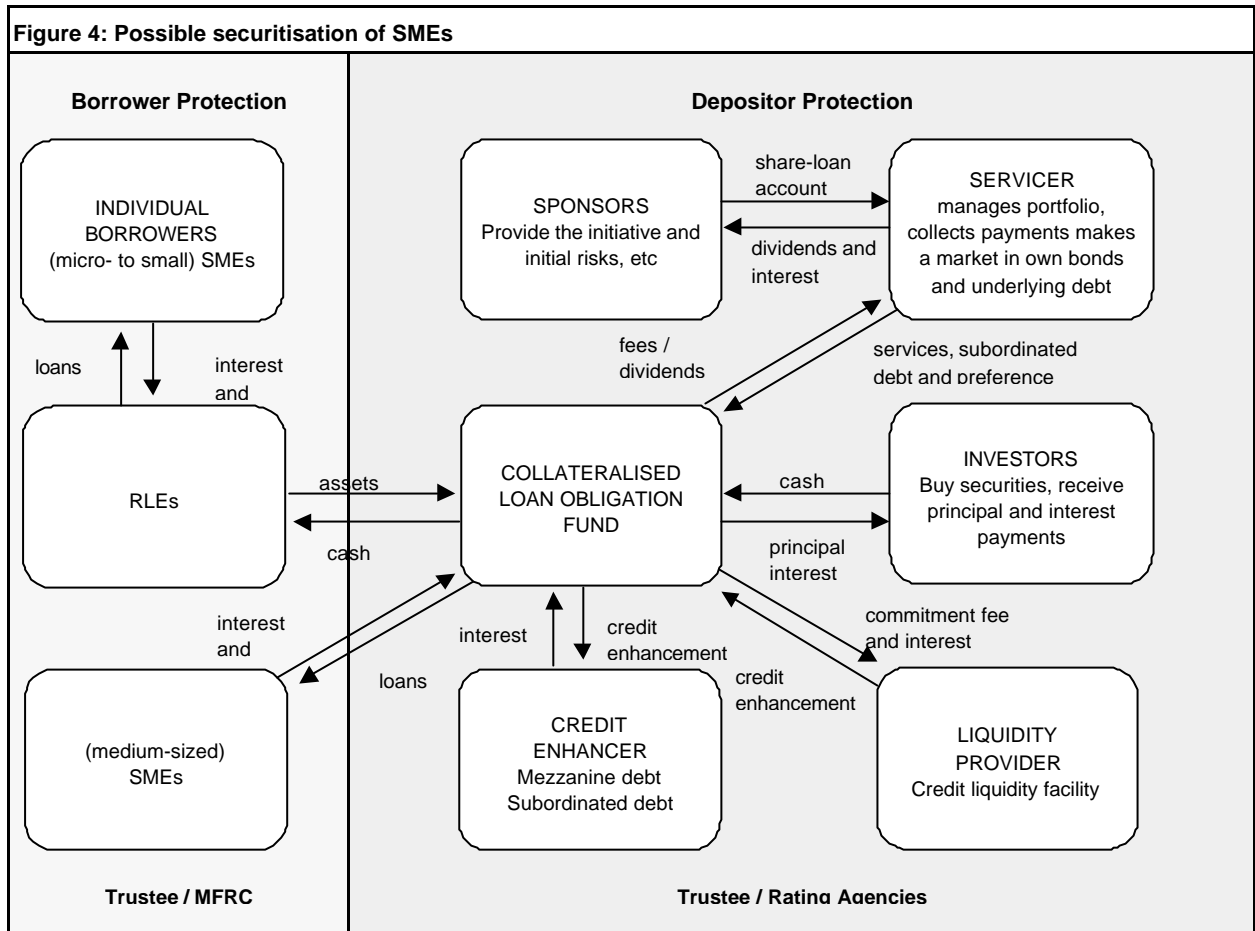
Two schemes can be thought of to guarantee good protection of borrowers' rights. The first option is to extend the role of the trustee, who is the custodian of the rights of the investors (as described in relation to the general structure), to include custodianship of the rights of the borrowers. However, it could be argued that an unacceptable conflict of interest would exist if the same trustee were to be charged with the protection of both borrowers and

lenders, whose objectives are clearly in conflict. In order to avoid this, in cases where the imperatives of borrower protection appear to justify an increased complexity, a second trustee could be introduced⁷.

In order to enable access to the securities markets for the financing of SMEs, a mechanism that is self-regulatory in nature is required. As previously stated, this is achieved easily with respect to the lenders. A measure of external regulation (that is, external to the CLO's structure itself), however, could be introduced with respect to the protection of the interests of the borrowers.

In this respect, as far as transactions originated by Retail Lending Entities (micro-lenders) are concerned, the Micro Finance Regulatory Council (MRFC) would be ideally placed to provide such oversight.

⁷ An example of complications resulting from this second arrangement with two trustees, is that a second trust deed would continuously need to be put in place, and the two deeds would have to be synchronised. Situations in which a self-regulator (for this is what the trustee is in this context) has to serve conflicting interest groups exist elsewhere. Consider, for example, the executive officer of a financial exchange. The executive officer has a duty to the shareholders, that is, the exchange members, to increase trading volumes, which may well be in direct conflict with the objective of protecting the integrity of the market. In relation to the SME securitisation structure, the important issue is the character and integrity of the trustee. The trust deed would have to include a provision stipulating the selection criteria for the trustee. A deciding factor here would be the attitude of the rating agency, which may refuse a rating of a particular level to the securities issued by the CLO if it was of the opinion that there was a conflict in a feature of the structure as vital as the trustee. In this case, the sponsors would have to consider a second trustee, regardless of the complications.



In the structure proposed in Figure 4, there are two levels of borrowers, namely, medium-sized SMEs that borrow directly from the CLO and micro- to small enterprises that borrow indirectly, that is, through RLEs, which, in turn are financed by the CLO.

The MRFC could thus have two roles in this regard. Firstly, any RLE from which the CLO acquires assets for collateralisation should be registered with the MFRC and subscribe to the Council's code of conduct and other rules. It would constitute an act of default for an SME securitisation to obtain assets from any RLE that is not a member of the MFRC, or to continue to hold assets of an RLE that has been declined continued membership of the Council. The bond trust deed may spell out requirements for RLEs in excess of the MFRC's minimum standards, but would not be allowed to fall short thereof.

Secondly, as far as the medium-sized borrowers are concerned, the MFRC could still be called to play a role if it is found to be competent. Such role could be, to set minimum standards for the bond trust deed in so far as it relates to the rights of the borrowers and, thereafter, allow the trustee to ensure that those rights are protected in practice. Accordingly, the sponsors of an SME securitisation scheme should be obliged to obtain the MFRC's approval of the bond trust deed before offering the securities to investors.

3.2 Investor protection

As emphasised above, the securitisation structure has as its main aim the protection of the investors. The suggested structure for an SME securitisation has the following characteristics, which bear some further elaboration.

3.2.1 *The rating agency*

A rating agency plays a vital role in any securitisation, and this is no different for an SME securitisation. For the securities issued by the SPV to be saleable they would have to carry an acceptable rating⁸ by an outside entity, approved by the Registrar and which is credible to the investors.

Using internationally accepted criteria and tests, the rating agency evaluates each element of the transaction and the interrelationships between each of them to ensure that the entire structure fulfils the required standards of strength and resilience to achieve a particular rating. The rating agency will ensure that the structure embodies the insolvency remoteness. It also checks and balances that investors can readily lend their money to the SPV at a price that they believe is in keeping with the risk of default as expressed by the rating.

⁸ A rating can be defined as an assessment of the probability that the rated entity will be able to meet its financial obligations.

The rating agency has a function at the launch of the fund and throughout its life. At the outset, the rating agency will ensure that the CLO structure is correct and in keeping with the claims of the offering document and the terms of the bond trust deed. Once the fund has been launched, the rating agency will call for regular reports and will conduct regular inspections to ensure that the fund does what has been undertaken in the trust deed, in order to ensure that the risks to the investor are controlled.

The value of the investment in the CLO may dissipate, and the rating may be downgraded as a result of a default or other negative credit event at one or more of the underlying obligors. The trustee and the rating agency, however, are there to ensure that the investment is not eroded by any inappropriate action or neglect on the part of the servicer or any other party to the transaction.

3.2.2 Securities exchange

Additional investor protection is provided if the CLO security is listed on an exchange, since the issue would be subject to the rules of the exchange, which, by virtue of the legislation in terms of which they are promulgated, carry the force of law. The financial exchange has to approve the structure, the terms of the offering document and the bond trust deed before it will grant the listing or permit the placement of the initial issue of the securities. If the issue were not, however, listed, current commercial paper regulations would require that the securities be transferred in denominations of R1 million or more, effectively confining the security to the institutional or professional investor.

4 Recent legislative changes facilitating CLO finance to SMEs

Asset-backed securitisation provides a suitable mechanism for channelling funds to SMEs from the securities markets. Until recently, however, this development would have been inhibited by the regulatory environment in

which this would happen. The implementation of new draft regulations governing securitisation by the Registrar of Banks could change this.

In the South African context, it was thought most appropriate to regulate securitisation under the aegis of the Banks Act, 1990. Since the Banks Act follows a functional approach, rather than an institutional approach, the emphasis is placed on the functions of taking and employing deposits, rather than on the individual institutions. In this context, the activities of a special-purpose institution may be deemed to constitute the business of a bank, since the issue of securities that may be offered to the public amounts to deposit taking. In this regard, it is important to bear in mind that not all securitisation schemes are subject to the Banks Act. Securitisation schemes in respect of which the special-purpose institution issues securities as private placements cannot be deemed to conduct the business of a bank and, therefore, do not have to comply with the Government Notice in terms of which securitisation is regulated.

Currently, asset securitisation is regulated by means of an exemption notice under paragraph (cc) of the definition of “the business of a bank”, in Section 1 of the Banks Act, 1990, which exemption notice (the “Securitisation Notice”) has not been amended since its publication in 1992. The main criticisms levelled against the Securitisation Notice are that it provides for the securitisation of banking assets only, thereby creating an unlevel playing-field in the market, and that its provisions are rigid and out of kilter with international market developments and current international guidelines and standards.

In May 2001, the Registrar of Banks made available for comment a new draft Securitisation Notice to govern the regulation, supervision and monitoring of securitisation schemes in South Africa. The new regulations go very far indeed in removing impediments that currently exist to the concept of securitising loans to SME and RLEs. The main characteristics of the new proposals are the following:

4.1 Easing of the ‘ultimate borrower’ and ‘application of funds’ provisions

Paragraph 12 of the draft new regulations removes the constraints that:

- The issuer of commercial paper has to be the ultimate borrower of the money raised through the issue.
- The application of such funds has to be for the issuer’s own working capital and may not be on-lent.

These provisions would hitherto have prevented a CLO such as that proposed in this chapter from raising funds through the issue of commercial paper and using the proceeds to purchase debt securities from an SME.

The removal of these constraints will be positive in that it will facilitate securitisation generally, and this initiative is therefore strongly supported.

4.2 Extension of securitisation-schemes regulations to non-bank institutions

A further important relaxation that will be brought about by the proposed regulations is that they will now permit non-bank institutions to participate in securitisation schemes as originators. This is positive with respect to the application of securitisation to SMEs. This change is positive for securitisation and the financial markets generally.

4.3 Multiple origination

Although the regulations do not specifically state that multiple originations are permitted, this can be inferred from the wording⁹. In general, in the South African environment, it would be useful to be able to securitise the assets of several originators, since this would facilitate larger, more liquid issues,

⁹ Indeed, the plural of the defined term “institution” is not specifically precluded. The trite principle of statutory interpretation, which states that in every law, unless the contrary intention appears, words in the singular number includes the plural, and *vice versa*, can be used as authority for this argument

rather than a proliferation of smaller issues. With regard to the securitisation of SMEs, it is clear that there would be a number of relatively small originators of assets for collateralisation and, unless the assets were first brought through a bank or an RLE, interposed between the SME and the SPV, it would be necessary for the regulations to permit multiple originators.

4.4 Ongoing substitution of assets

As the existing regulations do for banks, the proposed new regulations contemplate the removal of assets from a bank's balance sheet. The proposed regulations do not permit the securitisation of any particular asset class as an ongoing business. It expects that there will be a once-off transfer of assets, which will remain more or less static within the collateralised portfolio for the term of the securities issued. Replacement of assets and addition of new ones are allowed only under strictly controlled circumstances and within very narrow limits so as to ensure that such schemes are close-ended. The rationale for this limitation on banks is to ensure that the deposits in a bank are at all times backed by good-quality assets.

These limitations on the association with the securitised assets, as set out in paragraph 3 of the draft Securitisation Notice, are to a large extent not applicable to non-banking institutions participating in a primary role in a securitisation scheme. This special dispensation for non-banking institutions should allow an SME securitisation to substitute assets in a collateralised pool on a continuous basis.

5 Summary and conclusion

5.1 Asset-backed securitisation and the creation of vehicles such as collateralised loan obligation funds are an appropriate means to direct funds from the securities markets indirectly to SME's via RLE's or even directly, in some cases.

5.2 A properly structured CLO represents a refined form of market-oriented self-regulation in which:

- The checks and balances are evaluated at the outset by the rating agencies and monitored continuously by the rating agencies and the independent trustees.
- The structures have to provide a high degree of disclosure to enable the investor to evaluate the risks, in addition to having them quantified by the rating agency.
- Borrowers can be protected from exploitation by elements inherent in the structures and through the agency of the MFRC.
- Additional protection to both the borrowers and the investors would be provided if the securities issued were listed on a financial exchange.
- The cost structure remains efficient and tailored to the size of the transaction.

5.3 The Registrar of Banks has completed draft regulations governing securitisation schemes. These regulations will remove the impediments that currently exist to the application of securitisation to the delivery of funds to SMEs. The relaxations include the removal of the “ultimate borrower” and “application of funds” limitations. The new regulations will also explicitly permit non-banks to act in primary and secondary roles in securitisation structures. These changes are far-reaching with respect to securitisation generally and are welcomed. As regards the limitation on the substitution of assets, the regulations are highly restrictive if, as is likely to be the case, a bank or banks are involved in the SME securitisation in a primary role. It may be necessary in practice to seek exemption from these restrictions.

5.4 A welcome development would be for the private sector to sponsor the establishment of a substantial SME securitisation along the lines described in this chapter. Government may be requested to consider a supportive role by taking up some part of the mezzanine or subordinated debt that could be replaced over time by spread trapped in the structure.

CHAPTER 6

PUBLIC-SECTOR INCENTIVES TO SUPPORT SMES

1 Introduction

Although the promotion of SMEs is still the primary responsibility of the Department of Trade and Industry, Government decided in 2001 to promote small business “by creating clusters of ministers, where each department is now expected to bring input into the document in terms of what they are doing for small business and how they are providing support”.¹ In terms of this cluster approach, the various government departments have to work more closely together in future in order to promote SMEs.

Two government departments play a pivotal role in SME development, namely the Department of Trade and Industry and the National Treasury. In this context it has to be emphasised that the Micro Finance Regulatory Council (MFRC) reports to the Minister of Trade and Industry. As the financial backbone of Government, the National Treasury obviously plays an important role in SME finance (*inter alia* through its fiscal policy). Other important role players are the regulators of financial institutions, i.e. the Financial Services Board and the South African Reserve Bank, which have to ensure *inter alia* that SMEs have reasonable access to finance. Lastly, the Competition Commission has to ensure that the various players compete on a level playing field. Effective co-operation between different government departments is critical to ensure that public policy addresses any market failures, without introducing new distortions or different obstacles.

Asymmetrical information flows and possible monopolistic power pressures appear to be some of the failures that require public policy intervention.

¹ The Minister of Trade and Industry, *The Annual Conference of Southern African Entrepreneurship and Small Business Association*, Johannesburg, 14 August 2001.

This chapter examines more specifically the identified tasks for the Department of Trade and Industry, the MFRC, the Competition Commission, the National Treasury, the Financial Services Board and the South African Reserve Bank.

The chapter looks at the following issues:

- Inconsistencies between the Usury Act, Credit Agreements Act and Hire Purchase Act and the impact thereof on the allocation of credit.
- Consumer protection issues.
- The regulatory requirements for ensuring that non-bank financial intermediaries (NBFIs) play a more effective role in providing finance to SMEs.
- The regulatory requirements for ensuring that the secondary market for debt and equity plays a more meaningful role in the provision of finance to SMEs (and to the retail intermediaries from whom SMEs obtain finance).
- Certain practices or arrangements that constitute barriers to entry and that *appear to* undermine effective relating to access to clearing and settlement systems, access to information (both for financiers and their clients) and preferential treatment of bank debt due to banks' position *vis-à-vis* the national payment system.
- The fiscal changes that would be required to facilitate the increased provision of private equity to the SME sector (i.e. facilitating the development of "*business angel finance*") and fiscal changes to facilitate expansion of venture capital activity.
- Fiscal and other regulatory changes to remove the disincentives to formalisation and growth of SMEs.
- The changes that are required to the Banks Act to improve the level of competition in all areas of banking, and to encourage entry by entities that may be better placed to service the SME market.

Many of the issues raised are complex enough to justify further research in order to form a more definitive view of the nature of the problems and the most appropriate measures for addressing them. The Task Group believes that each of the above-mentioned issues are important, not only for

increased access to finance for SMEs, but also for more generally increasing the competitive environment in the financial services sector.

In each of these areas, the Task Group indicated short-term measures through which the immediate problem could be addressed (even if only partially), and the measures that would be required to improve the position over the long term. This implies that many of the latter group of recommendations may be in broad terms only.

2 Role of the Department of Trade and Industry

The development and promotion of SMEs in South Africa is an important objective for the Department of Trade and Industry. The most urgent tasks for this department in terms of SME development may well be the following:

- Revisions of the Usury Act, the Credit Agreements Act and the Hire Purchase Act and replacing these with overarching credit legislation.
- Improving sharing of information on SME repayment profiles, credit exposure and status of pledges.
- Improving the quality of the information collected and disseminated about the SME sector.
- Creating a simple uniform system for registering and enforcing commercially secured loans.

2.1 Usury Act and the Credit Agreements Act

a. Problem statement

The Usury Act,² Credit Agreements Act, Hire-Purchase Act and Usury Act Exemption Notice (No. 713 of 1999) prevent all lenders (banks and NBFIs)

² Credit transactions are treated differently depending on whether they are structured as loans (including finance leases) or as instalment sales. The latter are covered by the Credit Agreements Act and are not considered to be lending transactions. If a credit sale is for business purposes such as production or resale, the Credit Agreements Act does not apply, but the transaction comes under general Hire-Purchase law. If the transaction is a loan to an SMME, under R10,000 and provided by a registered lender, then it falls under the Exemption Notice and the MFRC's jurisdiction; otherwise, the Usury Act applies.

from playing a more meaningful role in extending finance to SMEs in the following manner:

- The interest-rate limitations undermine the viability of a whole range of transactions with particular loan sizes and risk profiles (including, in particular, SME loans up to as high as R300 000).
- The distinctions between loans and different types of credit are mis-targeted and create perverse incentives. In effect, producers and merchants transacting at the low end of the credit market have an incentive to set up micro-lending operations and to register them in order to benefit from the Exemption Notice.
- Making the regulatory treatment of a transaction dependent on its form encourages costly evasive strategies. The other effect of applying an interest rate cap to credit sales is that the availability of such transactions becomes restricted, making them available only to upmarket customers who spend more and are less at risk.
- The result of the loan size and loan-term limitation under the Usury Act Exemption Notice is that all SME loans above R10 000 or with repayment terms above three years cannot gain the benefit of the favourable interest-rate environment created by the Exemption Notice.

Unequal regulatory requirements and enforcement between, on the one hand the Usury Act Exemption Notice and, on the other, the Usury Act, Credit Agreements Act and Hire-Purchase Act, create a disincentive to provide more complex and higher risk types of finance such as SME finance.

b. Suggested short-term solution

In the short term, the most obvious solution would be to extend the parameters of the Usury Act Exemption Notice to enable lenders to meet the demand for SME loans. In order to manage the risk that such an extension might be exploited to increase consumption lending, criteria for loans and lenders could be incorporated, in terms of which such loans and lenders

would qualify for an expanded exemption, whereas the MFRC could be required to monitor adherence to such criteria.³ It need not be an “uncapped” exemption, and may require only a more accommodating cap than the one that is built into the various credit acts.

The above has to be recognised as a ‘**second-best**’ solution, being an indirect response to the too-low limit on the interest rates of the Usury Act, Credit Agreements Act and Hire-Purchase Act. The approach, however, incorporates an appealing incentive for the increased provision of finance to SMEs, as compared to the increased provision of finance for personal consumption.

c. **Suggested long-term solution**

The longer-term solution necessarily involves a comprehensive review of the Usury Act, Credit Agreements Act and Hire-Purchase Act. This has been recommended by a number of studies over the past decade, the latest of which was the report by the Financial Sector Assessment Program mission of the International Monetary Fund⁴.

Of course, legislative reform is complex and involves many stakeholders and groups with vested interests. The existing system of interest-rate control, however, substantially curtails the increased provision of finance to SMEs (that is, outside the narrow range of transactions that are exempted from the Usury Act by the present Usury Act Exemption Notice). **If the existing price control on lending is not lifted or modified, there may not be a significant increase in finance to SMEs, despite addressing other regulatory obstacles.** Short-term relief can be effected through changes to

³ The MFRC has developed detailed proposals in this regard that are being discussed with its various stakeholders. These proposals incorporate monitoring requirements, including a “general certification of compliance with the criteria” by the lenders’ auditors. These requirements obviously add to the cost of compliance, but would limit the extent to which an extension could be used for increased consumption lending.

⁴ The Financial Sector Assessment Program mission of the International Monetary Fund (IMF) recommended the enactment of a National Consumer Credit Act, with “truth-in-lending” provisions, to replace the Usury Act, 1968, and to apply to both banks and registered microlenders. (Reported in the *Annual Report of the Bank Supervision Department*, Pretoria: SA Reserve Bank, 2000, p.15).

the Usury Act Exemption Notice. This affords a low-risk approach to dealing with the present challenge of financing SMEs. However, it also further undermines the scope of applicability of the Usury Act and does not constitute a long-term solution.

It should also be noted that a simple lifting of the interest limitations applicable to the Usury Act and Credit Agreements Act might not be appropriate. There are indications that these pieces of legislation are not in conformance with international standards on consumer protection, and a lifting of the limits may leave consumers vulnerable.⁵

The long-term solution appears to consist of the following components:

- A comprehensive review⁶ of these pieces of legislation, with a view to ensuring (i) that the legislation is consistent with international standards on consumer protection and protection against usury, and (ii) that the legislation recognises the particular need in South Africa for the increased provision of finance to SMEs (given the profile of the SMEs and the demand for finance by SMEs).
- Potentially, replacing the Usury Act, Credit Agreements Act Hire-Purchase Act and Usury Act Exemption Notice with new credit legislation.
- Establishment of a regulatory agency outside Government and accountable to Parliament, that would be responsible for the registration

⁵ Noting, however, that the extent to which the prescriptions in these Acts are being circumvented is already exposing consumers to a level of risk that is not generally appreciated.

⁶ Such a review should give attention to the following issues that were highlighted by the Task Group as of particular concern in SA:

- The extent of usage of payroll deductions should be reviewed, potentially limiting this to pension and benefit packages and where a court order has been issued.
- The extent of usage of provident fund pension fund benefits as loan collateral should be reviewed, with a view to combating decapitalising retirement funding by predatory lenders.
- Creating a more debtor-friendly personal bankruptcy regime as found in the USA.
- Improving disclosure rules and instituting appropriate cooling-off periods such as embodied in the USA Truth-in Lending provisions.
- Creating a simple uniform system for registering and enforcing commercial secured loans.
- Placing limits on individual indebtedness as a percentage of income.
- Striking a better balance between creditor and debtor protection.
- Discretionary granting of debit orders by banks and payroll clerks, which may result in unmanageable consumer debt.

of all credit providers, for the monitoring of the compliance of such credit providers and for the resolution of complaints against such credit providers.⁷

2.2 Access to information

a. Problem statement

Lack of access to information constitutes a major barrier to the assessment of an SME's application for finance and, thus, constitutes a barrier to the increased provision of finance to SMEs as well as adding to the cost of such finance when provided. This area attracted attention in a number of other countries, including the UK (according to Cruickshank), Australia (according to Wallis) and a range of other OECD countries.

As noted in Chapter 4, progress in this area will be difficult without public sector intervention. The issues at stake involve two trade-offs, namely (i) between the public benefits flowing from the increased effectiveness of the market *versus* the commercial interest of individual firms and (ii) a trade-off between an individual's constitutionally protected right to privacy *versus* the efficient market's requirement for access to information.⁸ The following problems are currently major issues:

- SME-related information is withheld on a large scale from credit bureaux by some of the largest credit providers/lenders (including banks). This makes the credit assessment of applications for finance received from SMEs incomplete and expensive (for all competitors, whether banks or NBFIs).

⁷ These three requirements are based upon the European Union's minimum requirements for the regulation of consumer credit.

⁸ See Wallis, *Op. cit.*, p.478 and p.520: "*The Attorney-General should establish a working party to assess the costs and benefits of positive credit reporting. Extension of the privacy regime should include striking an appropriate balance between consumer protection, consumer choice and the effective and efficient delivery of financial services.*" and "*The absence of positive credit reporting may deny access to finance to customers who should obtain it. Positive credit reporting is widely used in the United States and Canada and is being used increasingly in several European countries. This practice may contribute to greater competition by enabling consumers with a good record of meeting their commitments to obtain finance more readily from institutions with which they do not have an existing banking relationship. Enabling institutions to assess credit risk more accurately may reduce the number of consumers defaulting and reduce interest rates.*"

- There is no ‘register of pledges’ that could enable centralised, electronic verification of the collateral being offered by SMEs applying for finance.
- There is no reliable SME database containing statistics on turnover and profitability per geographical area or per subsector, which, if it were available, could have facilitated the interface between lenders and applicants, and also assisted in the assessment of applications for finance.

b. Suggested short-term solution

To ensure a more level playing field between credit institutions (among banks themselves and between banks and NBFIs), the following short-term interventions by the Government could be considered:

- Improved regulation of private credit bureaux that would result in improving the credibility of these institutions and improved information flows to and from these institutions.
- Undertaking an investigation into the types and volume of information on the SME repayment profile and exposure that is currently **not being shared**, and the impact thereof on the provision of finance to SMEs.
- Undertaking an investigation into the feasibility of (and demand for) establishing a national “register of pledges”.⁹
- Review the nature of statistical information being gathered on the SME sector, the demand for different information and the most appropriate institutional arrangements for the collection and dissemination of such information.

The recommendations focus on a further investigation of the problems (which might well be best conducted by an independent commission of inquiry). The reason for this approach is that international investigators of the stature of

⁹ Such a register could obviously be run by either the public or private sector, depending upon the approach taken.

Cruickshank (UK) and Wallis (Australia) identified the issues listed above as of high importance to the effective operation of the credit market for SME finance. However, these issues are complex and their relevance for the South African market would have to be confirmed. If the relevance were confirmed, the appropriate intervention would similarly require considerable thought.

c. Suggested long-term solution

The outcome of the investigations recommended above would guide the longer-term approach. However, these issues may potentially also fall within the mandate of the Competition Commission and, if no more expedient solution were found, referral of such issues to the Competition Commission might be warranted.

2.3 Creation of a uniform system for registering and enforcing commercial security

a. Problem Statement

The following excerpt from the report by Meagher and Wilkinson¹⁰ is instructive:

“When a loan is extended on the basis of moveable or intangible collateral – for consumer or especially commercial purposes – the legal framework plays a critically important role. It defines the scope of what can be used as security, the procedures for creation and perfection (recordation) of a security interest, the ease with which such interests can be maintained and extended, the systems for identifying such interests, the scheme of priority rights in cases of default or insolvency, and the enforcement procedures. Effective regimes for secured finance are thought to widen access to credit by leveraging otherwise ‘dead’ capital and enabling lenders to overcome problems of information asymmetry and adverse selection without depending on identity, status, or relationships as the basis for discrimination. Several countries – including the U.S., Canada, Holland, and several East European

¹⁰ Meagher, P. and B. Wilkinson, Filling the Gap in South Africa’s Small and Micro Credit Market: An Analysis of major policy, legal, and regulatory issues, Johannesburg: MFRC, 8 September 2001, p. 46

nations – have special laws that support efficient secured finance arrangements in the commercial context.”

Legal experts report that:

- South African law does not provide for a non-possessor security interest as such, i.e. one in which the debtor is able to continue possessing and using a pledged asset.
- There is no uniform system of security interests.
- There is no uniform registration system for security interests, and perfection through recordation requires a relatively cumbersome and expensive procedure.¹¹

The experience of countries that have achieved a breakthrough in broadening access to SME finance, is that the creation and perfection of “collateral rights” requires only fairly simple documentation and a notice in the relevant registry — and this makes possible a cheap, high-volume stream of secured transactions. In South Africa the transaction costs of creating the security interest appear to make it impractical for smaller-scale secured loans.¹² This is unfortunate because where the law supports such transactions in a simple, uniform manner, as in North America, these secured loans take place rapidly and in high volumes, supporting a wide range of industrial, agricultural and commercial activities — and provide the bulk of SME credit.¹³

Addressing these areas would require the comprehensive reform of commercial credit laws and the strengthening of systems for the enforcement of debts and commercial bankruptcy.

¹¹ Known as the notarial bond (Deeds Registries Act, 1947, Security by Means of Moveable Property Act of 1993).

¹² “This means that loans, finance leases, credit sales, and other transactions taking various forms and involving banks as well as non-financial companies as creditors, are all accorded the same treatment. Since legal effectiveness requires recordation, any potential creditor has notice of prior liens. Moreover, the North American systems and recently reformed systems in Europe and Latin America recognize a wide array of goods and rights as security, including accounts receivable, crops, intellectual property, inventory, proceeds of sale, and future acquisitions”. Maeher and Wilkinson, *Op. cit.*, p. 47.

¹³ Moreover, enforcement of security interests in South Africa is reported to be subject to overly lengthy and costly procedures that make it impractical for small loans. Likewise, self-help repossession is not accommodated in the law (Standard Bank 2001).

b. Suggested short-term solution

There are no obvious solutions in the short term. However, it is imperative for discussions to take place between the range of parties that would have a role to play in addressing these weaknesses. The relevance and implications of these weaknesses would have to be confirmed so that a reform agenda could be developed. The importance of these issues should not be underestimated. Intuitively, it helps explain why the delivery of finance to the SME sector has so consistently failed to meet expectations and why “lack of security” is so frequently advanced as a reason therefore.¹⁴

c. Suggested long-term solution

Given the range of the changes required, most of which are in primary legislation and nearly all complex, these changes may only be possible over the long term.

3 Role of the Micro Finance Regulatory Council

In the relatively short period of its existence, the MFRC has already done pioneering work (see Chapter 4). However, the focus appears to have been on improvement in consumer protection. Although this may have been important given the concerns that led to the establishment of the MFRC, it may be necessary for the MFRC to review its role with regard to other parts of its mandate, and in particular in facilitating the increased provision of SME finance.

a. Problem statement

In terms of the development of micro-finance in South Africa the following broad challenges can be identified:

¹⁴ This does not discount the impact of the apartheid policy of the past in preventing asset accumulation in the black community. It does indicate that even when assets are available, there are substantial obstacles to utilising this as security for securing finance. This obviously impacts negatively upon all SMEs, whether or not the owners are from previously disadvantaged communities.

- The provision of appropriate protection for the “emerging market”, including low-income/middle-income wage earners and small and micro-enterprises;
- The consistent and appropriate regulation of all entities that fall within the definition of “second-tier banks” (mostly prudential regulation, as is performed currently by the “self-regulatory bodies”).
- A “market development” role that includes the facilitation of developments such as the recent establishment of the National Loans Register or the kind of facilitation function that may be required for the establishment of a “second-tier capital market” from which the NBFIs (and micro-lenders) may access capital.¹⁵
- Performance of an “oversight function” after the establishment of some of these developments. For instance, monitoring and overseeing the operation of the National Loans Register or playing a similar role in respect of special-purpose vehicles that may in future be established for the micro-lending industry.

The problem is somewhat complicated though, in that certain of these regulatory functions fall within the broad mandate of existing regulators. For instance, any oversight over securitisation vehicles (not involving banks) should properly fall under the FSB, whereas the regulation of second-tier banks should properly be the responsibility of the Bank Supervision Department. However, coming to such a conclusion too easily discounts the primary reason for the focus on “micro-finance” over the last number of years. This is that the aggregate value of these “micro” transactions normally remains insignificant relative to the size of the industries within which they fall.¹⁶ This is complicated yet again when one considers that these relatively

¹⁵ This could include developments that would facilitate the establishment of vehicles for the securitisation of micro-lenders’ assets.

¹⁶ For instance, despite massive growth in the micro-lending sector, the total assets, which currently stand at approximately R13 billion, are still less than 2% of the total assets of the banking sector. Similar relative weightings are likely to apply when these assets are being securitised.

modest totals (by mainstream finance standards) may be made up of huge numbers of low-value transactions and that their risk profile or “contract structures” may be unconventional (again, by mainstream finance standards!).¹⁷

Thus, simply reassigning the responsibility for oversight for developments in the micro-finance market to the mainstream regulators would discount the reasons that the micro-finance market developed differently. Any unnecessary fragmentation of regulatory oversight would at the same time not be desirable.¹⁸

Striking the appropriate balance¹⁹ between these contradictory requirements would require a skilful balancing act!

b. Suggested short-term solution

In the short term, the solution may be relatively uncomplicated:

- The consumer protection function (in respect of loans within the Exemption Notice’s parameters) is already part of the MFRC’s existing mandate and current functions, and could be expanded.
- Within its current structure and mandate, the MFRC could implement and monitor an expanded Exemption Notice that would allow increased SME lending (refer to the previous section for further details).
- The “market development” role is similarly part of the MFRC’s current mandate and function.

¹⁷ All these “complications” are to some extent “normal”, given that financial service providers are seeking mechanisms through which to provide finance and obtain security in a market segment where clients may not have access to conventional security or where conventional financial services are too costly to deliver.

¹⁸ For exactly the same reasons, the world and South Africa have spent so much time and effort over the last decade to integrate and consolidate financial regulation.

¹⁹ Within the MFRC, this balance has to some extent been achieved by the MFRC’s specific focus on the area of micro-finance, whereas the mainstream regulators are co-ordinated by their having representation on the MFRC’s Board of Directors.

The co-ordination of the regulation of village banks and co-operative banks between the self-regulatory bodies and the MFRC may have to be reviewed. Given that these entities (and the micro-lenders currently being regulated by the MFRC) are all involved in micro-finance transactions, it is desirable that there should be increased integration in the regulatory oversight of these different entities.

c. Suggested long-term solution

The long-term arrangement is largely dependent upon the result of the review of the credit legislation (dealt with in the previous section) and with the developments related to the establishment of the “super-regulator”. In making these decisions, the need for an institution that has a focus on micro-finance would have to be considered, for the reasons stated before. Consideration would also have to be given to potential contradictions between the roles of “market development”, consumer protection and prudential oversight.

4 Role of the competition authorities

SME development is currently compromised by a lack of fair competition in two specific areas, namely price-competitive access to the clearing and settlement systems of the major banks and the power of account-holding banks to rearrange collection preferences in their favour. The competition authorities, which embrace in this specific instance the SA Reserve Bank, the Financial Services Board and ultimately the Competition Commission, should investigate these issues in greater detail.

4.1 Access to clearing and settlement systems

Today the four largest banks in South Africa are the *de facto* owners of all clearing and settlement systems in the country. Specifically, these four banks have total shareholder control over the Payment Association of South Africa (PASA), and the clearing and settlement institutions of the financial

exchanges (UNEXCOR, STRATE and SAFCOM). Whether or not the banks use this economic power to their advantage still has to be investigated.

In the UK, where a similar arrangement exists, the Cruickshank Commission (March 2000) came to the conclusion that this natural monopoly was costing consumers and SMEs some £4 billion a year. The British Competition Commission finalised its investigation on this topic early in 2001 and concluded that the four big banks in the UK did indeed operate as a “complex monopoly”.

a. Problem statement

The problem at heart is the fact that the clearing and settlement systems in the financial markets are subjected to major economies of scale. Accordingly these systems have all the characteristics of a natural monopoly. For instance, they are highly dependent on market liquidity, which in turn results in ever-greater operating systems. As the national payment system and the clearing and settlement systems of South Africa probably cost in excess of R0,5 billion, only large, well-capitalised institutions are in a position to make fixed investments of this kind. Entry barriers are high and may limit the level of competition for new entrants.

A number of problems have been identified in this area:

- Lack of access to the national payment system for NBFIs that provide loan facilities to SMEs. Except for systemic reasons, there are no convincing reasons for limiting access to the national payment system to banks only. For example, in the UK and Australia non-banks have access to the national payment system (if necessary, this may mean that the risks that non-banks introduce to the national payment system should be fully covered by requiring these entities to provide acceptable collateral).
- The manner in which prices charged to smaller banks for clearing and settlement facilities (including the ATM system) is being determined. More research is required on this important area of competition policy in South Africa.

- The ability of banks (and account-holding banks in particular) to create preferences for repayments, either to themselves and/or to parties with whom they may have special relationships.

All these factors are major obstacles to effective competition between banks and to NBFIs providing finance to SMEs. Of course, the issues are complex and cut to the core of the position that banks play in the financial system in South Africa. Nonetheless, a resolution of these important issues cannot be avoided for much longer. It compromises the extent of competition in the financial system, among banks themselves and also between banks and NBFIs. These issues clearly also impact on effective financial service delivery in many areas beyond SME finance only.

b. Suggested short-term solution

Whether South African consumers and SMEs are indeed disadvantaged by the natural monopolistic powers in banking is an issue that still has to be investigated. The Task Group recommends consultation between PASA and the competition authorities to address the immediate problems. A special enquiry by national payment experts would further assist in giving clarity in this important area.

The South African Reserve Bank may, in the interim, consider assisting those banks that are not members of PASA by clearing and settling more of their payment transactions (i.e. the low-value, high-volume business) directly through the central bank (the SAMOS system) rather than through the ACB system of PASA. Moreover, the central bank may consider following the UK example by becoming involved in clearing and settling the transactions of non-bank financial institutions too (obviously based on stringent entry requirements, such as sufficient collateral). This short-term solution implies that, in the national interest, the central bank would increasingly be competing with the large clearing banks for clearing and settlement business on quasi-commercial terms.

c. Suggested long-term solution

Should the regulatory authorities conclude that the current regulatory arrangements for clearing and settlement in South Africa undermine effective competition and the weaknesses are not addressed expeditiously, referral of this issue to the Competition Commission may have to be considered. The long-term solution might well include a licensing regime similar to that proposed by the Cruickshank Commission in the UK. (See Appendix 5.)

4.2 Collection preferences of account-holding banks

a. Problem statement

Currently NBFIs are at a major disadvantage *vis-à-vis* account-holding banks regarding the collection of repayments. Through various mechanisms in the payment system (such as placing a hold on the client's bank account or by creating a 'dummy account'), banks can ensure that they become preferred creditors. These arrangements operate as a deterrent to any competitor of the account-holding bank, given the uncertainty and risk that providing finance to such a bank's clients would entail. These arrangements not only have negative implications for consumer protection but also taint the integrity of the national payment system. They obviously also undermine competition among banks.

b. Suggested short-term solution

The Banking Council South Africa could use moral suasion on its members to stop this undesirable practice with immediate effect. Moreover, the Registrar of Banks should consider issuing to the banks' compliance officers a directive for an immediate halt to this practice.

c. Suggested long-term solution

A long-term solution to this problem has to be sought in legislation that explicitly prohibits banks from creating mechanisms through which they become preferred creditors. An example of such legislation is found in the European Union Directive 87/598/EEC.

5 Role of the National Treasury

The National Treasury plays a key role in the development of SMEs. Fiscal incentives could play an important role in overcoming the market's failure to give SME access to finance, as these incentives do in many OECD countries. Broadly speaking, the focus of fiscal support should shift gradually but meaningfully from debt incentives to equity incentives. This means that the National Treasury would have to give attention to the following issues: how to overcome the "equity gap" problem, how to ensure that fiscal stimulus would address specifically the problems of smaller companies, and how to ensure that institutional investors would have an interest in the development of venture capital and SMEs in general.

5.1 Fiscal incentives to overcome the equity gap

a. Problem statement

A major problem for SME finance is the existence of an equity gap. Currently too little is done by the National Treasury to promote a "business angel" culture in South Africa as described in Chapter 2.

b. Suggested short-term solution

The Government has to recognise explicitly the problem of the equity gap for SMEs, as well as the brake it can put on SME growth through its taxation policies. It has to correct these market failures, *inter alia* through public interventions that seek to offset the high transaction costs and risks associated with investments of this size. These public interventions fall in two categories:

- Debt-oriented interventions
- Equity-oriented interventions

In the short term it would probably be easiest if Government did a detailed study of the fiscal incentive schemes for SMEs in the UK. In broad terms the UK did the following in this respect:

Debt-oriented public policy interventions:

- The establishment of a Small Firms Loan Guarantee Scheme (now integrated with the DTI's Enterprise Fund in the UK).
- A range of interventions aimed at enabling innovative knowledge-based businesses to secure bank finance. These interventions include a "knowledge bank" (i.e. a special fund created by issuing bonds to private-sector institutions, which in turn would be lent on to eligible businesses); a loan guarantee for bank lending to knowledge-based start-up enterprises; and a "challenge fund" under which private-sector financiers could bid for Government support for the finance provided to knowledge-based firms.

Equity-oriented public policy interventions:

- An Enterprise Investment Scheme (EIS), which would involve tax relief to the investor on investments in SMEs to help overcome the problems small companies face with raising small amounts of equity finance.
- "Corporate venturing", which is an umbrella term for the establishment of mutually beneficial relationships between companies. Commonly, though not exclusively, this involves a relationship between a large and smaller company in the same line of business. By introducing a specific tax incentive the UK hopes to stimulate the accelerated development of corporate venturing.
- Venture Capital Trusts (VCTs) which were established to encourage individuals to invest via VCT investment trusts in a portfolio of smaller, higher-risk trading companies.
- The establishment of a network of Regional Venture Capital Funds, by supplementing private finance with public resources for investments in the range from £100 000 to £500 000, where market failure is frequent.
- Establishment of the UK High Technology Fund that will operate as a "fund of funds" and will invest in venture capital funds specialising in early

stage high-technology investments. It is to be started with a government investment of £20 million.

- The combined cost of these public-sector initiatives is in the region of £35 million a year and about £50 million in preferential tax treatment.

c. Suggested long-term solution

The Cruickshank Report concludes that improving the UK risk-capital market calls for public policy in four key areas:

- Debt finance for higher-risk SMEs.
- Venture-capital funds.
- Tax treatment of "business angel" and other entrepreneurial investments.
- Public equity markets for smaller companies.

The Report assesses the interventions against the following criteria:

- Does the initiative focus efficiently on the market failure?
- Does it follow the US mantra of "low, simple capital gains tax, easy exit"?
- Does it align the interests of entrepreneurs and equity backers?
- Does it align the interests of those receiving government funding with the objectives of government intervention?

With regard to the specific support mechanisms in the UK market, the Cruickshank Report concludes that support should be switched away from debt-oriented interventions such as the Small Loans Guarantee Scheme and Knowledge Banks to initiatives that support or facilitate the provision of equity to SMEs. It should therefore support the Venture Capital Fund and the establishment of regional venture capital funds.

Comparing the UK's track record with that of the US, the Report notes further: "*The US regime has been widely acknowledged for its contribution to the enterprise growth climate*", and in this context recommends a capital gains tax structure that would incentivise entrepreneurial investment. "*Investment at this end of the risk capital market is primarily for growth rather than income and so is crucially affected by the taxation of capital gains.*" The

development of "second-tier markets" such as the Alternative Investment Market, which has lower entry requirements than the main market, and recent moves by the London Stock Exchange to develop a fast entry route to the market for technology-based companies, are further positive developments.

In short, the South African tax authorities could gain considerably from a thorough assessment of the UK's experience, and should give special attention to the following two areas:

- The creation of a scheme for SME finance along the lines of EIS as described in Chapter 2, Section 3.3, and
- stimulating the flow of business-angel finance, i.e. of private investment flows into the SME sector.

5.2 Venture capital as a recognised investment for institutional investors

a. Problem statement

Currently institutional investors are prohibited from investing in unlisted venture capital companies, and therefore in SMEs, as these enterprises normally do not qualify in terms of their investment criteria. Considering that more than 40 per cent of the national output is produced by SMEs, this curtailment on investments in SMEs seems too harsh. A well-diversified investment portfolio should have at least some room for these high-risk, high-return assets.

b. Suggested solution

Legislation should be changed to allow institutional investors to invest, within reason, in venture-capital or small-capitalisation companies (i.e. SMEs) if they so desire.

5.3 Higher tax thresholds for SMEs

a. Problem statement

SMEs often bear a disproportional burden in complying with many types of regulations. They face high compliance costs, extensive and complicated paperwork, and economic regulations that prohibit certain activities.²⁰ Smaller firms have less capacity to absorb unproductive expenditures because they have less capital available than larger companies. They also have fewer managerial resources to devote to paperwork.

According to international research, the cost of public red tape is about four to five times higher for SMEs than for larger companies.²¹ Often it is only the owner-manager who can give attention to these issues at great opportunity costs.

b. Suggested solution

The National Treasury, as well as the provincial and local authorities, should do detailed cost-benefit analyses of the various taxes and levies they impose on small business. Particular attention should be given to the thresholds at which these taxes and levies become effective. Likewise, the various regional services levies could differentiate – on a cost/benefit analysis – more meaningfully between SMMEs and larger companies.

The costs of fiscal generosity to smaller firms are likely to be minor for the National Treasury, but the potential returns for business – in particular small- and micro-businesses – and for the country in general, could be significant. Not only do the financial costs require attention, but so does reducing the levels of frustration in dealing with the various authorities.

²⁰ OECD, *Regulatory Reform for Smaller Firms*, STI Paper, Paris, 1999, p.7.

²¹ OECD, *Small Businesses, Job creation and Growth: facts, obstacles and best practices*, Paris, p.22.

6 Role of the Financial Services Board

There are three areas in which the FSB could play a more powerful role in promoting SMEs' access to finance. Firstly, it could actively promote the venture-capital markets in an OTC context. Secondly, it should play a more active role in the development of a local securitised asset market that is still underdeveloped relative to international trends. Lastly, it should legally and administratively support the development of CLO funds (particularly those that cater for SME financial needs).

6.1 Development of the venture-capital market

a. Problem statement

For all practical purposes the JSE has failed in its efforts to promote a meaningful local venture-capital market. Currently, only slightly more than a hundred companies are listed on the JSE's DCM and VCM (see Chapter 2). This is far too few considering the relative importance of SMEs in the South African context. It is even doubtful whether the JSE, with its more international character, is in a position to give the venture-capital market the attention and support it deserves. Though the JSE's listing requirements for the VCM and the DCM are less onerous than for the main board, the administrative burden on SME's when listing on these markets is arguably a deterrent.

b. Suggested solution

If the formal financial markets cannot give an appropriate answer to the underlying "equity gap" problem facing SMEs, the Financial Services Board should more actively promote the development of an over-the-counter (OTC) market for venture capital. In real terms the price of trading systems has been falling continuously over the years. Markets with low liquidity characteristics, such as small cap stocks, may need the support of such OTC trading systems which, hand-in-hand with fiscal incentives to "business

angels” and a better disclosure regime, might overcome some of the current constraints on development.

The promotion of an OTC market for low-liquidity securities, which would compete with the JSE at the fringes of its main business, can no longer be left to the major players in today’s securities markets. Their commercial interests lie elsewhere. Instead, the FSB could investigate ways of being more supportive to those OTC markets that wish to trade in low-liquidity securities. For example, the FSB could create a simpler supportive legal framework for such OTC trading systems than that required by the formal exchanges. Similar to the concept of second-tier banking (as discussed in Chapters 3 and 4), the securities markets could differentiate between first- and second-tier markets. In this context the formal exchanges could be seen as first tier, whereas some of the OTC markets could develop as second-tier markets. From a competitive viewpoint it would then be important to have effective competition between the first- and second-tier markets. Accordingly, the Competition Commission should keep a watchful eye on this factor.

6.2 Development of the securitised-asset markets

a. Problem statement

The reasons for securitised-asset markets not developing in South Africa as they have abroad, are multifaceted. What comes to mind is a badly outdated Companies Act (which was a major reason for the Master Bond debacle in the early 1990s), the various restrictions emanating from the Commercial Paper Notice of 1994 and the Securitisation Notice of 1992 (which in turn were practical answers to the failings of the Companies Act: see Chapter 5), and the fact that the major players in the securities markets are banks which have good commercial reasons to contain this market. In essence the securitised-asset market is in direct competition with the banks’ financial intermediation activities. Moreover, the levels of inflation and interest rates have militated against the use of credit to fund development, not only for SMEs but also throughout the corporate sector. As a result, South African companies are significantly under-borrowed in comparison to companies in

other developed economies. The tax regime, where interest is taxed, but not dividends, also tends to favour equity above debt finance.

b. Suggested short-term solution

Considering that two important pillars of the financial system are the banking sector and the securities markets, it is of systemic importance to regulate these competing components separately. Conceptually it seems wrong that the development of the securities markets is made dependent on legislation issued by the bank regulator (i.e. that a bank should form part of a securitisation structure), because of the competition issues involved. Currently the ambit of the Banks Act seems too wide, which in turn impacts on the responsibilities of the securities regulator. The FSB and the Bank Supervision Department of the SARB have to address these “borderline” issues with a degree of urgency, preferably before the single-regulatory structure takes form in South Africa.

c. Suggested long-term solution

Once the legal system has become friendlier towards the securitised-assets markets, the FSB could give long-term support to the securitised-asset markets by actively supporting an effective competition policy, *inter alia* by ensuring a level playing field between indirect financial intermediation (e.g. banks) on the one hand and direct investments (e.g. CLO funds) on the other. As the securities markets are changing rapidly in their forms and dynamics, this competition policy would be an ongoing issue for the regulatory authorities.

6.3 CLO-fund finance for SMEs

Conceptually the collateralised loan-obligation fund is part of the securitised-asset markets, but it may require separate mention because of its importance for SME finance as well as its highly specialised character.

a. Problem statement

Securitisation has not reached the same level of acceptance in South Africa as in many of the other developed economies. It is therefore unlikely that CLO-fund finance with SMEs as the ultimate borrowers will see the light of day in the short term.

Historically, the development of a CLO-fund finance specifically for the funding of SMEs was held back by legislative constraints. Although it is envisaged that the Registrar of Banks will lift these constraints later in 2001, from a regulatory viewpoint it is still debatable whether or not the regulator for these funds (i.e. if they do not involve banks), should be the Registrar of Financial Institutions (i.e. the FSB). As CLO-fund finance is a form of securitisation, banks are by the nature of their business in competition with these funds. The Registrar of Banks cannot be expected to involve himself extensively in the competitive issues of financial institutions over which he does not have regulatory oversight.

b. Suggested solution

The regulatory responsibilities for CLO-fund finance (i.e. those that do not involve banks²²) should be shifted from the Bank Supervision Department of the SARB to the FSB as soon as the Securities Services Bill and the Collective Investment Schemes Bill have been enacted by Parliament. Moreover, the National Treasury should support the securitisation of SME debt by partnering the private sector in a meaningful venture aimed at kick-starting this source of finance. The National Treasury should consider offering to take up the junior debt in such a securitisation, or CLO. The participation of the public sector could be reduced and eventually eliminated in two ways. Spread would be trapped in the structure to replace the junior debt without affecting the security of the senior investors. As the fund becomes more accepted in the market and the appetite for riskier, high-yielding investments increases, private sector investors could replace the

²² The proposed new Securitisation Schemes regulation distinguishes between securitisation by a bank and a non-bank. If a bank were involved in a securitisation in a primary or secondary role, the Registrar of Banks would necessarily have to be involved. But if the securitisation does not involve a bank, then it would seem that the FSB should be the regulator of choice.

National Treasury as the holder of the junior debt. As the Treasury did in the UK, it is important to shift the fiscal intervention gradually from debt to equity incentives. Supporting CLO-fund finance for SMEs is one of those public-sector incentives that carry relatively little risk.

7 Role of the South African Reserve Bank

In many of the public sector incentives discussed above, the South African Reserve Bank is a key participant. Four regulatory issues will be emphasised in this section: (i) the Banks Act and its exemptions, (ii) the role of the SARB in the national payment system, (iii) the establishment of second-tier banks, and (iv) disclosure rules and systemic risks.

7.1 The Banks Act and exemptions from the Banks Act

a. Problem statement

The existing regulatory framework, as represented by the Banks Act and the exemptions from the Banks Act, has the following limitations concerning appropriate and adequate access to funding for NBFIs:

- Intermediation between entities with surplus funds (whether retail depositors or persons or entities with investment funds) and entities requiring loan finance is limited mainly to banks. Apparently certain sections of the Banks Act (such as the commercial paper exemption²³) were drafted in a manner that has resulted in the scope of regulation being wider than the intended scope.
- NBFIs (apart from “common-bond” institutions, which effectively operate as quasi-banks) are systematically prevented from accessing capital for purposes of on-lending, including from accessing funds that could be termed “wholesale deposits”.

²³ Similarly, in the exclusion under the definition of the ‘business of a bank’ of deposits received from less than 20 people amounting **to less than R500 000**, the latter part of the exclusion is so limiting that it unduly broadens the scope of the Banks Act.

- Apart from the “common-bond” exemptions, the Banks Act makes no provision for access to funding for NBFIs (i.e. if the purpose of raising such capital is for it to be on-lent as loans).
- The regulatory framework of the “common-bond” exemption does not appear to be adequate for ensuring compliance with the conditions of the exemptions. Although the intensive regulation of “common-bond” institutions may not be warranted,²⁴ the current minimalist regulatory oversight of these institutions undermines the credibility of these institutions, i.e. in the eyes of the potential members and of the counterparties (including the linked banks) with whom these institutions wish to transact. The current framework therefore seems to undermine the growth prospects of these entities.
- The level of legislation and regulation in respect of *stokvels* is inadequate for similar reasons, particularly in view of the amounts of money processed and their potential growth in time to come. This minimalist framework and lack of regulatory certainty similarly undermine the growth potential of *stokvels*.

b. Suggested short-term solution(s)

In response to the issues raised above, the following range of short-term interventions are suggested:²⁵

²⁴ This is obviously true if the yardstick is the potential for ‘systemic risk’. These entities, whether looked at in isolation or in aggregate, are simply not large enough to pose any systemic risk.

²⁵ Note that the priorities and feasibilities vary for different options.

- Issue a Banks Act Exemption Notice to enable NBFIs to raise wholesale deposits from legal entities and private individuals, but subject to specific conditions.²⁶

or

- Alternatively, revise the wording of subparagraph (ee) of the definition²⁷ of “the business of a bank”.²⁸ Enhance the prescriptions for the regulatory functions to be performed by the self-regulatory bodies in the “common-bond” exemptions and increase the level of oversight over the performance of such regulatory functions by the Bank Supervision Department.

It is worth noting that, although these changes are not motivated only by or solely from the perspective of increased provision of finance to SMEs, they form part of a conceptual approach of allowing a *greater range of institutions to play a meaningful role in financial intermediation*. This should lead also to a greater availability of finance to a broader range of SMEs (including micro-enterprises), given the range of financial service providers that could develop and the increased competition that could occur between such institutions and the traditional financial service providers. Note further that it may very well also lead to the increased entry into financial service provision (and SME finance) of large and small corporations that may currently not be involved in financial service provision, and in the increased provision of SME finance by the micro-lending sector. *The rationale for both these expectations is that*

²⁶ The Bank Supervision Department has indicated that, in principle, it is in favour of non-bank retail-lending institutions being allowed to take wholesale deposits from corporate/commercial investors. Some progress has already been made with the development of proposals for a suitable regulatory framework in order to provide explicitly for accredited institutions lawfully to solicit or take wholesale deposits, that is, deposits of not less than R1 million. Since the proposed regulations would not allow retail deposit-taking, the notice would affect only the wholesale deposits of larger investors who are able to assess the risks involved. In addition, the possibility of increasing access to funding for micro-lenders by way of commercial-paper issues is being addressed in the Collective Investment Schemes Control Bill, 1999.

²⁷ This would imply at least the following changes: (i) That the listing requirements on entities be removed; (ii) that the minimum net asset level be reduced to no more than R10 million; and (iii) that the prohibition on utilising the funding raised for the provision of loans be removed.

²⁸ The former approach would have lower risk, since access to the exemption could be managed through requiring registration with an institution such as the MFRC, under the conditions prescribed by the Bank Supervision Department.

*access to capital is a substantial obstacle to such entities providing the type of finance required by an SME.*²⁹

c. Suggested long-term solution(s)

To arrive at a long-term solution for the identified weaknesses, the following course of action appears advisable:

- A comprehensive review of the definition of a deposit and of banking business (and the related sections) in the Banks Act, against international benchmark legislation. The purpose of the review would be to identify areas in which the South African definitions are too wide, or the exemptions too narrow, given that they limit the ability of NBFIs and other commercial entities in the economy to raise capital in the most efficient manner.
- Investigating the feasibility, implications and requirements for the establishment of a category of “second-tier” banks, including core banks as set out in Chapter 3. These second-tier banks should have limited mandates. Further recommendations on this important area are made in Section 7.3 below.

7.2 Access to and neutrality of the national payment system

a. Problem statement

In South Africa, access to the national payment system is limited to banks only. A number of industrial countries, including the UK and Australia, have opened their national payment system to non-bank financial institutions as well, with the aim of increasing competition between banks and non-banks. As emphasised in Chapter 4, improved access to finance for SMEs hinges critically on establishing a level playing field between banks and NBFIs. For the regulatory authorities the problem is how to increase membership in the

²⁹ The manner in which the micro-lending industry developed provides substantial intuitive backing for such exceptions. The changes proposed would also enable a change in the *profile of finance* being provided by micro-lenders, from short-term consumption finance to longer-term and larger amounts of investment finance (e.g. in both housing and SMEs). The type of funding to which this sector currently has access, inhibits such a change.

national payment system without at the same time increasing the systemic risks.

b. Suggested short-term solution

A guiding principle is that, wherever possible, the regulatory authorities should promote competition, with due regard to systemic risks and consumer protection. Increasing non-banks' access to the national payment system would be a major step *in principle* for the SARB that would make a substantial contribution to increased competition in the financial sector. However, it would be a far-reaching step and would have to be investigated thoroughly. In the short term, an SARB task group should investigate the viability and consequences of opening the payment system (i.e. the SAMOS system) to non-banks. Depending on the findings, the SARB could then formulate policy accordingly.

Another area that may need an in-depth investigation is the competitive relationship between the four major clearing banks and other banks (and NBFIs) *vis-à-vis* the Payment Association of SA (PASA).

c. Suggested long-term solution

Considering the efficiency gains that would flow from increased competition, as well as the openness of the South African economy, the long-term solution may lay in harmonising the national payment philosophies with those abroad, even if introduced in phases.

7.3 Establishment of second-tier banks

a. Problem statement

Currently the initial capital requirement for banks is R250 million. This entry barrier seems too high for a developing country like South Africa, where many NBFIs may wish to obtain a restrictive or "specialised", rather than a fully-fledged or "universal", banking licence. The minimum initial capital requirement currently operates as a *barrier to entry* rather than a *standard of entry*. Research has identified the need for deepening the market beyond the banks at the top end and micro-lenders at the bottom end. The development

of a significant second tier of deposit-taking institutions to serve the lower end of the market has become imperative.

b. Suggested solution

A lower initial capital requirement should be stipulated for those banks that are willing to reduce their risk exposures in a meaningful way. For example, the new Basel Capital Accord (2004) distinguishes between main classes of financial risks, with the most important classes being market risk, credit risk and operational risks. If a bank commits itself *a priori* not to be exposed to some specified risks such as credit risks (e.g. by investing all assets in money-market instruments), or foreign-exchange or derivative exposures risks (e.g. by excluding such financial instruments from their daily operations *in toto*), the Registrar of Banks should be able to grant the specialised banking licence at much lower initial capital requirements than those for universal banks.³⁰

If the regulatory authorities accept this broad principle, the Bank Supervision Department of the SARB would have to do more detailed research to determine the exact capital requirements for second-tier banks of various kinds. For example the Postbank, as a public-sector bank for areas with a low population density, has a specific role to play in the South African financial system, and could well be further developed along the lines of second-tier banking. Clearly, the topic is vast and no immediate change in legislation seems possible without substantial research.

7.4 Bank disclosure and systemic risks

a. Problem statement

Currently the SA Reserve Bank publishes only the balance sheet of banks in the public domain. All other information contained in the official returns (detailed information obtained from banks on a monthly basis) is kept confidential within the Bank Supervision Department of the SARB. As a

³⁰ In this context see also: Van Greuning, H. and J. Gallardo and B. Randhawa, A Framework for Regulating Microfinance Institutions, *Policy Research Working Paper* No. 2061, Washington: World Bank, 1999.

result, the SARB assumes a huge burden of responsibility in terms of competition policy. For instance, rating agencies would be able to increase the quality of their reports substantially if more information were to be published, and market forces could react more quickly and more forcefully. *The corrective processes of the market mechanism are hampered by not publishing sufficient official information about banks.*

The SARB faces a number of fundamental issues concerning disclosure, such as when to publish information (i.e. the optimum time delay), what to publish (i.e. avoidance of information overflow), how to publish (e.g. for the industry on an aggregated basis or per individual institution) and whether it is collecting the right information for the markets in the first place (e.g. information on the risk-weighted returns of various banking activities). Currently South Africa has no public-sector credit bureau; unlike the Banque de France, the South African Reserve Bank does not gather credit-scoring information on SMEs; there is no official support to create credit-rating agencies for SMEs or to create a low-cost Internet-based bulletin board (or electronic meeting room) where venture capital firms could be introduced to one another.

b. Suggested solution

Obviously the gathering of appropriate information for the financial markets is a complex task involving various regulatory bodies, government departments and the private sector. In principle the Bank Supervision Department of the SARB could concentrate primarily on the type of information that may have systemic implications (e.g. financial statements and risk-exposure information of banks), the Financial Services Board in contrast may focus on consumer-type information (e.g. full disclosure of product prices on an Internet-based bulletin board), and the Department of Trade and Industry could give support in non-financial information flows (such as support for a non-profit matchmaking service for business-angel investors). As the disclosure of information may have unintended consequences, the authorities should be careful in managing any change in this respect. An expansion of the nature and extent of the information collected and disseminated by the private-

sector credit bureaux on SME repayment profile and financial exposure may similarly help to increase the efficiency of the market for SME finance.

As a short-term measure, the whole issue of disclosure has to be investigated in far more detail, and comparisons have to be made with other countries. Accordingly, a task group should be formed consisting of representatives of the SARB, the FSB, the DTI and the MFRC to investigate maximum disclosure within the constraints of systemic risk management and consumer protection.

8 Summary and conclusions

Ensuring an efficient and effective business environment for SME finance requires an orchestrated initiative by various public and private sector entities. Effective co-operation between the Department of Trade and Industry, the National Treasury, and the various regulators of financial institutions are particularly important in this context.

Currently the Usury Act does not protect consumers effectively and constrains the delivery of finance to SMEs. Moreover, NBFIs cannot develop their businesses owing to a grossly uneven playing field *vis-à-vis* the banking sector. Improving fair competition and ensuring appropriate consumer protection would be a big task for the Government. In addition, ensuring that South Africa remains internationally competitive would require that many of the recommended regulatory changes should be implemented in a relatively short time span.

Of course, South Africa is not the only country that tries to combat unemployment and crime by stimulating its small business sectors. In a world that is becoming ever-smaller owing to technological advances, time is clearly not on our country's side. In fact, to make the required economic breakthroughs, SMEs would have to enter the export markets in a significant

way in the not too far distant future.³¹ If they are to succeed in these markets, the regulatory framework, the tax laws and legal framework affecting SMEs would have to be subjected to proper cost-benefit analyses. Any requirements that do not make commercial sense should be eliminated as soon as possible.

³¹ Tourism, as a potential major earner of foreign exchange, is an obvious example in this regard.

EPILOGUE

BEYOND THE REMOVAL OF INSTITUTIONAL CONSTRAINTS

1 Introduction

This investigation focused on regulatory issues. It identified significant weaknesses in the competitive environment for the provision of finance to SMEs, which need to be dealt with. It also identified substantial obstacles that impede financial institutions from providing finance to SMEs or that inhibit the market for SME finance to function efficiently. Implementing the Task Group's proposals would go a long way to bringing the regulatory framework of SME finance in line with best international practice as well as in ensuring that SMEs are treated fairly.

Although regulatory improvements are a necessary condition, they are by no means sufficient for the flourishing of the SME sector or even for substantially increased access to finance. Other actors in the economy and in civic society have a role to play, particularly in addressing issues related to the dual nature of the South African economy. Whether private sector can address these issues will depend on the costs and risks related thereto.

While the commitment to an increased access to finance will have to come from the various market players, public interventions involve setting appropriate incentives for the market or dealing with certain constraints originating outside the financial sector. Without extensively discussing these complex issues, this epilogue identified two main categories: (i) demand-side issues that have to do with the fragility of the SME sector and with SMEs' capacity to meet reasonable credit criteria and; (ii) supply-side issues related to the readiness of financial institutions to engage on the SME market.

2 Demand-side issues

Conceptually, three types of demand-side issues have been noted: the fragility of the SME sector (for example, as a result of AIDS or of a lack of skills); the firms' ability to absorb more capital (growth constraints and ability to meet reasonable credit criteria); and the SME owners' willingness to take the risk associated with accepting external capital (growth and ownership ambitions).

2.1 The impact of Aids on SMME development

According to the latest projections about one million people per annum will die as a result of Aids by the middle of this decade, while the infection rate is likely to lie between 25 and 35 per cent of people in the age category 15-55 years. Given the specific nature of SMEs, where the owner-manager is typically the pivot of the enterprise, an Aids infection rate in excess of a quarter of the workforce may be a serious setback.

In terms of access to finance, this could have the following consequences:

- As far as the short-term is concerned, Aids should not have a significant direct impact on the extent of lending to SMEs, as long as it remains an insurable risk. However, it is likely that the general confidence of creditors will be affected, so that the financial sector is likely to keep SME exposure within tight limits or, alternatively, it may discriminate against Aids-affected firms.
- The threat of Aids could also inhibit the development of medium- to long-term financing to SMEs.
- The impact of Aids on the cost and volume of SME finance depends upon the insurability thereof, and on the manner in which it is treated in legislation.
- Depending upon lenders' perception of the Aids risk across different cultural groups or across different geographical areas, financiers may well respond differently to SMEs from different cultural or geographical

backgrounds. The latter type of differentiation could be very negative if Aids does not become a notifiable disease or if it is not insurable, resulting in *perceptions of Aids risk* (rather than reality) dominating.

- The foreseeable increased mortality among small business owners is likely to pose an unprecedented succession challenge. There may be some room for a greater liquidity of small business assets (favourable to consolidation), to the advantage of equity investors. However, this will depend to a great extent on the fiscal, organisational and cultural environment. Obviously this will be a considerably complex and sensitive matter (as for instance predatory behaviour of lenders can be expected).

Without pretending to have a solution to these considerable difficulties, the Task Group would like to mention two possible approaches to mitigate the financial impact of the Aids risk:

- Private-sector insurance:

Currently lenders and enterprises can make use of “key person insurance” to manage the risk of a loss at managerial-level. However, with Aids being a “non notifiable” disease in terms of existing health legislation, insurers cannot price this illness appropriately in their policies. This may imply that the product will disappear from the market for all practical purposes - to the obvious disadvantage of particularly SMEs¹.

- Public-sector re-insurance scheme:

Alternatively a “SASRIA-type” reinsurance scheme could be established with the purpose of granting a basic cover to financial institutions against the Aids risks. Like SASRIA, it could be created as a non-profit organisation ultimately reinsured by government. Although quite challenging in its implementation (measurement of losses, etc.), such a scheme, if sufficiently credible, would release lenders and investors from their fears. If key-person insurance becomes difficult to obtain, or if the cost of such insurance becomes

¹ Dealing with this issue is certainly difficult because of ethical exclusion problems. The Task Group could not come to an agreement on appropriate solutions but does want to raise awareness of the problem.

exorbitant, the introduction of such a scheme may be essential for continued SME lending.

2.2 The lack of technical and business skills

The lack of business skills, of technical skills and of appropriate experience is a primary reason for failure of start-ups². However, these factors also increase the risk of lenders. There is therefore a need to improve the situation through:

- mentorship as a short-term solution (for enterprises currently in business), and
- entrepreneurship education as a long-term approach.

While there are currently mentorship schemes in place, there appears to be a need for a larger-scale approach to mentorship, which would have to be geared towards the specific factors that are impacting upon entrepreneurs from previously disadvantaged backgrounds in particular³.

2.3 Lack of collateral

One of the most discussed demand-side constraints is the inability of SMEs to raise collateral of the value and type reasonably required by the lender. Given South Africa's socio-economic background, capital accumulation by black South Africans has been undermined and thus also their ability to meet the lenders' collateral requirements. However, collateral impacts upon the lender's risk at two levels: it reduces the lender's net exposure and, more importantly, counters potential inverse incentives. The latter is not to be scoffed at. From the borrower's perspective, it is ideal to fund a high-risk venture with external debt finance without encumbering any of his/her own assets. If the venture were to fail, the financier would lose the amount advanced, leaving the entrepreneur to move on to the next venture with minimum loss of personal assets and undermining the soundness of the

² It thus impacts on the business success of enterprises of previously disadvantaged groups.

³ The DTI has commissioned some research on these issues.

financial system. Inadequate or deficient collateral is a valid reason for lenders to refuse to lend, even in a highly competitive market.

Guarantee funds can be structured to lower the exposure of the lender with reasonable ease. However, if the assets of the SME owner are not encumbered, this may create inverse incentives of the type described above⁴. Thus: collateral is creating a constraint on demand which would have to be relieved for capital to start flowing to SMEs, which are not appropriately addressed through conventional guarantee schemes.

This problem is exacerbated by the problems in the housing market. The most conventional security for the owner of an SME to offer would be residential property. However, this would require a relatively liquid housing market, with effective contract enforcement, also in township and peri-urban areas. The impact of changes in this area is likely to be large and wide spread. Therefore if these conditions are met and the assets that are owned by black South Africans become 'liquid' and available as collateral for SME loans, this could leverage finance for SMEs of a wide range of different types and sizes located in many different parts of the country.⁵

2.4 The determinants of small business growth

Even sound firms managed by healthy, well-qualified and business-skilled entrepreneurs may not be growing and making use of financial facilities as much as one might expect. There are many other requirements that need to be identified to stimulate the sector's dynamism, for example:

⁴ The general perception is that most of the lending that is supported by the Khula Guarantee Fund may well have taken place even without the guarantee. Even though their net exposure is lowered with the guarantee, the lenders are (rationally) wary of the inverse incentives created. A simple guarantee scheme does thus not address the "collateral deficiency" appropriately.

⁵ The weaknesses in securities legislation clearly exacerbate the problem, as it complicates or prevents collateralisation of even the security that is already available. It thus extends the argument to offering government contracts, shares on property development contracts and similar interests to lenders as collateral.

- easier access to markets (better linkages on local markets, better export opportunities);
- increased innovation (change in the entrepreneur's values; organisation of idea-generating sessions); and
- willingness to grow versus the preference for a 'lifestyle'-sized business.

2.5 The readiness of SMMEs for venture capital

This Report placed a strong emphasis on venture capital as an appropriate financing vehicle for high-growth SMEs. There is a strong presumption, however, that there is still little institutional demand for public venture capital.

The current listing requirements are tailored for firms which:

- should be medium-sized or larger (otherwise they cannot remunerate adequately the minimum subscribed capital of R500 000);
- must still have a high growth potential; and
- must agree to the concept of venture capital, which is to share ownership and control.

This target group is barely existent in South Africa's current dual economy. The following demand problems arise:

- those emerging SMEs with a substantial growth potential are too small to be listed,
- the larger SMEs, which would fulfil the size requirements, generally do not have a sufficient growth potential (they are traditional enterprises having already reached maturity); and
- even those that would qualify often prefer to avoid a loss of control⁶.

To avoid the risks of instability involved with "bringing the supply requirements down to current demand", there must be efforts to increase the institutional demand. Smaller enterprises should be helped to reach the

⁶ Giving up a share of the equity and thus, a part of the enterprise's control to external investors is often seen as a major disadvantage.

critical size, while established enterprises should be encouraged to expand⁷. In addition, South Africa needs to create a “culture of equity”, whereby enterprises will better understand the value of venture capital, and be more prepared to share ownership and control in order to realise the business’ potential.

3 Supply-side issues

As noted in Chapter 4 and 6, the major challenge is to “make small business finance profitable” to financial institutions. This section turns to various institutions and investigates to what extent the sector is attractive to them, and whether they are ready to engage with the sector. Also, this section addresses a major supply-side constraint, namely the narrowness of savings.

3.1 The considerable re-organisation needed within large banks

A wide-ranging engagement of large banks in the SME lending sector implies some organisational and economic prerequisites that are not necessarily at hand at present, such as (i) the ability to decrease transaction costs, in particular for risk assessment and risk monitoring; and (ii) the ability to implement risk-adjusted pricing.

On the first issue, reference is made to the evaluations given by the Banking Council South Africa⁸ on the processing costs of various types of loans. Clearly, the access to qualified personnel, the implementation of IT systems and appropriate training measures are investments that take time and must be justified by the expected returns⁹.

⁷ For example, through mergers and acquisitions.

⁸ Banking Council South Africa, *The Role of Banks in Financing SMME*; Submission to the Portfolio Committee for Trade and Industry, 6 June 2000

⁹ Public interventions may have a role to play to facilitate these changes. For example, there is a need for a greater skill-availability in labour markets through a sensitive immigration policy. More direct interventions are conceivable as well.

On the second issue, informal sources suggest that there is limited application by banks of risk-adjusted pricing in SME lending¹⁰. Under such circumstances, even an extension of the exemption to the Usury Act would not directly enable banks to increase their SME lending. As the experience of European banks indicates¹¹, it will take a lot of market evolution (increased competition and improved transparency), strategic boldness and organisational talent to reach this stage.

3.2 The ability of second-tier banks to operate profitably

Opening the legal possibility for an institution to operate as a second-tier bank does not necessarily mean that these institutions will flourish and be profitable. A number of questions can be raised as to their ability to operate profitably:

- As far as *core banks* are concerned, greater analysis would be required to determine whether the fees that they would charge for money-transfer services in a competitive environment would cover the costs of the infrastructure required to provide such services. It should be noted, though, that technological change could modify the cost/benefit calculation very rapidly.
- Regarding *small banks lending to SMEs*, it is probable that they would draw most of their revenues from the interest-rate differential. Should this differential become too small it may limit the attractiveness of such business, since these small banks will not have recourse to the “endowment effect” on which the larger banks rely.

¹⁰ This appears to be the result of the segregation of the risk assessment function and contract administration within banks.

¹¹ In Europe, until the early 1990s, a total lack of integration between credit risk management and product pricing (i.e. setting the interest rate for specific applications) has been the norm in SME lending (a lack of standardised risk-measuring tools may have been an important contributing factor). The reasons for gradual change have been: (a) fierce competition on the SME lending market; (b) technological progress enabling better (automatic) risk measurement with credit scoring systems; (c) increased transparency in the fee-interest structures and the resulting P&L-impact for the bank and (d) the complexity of implementing such changes in large organisations.

However, the Task Group reasoned that it is not the function of the regulator to prohibit any activity that may be unprofitable. Thus, if there is no regulatory or public-interest consideration that deems a particular activity or

business structure undesirable, there should not be any prohibiting laws or regulations. This would thus allow the financial sector to evolve in response to changes in the market and to the external environment (such as technological changes).

3.3 The cost-efficiency of CLOs for medium-sized enterprises

Again, the success of the ABS structure or collateralised loan obligation fund will depend on its cost-efficiency¹². In CLOs, as in other types of financial transactions, the smaller the transaction size and volumes, the more likely there will be cost-efficiency problems. If the scheme is either not affordable to enterprises, or not profitable to the various parties involved, it is likely to have only limited impact on the access to finance problem.

3.4 The readiness of the venture-capital and private-equity industry to deal with SMMEs

Although there are exceptions, a majority of venture capital and private equity companies have not engaged very deeply into the SMME sector. Here again, profitability considerations (i.e. transaction cost issues) have motivated their focus on larger transactions.

Even if these institutions were given incentives to increase their interest in early-stage and smaller firm segments, there are a number of big challenges (including cultural re-orientation) on entering this very different market

¹² Technically, there are three criteria of efficiency used to rate ABS schemes: **(i) Cash efficiency** (i.e. how much additional cashflow does the programme mobilise as a percentage of the disposable outstanding?), **(ii) Delcredere-efficiency** (i.e. how high are the delcredere risk-protection expenses after taxes as a percentage of the mobilised additional cashflows out of outstandings?) and **(iii) Legal efficiency** (i.e. how water-tight is the fiscal security of this concept? For example: true sale-compliance).

segment. However compared to large banks, private-equity firms are smaller, more numerous, while their investment procedures are also more individual and more innovative. Given an enabling environment, it is likely that a few of these entities would develop approaches that are suitable for the SME market or different sub-sections thereof.

3.5 The country's narrow capital base

Most observers do not believe the aggregate supply of venture capital available in South Africa to be a substantial obstacle at present¹³. However, this may be the result of an environment with limited “effective demand¹⁴”. Once progress is made on the demand side, the pressure on the supply side will also increase. This in turn means that additional efforts will be required to mobilise funds, whether from foreign investors or from domestic agents (who currently have limited investing opportunities). This, however, is a complex topic and should be the subject of a separate report.

¹³ I.e. the problem is in regulatory obstacles to access to capital, rather than the availability of capital.

¹⁴ I.e. SME applications for finance that meet the financiers' credit criteria.

Appendices:

Appendix 1 : The Relevance of the Cruickshank Report

Appendix 2 : Executive Summary

Appendix 3 : Measuring Profitability

Appendix 4 : International Comparisons

Appendix 5 : Review of Banking Services

The Relevance of the Cruickshank Report for SME Financing in South Africa

First Progress Report

By

**The Task Group on the Promotion of the Securities Markets to Support Small and
Medium Enterprises and Micro-lending Associations in South Africa**

18 April 2001

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1 Introduction and summary

In March 2000 Don Cruickshank completed a two-year review on competition in UK banking services (the “Review”). The scope of the Review was as follows:

- to examine the banking industry in the UK, excluding investment banking;
- to examine levels of innovation, competition and efficiency in various submarkets, including relationships with small and medium sized businesses;
- to look at how these compare with international standards; and
- to consider options for change.

Given the impact that this Review had on policy related to banking regulation on the UK, the Task Group reviewed the report and assessed the Review’s conclusions to the extent that they related to small and medium sized businesses (SME) finance.

In respect of access to debt finance for SMEs, the Review finds no indication that the quantum of debt finance that is available is insufficient, although there are inefficiencies in terms of product range, the cost of debt finance and the service provided to SMEs. The reasons for these inefficiencies relate mainly to competitive factors, i.e. the dominance of a small number of major banks and barriers to the entry of new financial service providers.

In respect of access to equity, the Review concluded that a greater role should be played by “business angel” finance.¹ SMEs are confronted with a form of market failure in respect of equity financing, because the transaction and running costs of funds aiming to provide around £500 000 of equity are higher than the recipient firms can reasonably support. The US market, where the Small Business Administration has been instrumental in developing small-scale venture capital for the past 40 years, shows that long-term public sector commitment to SME financing is necessary.²

With regard to the public policy interventions such as specific support mechanisms in the UK market, the Review concludes that support should be switched away from debt-oriented interventions such as the Small Loans Guarantee Scheme and Knowledge Banks to initiatives that support or facilitate the provision of equity to SMEs. It should thus support the expansion and/or establishment of national and regional venture capital funds.

2 General scope of the Review

The Review’s conclusions cover three main markets:

- Money transmission. This is the flow of money between firms, individuals and Government through the payment systems. The Review examined at all of the main methods of money

¹ See Section 6.4 for further details of “business angel” finance.

² It goes on to indicate a number of principles that would have to be followed in structuring and managing such funds.

transmission, including cash machines, credit and debit cards, cheques, direct debits and standing orders as well as high-value payments.

- Services to personal customers. The main services investigated were current accounts, savings products, personal loans, mortgages and credit cards.
- Services to small and medium-sized businesses (SMEs). The main services considered in the review were current accounts and external finance.

For each of these three groups of markets, the Review came to the general conclusion that there is not effective competition in any of the markets investigated and that government intervention would be required to address the deficiencies.³

The above observations are presented only as general context for the Review's observations about finance to SMEs. The remainder of this synopsis of the Review will focus on the analysis and conclusions which the Review reached in respect of banking services, debt finance and access to equity for SMEs.

3 Definition of SMEs

With respect to access to debt and related financial products, the Review defined SMEs as entities with a turnover of up to £10 million, or employment of up to 250 people, but which are no longer treated as personal customers by their financial service providers.

With respect to access to equity, the Review defines the area of investigation as the needs of firms without access to capital markets, but that require risk finance, particularly to fund rapid growth or substantial innovation. This type of financing is relevant to only a narrow band of the UK's 1,3 million SMEs, probably fewer than 200 000, of which some 20 000 to 50 000 need risk finance at any one time. In terms of the UK market, the Review concludes that the firms that are most negatively affected by the failure in the equity market are firms wanting to raise between R1m and R2,5m, but with indications that the market failure may begin to affect larger deals of up to R5m.

³ Refer Paragraphs 14 to 18 of the Review's Executive Summary for further details.

4 Conclusions on SME access to finance

The Review's conclusions on SME finance fall into two main categories, namely (a) access to debt finance and other financial services; and (b) access to equity.

4.1 Access to debt finance and other financial services

The Review concluded that there was a sufficient supply of debt finance with reasonable rejection rates.⁴ The reasons for rejection of applications for debt varied from bad business plans, excessive outstanding debt and insufficient collateral or a limited track record. The Review concludes that these reasons for turning down applications for debt finance are consistent with the application of the theory of credit rationing and indicates that the **quantum** of debt finance that is available to SMEs is sufficient. There are grounds to believe that those applications for debt finance that are rejected are high-risk products that would be better financed through equity and hybrid products, and not through debt finance provided by banks.⁵

However, the Review finds that the supply of debt and other financial products to SMEs is dominated by a limited number of major banks and that there were inefficiencies in the competition among these entities.⁶

The Review also considered SMEs' access to money transmission facilities and current accounts. The following conclusions apply to all three these areas, being the attributes of debt finance available to SMEs, and access to current accounts and money transmission facilities:

- That there is no effective competition among the banks that provide finance to SMEs.
- That consumers perceive significant competitive, as well as perceptual, barriers to switching their accounts.
- Few consumers are aware of the terms and conditions of the products they hold, pointing to significant information problems.
- Consumers have inadequate representation and redress.
- The markets to supply these services are extremely concentrated, and barriers to entry are high.
- In the absence of government intervention, the prospects for effective competition in these markets are remote.

These constraints imply that the cost of the debt finance available to SMEs may be higher than it might have been in situations of effective competition. It similarly implies that the level of

⁴ Cruickshank, para 5.7 to 5.11.

⁵ Cruickshank also conducted a detailed review of the government interventions to stimulate the provision of debt finance and concludes that these are misdirected.

⁶ The Competition Commission in the UK has since found that the big four commercial banks (i.e. Barclays, HSBC, Lloyds TSB and the Royal Bank of Scotland) which have almost 90% of the SME market, operate as a "complex monopoly" (which in turn was defined as restrictive competitive policies without cartel agreements).

product innovation is lower than it might have been in an environment of effective competition and thus that the availability of products that are most suitable for the needs of SMEs may be impaired.

Section 5 below goes into more detail of the Review's observations and conclusions in this important area.

4.2 Access to equity

The Review found that there was **market failure** in respect of the provision of small-scale equity finance to high-potential SMEs. This resulted in (i) insufficient small-scale risk capital being available to SMEs (in particular to high growth potential SMEs); and (ii) illiquid equity markets for small firms.

The Review sees these shortcomings in the equity market as more significant than the access to debt and other financial services. Accordingly a number of recommendations are made with regard to the establishment of, and/or support to, national and regional venture capital funds for SMEs. Section 6 below expands on the Review's observations and conclusions in this area.

5 SMEs access to “banking services and external finance”⁷

5.1 Internal versus external finance to SMEs

The largest proportion of SME finance is internal with only 39% of SMEs seeking new external finance. This also implies that the provision of SME finance, and particularly finance for small and micro- enterprises, is intrinsically part of the investigation into access to and the efficiency of the markets for access to **personal finance**. The majority of SMEs would access finance in the names of the owners of such SMEs in their personal capacities.⁸

5.2 Products covered by the Review

The review covered the following range of products:

- overdraft;
- bank debt;
- factoring and invoice discounting;
- asset finance (including commercial mortgages); and
- equity (both business angel and formal venture capital)⁹.

⁷ This section draws on the Executive Summary and on Chapter 5 of the Cruickshank Report.

⁸ In the South African contexts this is even more valid for micro-enterprises as it is likely that for the foreseeable future it would be the owners of the vast majority of micro-enterprises that would obtain finance, rather than the enterprises themselves.

⁹ This is discussed in the next section.

From a review of rejection rates¹⁰ the conclusion is that the quantum of debt finance that is available to SMEs is sufficient.¹¹

5.3 Barriers to entry: local characteristics, transmission facilities and access to SME information

The market for providing current account services and bank debt exhibits strong local characteristics:

- For those firms with a high volume of cash and cheque transactions, access to a local facility is considered essential.
- SMEs tend to use a local provider. The Review found that half of all businesses used the closest provider of their main source of finance (which includes non-bank debt). The median travel time between the firms' location and a branch used for money transmission was eight minutes. Over 80 per cent of SMEs were less than 30 minutes travel time from their main provider of finance. Firms were much more likely to be closer to the financier if their main source of finance was bank debt.
- The price of credit and banking services varied significantly in different areas.
- Local knowledge of the SME business environment is important for lending decisions. Lenders can reduce their risk by understanding local economic conditions and the impact these are likely to have on the success or failure of individual projects.

The local characteristics of the markets for these products imply that branch infrastructure and a retail distribution network are important factors in access to such products or services and are also a significant barrier to entry.¹²

The Review emphasises how important access to banking services is for SMEs, particularly access for SMEs to money transmissions facilities. "Banks are able to continue to exercise market power because current account services and term loans are generally sold in a bundle. There are good reasons for doing this. The bank is able to price the risk of a loan more accurately when it has a long transaction history. Empirical evidence suggests that this advantage is real: SMEs tend to get relatively better loan rates the longer they remain with a bank. The overall effect of bundling therefore may give some individual SMEs a relative advantage, but it also means that a small number of banks can collectively exercise market power over the SME population as a whole."¹³

¹⁰ Rejection rate of 5 per cent for all forms of finance. The lowest rejection rates were for credit cards, asset finance and factoring (2 to 4 per cent); the highest for term loans (13 per cent). This is in line with previous studies, which have found rejection rates for bank debt varying from 10 to 20 per cent.

¹¹ The Review observes that many of the activities that are rejected are high-risk activities which would be better funded by equity or hybrid products. However, banks have tried introducing these products (either loan repayments linked to turnover, or equity options), but they have attracted very little participation.

¹² This seems to underline the importance of participation by non-bank financial intermediaries in the provision of SME finance, given the local presence of these institutions.

¹³ Cruickshank, Paragraph 5.74.

Banks make “excess profits” in money transmission services provided to SMEs (a service for which the banks have a monopoly). This “excess profit” may in turn be used to subsidise the debt provided to SMEs (where the banks face competition from non-bank service providers).¹⁴ “The hard information on market structure is supported by softer evidence, which tends to confirm that SMEs are in general treated poorly by banks.”¹⁵

The Review observes that in the US, where there is far less concentration in SME banking markets, agency arrangements for money transmission facilities are commonplace. This reduces the barriers to entry and facilitates competition among different financial service providers for SME clients. This has benefits both in respect of the cost at which SMEs can access such services and in terms of the range of products available to SMEs (as result of higher levels of innovation).

5.4 Access to information, obstacles to switching and disclosure of pricing

The Review confirms that knowledgeable consumers provide the best incentive to effective competition. *“With the right information, consumers can take responsibility for their own financial well-being, shop around and exert the pressures on suppliers which drive a competitive and innovative market. There are a number of actions that government can take to improve information conditions in retail markets. The costs are small, and the potential gains from catalysing competition large.”*¹⁶

Furthermore, some groups of consumers need more help in making choices than others – specifically small businesses and those who are currently excluded from financial services. The Review recommends that the resources devoted to consumer awareness should accommodate the information problems experienced by SMEs, and people on a low income, especially those currently excluded from banking services.

The SME clients generally do not have sufficient or appropriate information with which to compare the cost of services offered by different financial service providers. A number of reasons are mentioned: (i) transaction and/or product risk profiles are non-standard, making comparison difficult; (ii) owing to weak disclosure, SMEs frequently are ill-informed about the cost of their existing financial services (e.g. arbitration between transaction fees and interest rates makes evaluation of actual cost very difficult); and (iii) the pricing between different services utilised by

¹⁴ See the Executive Summary and para 5.35 to 5.40: “Banks are able to sustain undue price discrimination within classes of SMEs that have the same economic characteristics.” Or para 5.41: “Research suggests that larger banks with greater market share charge more for loans of equivalent risk, and demand more collateral. And again in para 5.45: “At institutional level, the firms principally concerned in SME banking markets have together made cumulative returns for their shareholders in excess of nearly all other sectors of the UK stock market. This finding holds true for a number of periods of time, all including the economic downturn of the early 1990s. Para 5.46 notes: “Review’s analysis confirms the old saw that ‘banks make more money than their small business customers’.”

¹⁵ Cruickshank para 5.48.

¹⁶ Executive Summary.

the SME client are linked (e.g. the SME fears that by switching for cheaper debt finance it may pay higher transaction costs).¹⁷ They therefore generally do not shop around.

Making more information about SMEs available to potential suppliers could enhance the provision of finance to SMEs and competition in this market segment. This would help to reduce entry barriers to banking markets by making it easier for new entrants to identify potential clients, market their services to such clients and assess the risk of new applicants by, for instance, constructing appropriate credit scoring models.¹⁸ The information problems and barriers preventing SMEs from switching between financial service providers imply that the risk profile of the SMEs applying for new finance tend to be higher than average. As the SMEs existing bank has the benefit of information about client behaviour, usually built up over the years, the SME owner may find it difficult to switch his accounts to another institution for a number of years. Breaking down these barriers to information would increase the competition for SME clients, lower the cost of SME finance and improve product innovation in this market segment.

The observations in the foregoing sections imply that the bank has no incentive to lower the cost to its established SME clients as: (i) the client is unlikely to “shop around”; and (ii) its competitor banks are unlikely to market their services to these clients.

6 SMEs access to equity

6.1 Scope

The Review assessed the needs of those firms that require risk finance, but do not have access to capital markets, and in particular wish to finance rapid growth or substantial innovation. It indicates that this type of financing is relevant to only a narrow band of the UK’s 1.3 million SMEs, probably fewer than 200 000, of which some 20 000 to 50 000 need risk finance at any one time. “Although small in number, these businesses could potentially contribute significantly to UK output and productivity growth.”

In terms of “deal size”, note that the scope of the Review includes firms wanting to raise between R1m and R5m.¹⁹ The Review’s conclusions are therefore valid for relatively small transactions, even in the South African situation.

Furthermore, to the extent that access to the capital of small to medium sized non-bank financial intermediaries is included in the scope of the Terms of Reference of the Task Group, the scope of the Task Group’s investigation and recommendations would extend to enterprises that fall below the lower cut-off point of the banking review conducted in the UK. The Task Group

¹⁷ The rules and “practices” relating to the release of collateral may be another big factor. Para 5.67 refers to one such arrangement (“floating charge over assets”).

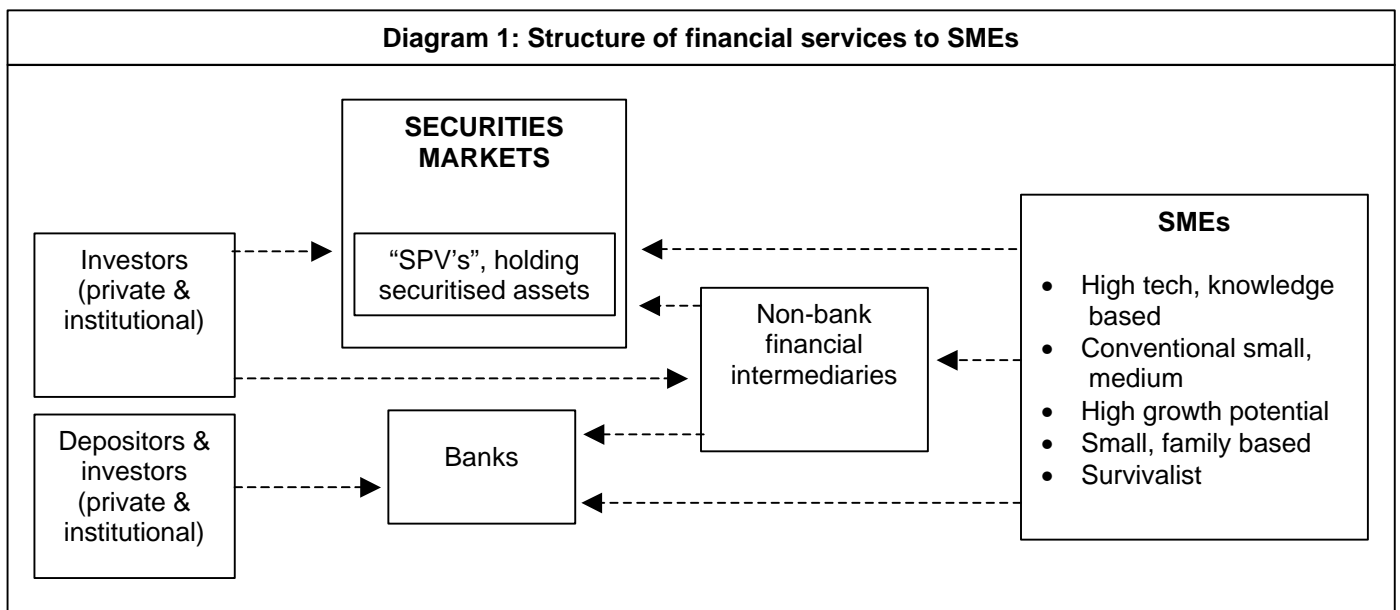
¹⁸ Executive Summary.

¹⁹ Cruickshank, paragraph 6.16: “The problem has commonly affected firms seeking to raise between £0.1m and £0.25m. However, if the upward trend in venture capital deal size continues, firms seeking up to £0.5m are likely to experience difficulty in getting access to this type of external finance”.

therefore recognises that there are enterprises in the South African context where the profile of the enterprise, whether in terms of risk profile, availability of collateral or amount of finance required, may not meet either the criteria applied by commercial banks or be of a size that is likely to gain direct access to the securities markets. Given the prominence in South Africa of non-bank financial intermediaries, commonly known as “micro-lenders”, the Task Group explicitly includes this as a group of entities whose increased access to finance could lead to increased availability of finance to small and micro- enterprises that may not have formed part of the scope of the banking review in the UK.

However, the Task Group also wants to make it clear that its focus is on conventional and valid financial sector criteria. Therefore, the focus of this assessment does not detract from other evaluations of obstacles to access to finance that may be based on discriminatory grounds, “red lining” or similar practices. The conclusions and recommendations of the Task Group should not serve as a rationalisation for such practices.

The potential structure of financial service provision to SMEs of different size, risk and collateral profile is illustrated in Diagram 1 below.



6.2 SME growth phases and funding cycle

Table 1 illustrates the funding cycles for different types of SMEs. This structure is expanded in the following paragraphs and used to develop a profile of the nature of the funding requirements of SMEs at different stages of their growth.

The financing cycle as depicted in Table 1 consists of the following stages:

- At the start-up stage, the business is characterised by a heavy reliance on insider finance from “owner-managers”, family and friends. This is economically rational and efficient as there is

likely to be insufficient information and/or collateral for an external financier to assess the risk.

- When trading is established, and growth potential becomes clearer, external equity may be available in the form of “business angel” finance, formal venture capital, corporate investment and bank debt. At this stage it has become possible for the external financier to assess the risk and level of profitability and return.
- In the final phase the existing external equity providers exit via a sale through the capital market or a trade sale. Either way the firm now has direct access to public capital markets.
- It is worth noting that less than 15% of SMEs²⁰ are likely to fall in the category “high potential and attractive”. Probably only some 20 000 to 50 000 SMEs in the UK need risk finance at any one time. These is a relatively small number, with obvious implications for scale and structure for the financiers or venture capital structures wishing to provide finance to this segment. However, these businesses could contribute significantly to output and productivity growth, thus warranting attention that may be out of proportion to the number of entities involved.

Table 1: SME growth phases and funding cycle				
Type of SME	Start-up phase	Growth phase	Stable	Exit for external investor
Traditional, providing income for an individual, family or small group of employees	Family, friends Savings Equity in residential property Trade credit	Asset-backed finance Factoring Bank debt	Often none, but debt if required	n/a
High potential with growth aspirations	"Angel" finance, Team equity, some venture capital	Venture capital Private placement of equity, Asset-backed finance Some bank debt	Venture capital High-yield debt market Bank debt	Either exit via capital markets or Direct access to competitive capital markets
Attractive with high tech information and life sciences IPR	"Angel" finance Venture capital Corporates	Venture capital Corporates Asset-backed finance	Corporates Bank debt	Exit typically via trade sale
Source: <i>Banking Review</i> (cited in Cruickshank)				

²⁰ Statistics based upon research in the US. Cruickshank thinks that the percentage may be lower in the UK and it may therefore be even lower still in SA.

At the earliest stages, finance from owner-managers and other working shareholders, family and friends is most important. The motivation for such investments frequently goes beyond financial returns, with entrepreneurial ambition and personal ties also playing an important part.

As successful firms develop, they would probably outgrow sources of internal equity and graduate to external capital, including venture capital, corporate investment and bank debt. This growth could be via intermediate sources such as “business angel finance”.²¹ This form of finance is discussed further in Section 6.4.

6.3 Limitations on debt and equity finance

For high-risk, high-return business propositions, debt finance is inappropriate owing to difficulties in accessing the implicit business risk. In practice, these risks are not easily compensated for in a higher rate of interest charged. For example, the initial financier of an SME takes the risk at the start-up phase and prices for it in the interest rate charged. However, those SMEs that are successful will continually assess the cost of this form of finance, eventually settle the facilities with the initial financier and progress towards cheaper finance with the more risk-averse financier. The initial risk-taking financier is therefore not being fully rewarded for the risk taken during the start-up phase.²²

It follows that for firms wishing to fund high-risk, high-return propositions the most appropriate source of finance, is often small amounts of external equity. But there are well-known and long-established problems in the private provision of small-scale risk capital in the UK and elsewhere. These problems have at their core the information asymmetry between investors and the firms, the degree of risk involved in financing relatively fragile firms, and the costs for the investor in obtaining information and structuring finance accordingly.²³

6.4 "Business angel" risk capital

“Business angel” risk capital can be defined as individual financial investments made by private persons (individually or in small groups) directly in SMEs. “Business angel” risk capital has certain tax advantages in the UK and plays an important intermediary role in the finance market for SMEs. In essence it forms a bridge between internal finance and access to formal venture capital. It is often cheaper and more readily available than venture capital, given the lower transaction and due diligence costs involved in individual investments of this type. “Business angels” have clear industry preferences, they invest in industries that they understand and usually operate locally, given the requirement for local knowledge. Business angels have invested some £650 million annually in the UK’s total of 1.3 million SMEs. This is significantly larger than the investments made by formal venture capital funds in seed, start-up and early-stage finances.

²¹ Cruickshank, 6.9 to 6.11.

²² See Cruickshank, para 6.5 to 6.8, being a systematic analysis of the problems with debt finance granted to high-risk ventures.

²³ Cruickshank, para 6.8.

Given its importance in the UK market, it would be of interest to find out the possible potential equivalent of “business angel” finance in the South African market. If significantly less than in the UK, the question could well be asked why? The current structure of the South African tax system may well be a disincentive.

6.5 Market failure in provision of small amounts of equity to SMEs

Cruickshank concludes that there is clearly a mismatch between the needs of firms requesting small-scale equity investments and the supply of these investments, i.e. the long-recognised market failure known as the “equity gap”.

The equity gap probably has the following roots.²⁴

- The transaction and administration costs of operating a venture capital fund are largely fixed, irrespective of the size of the equity required.
- For small amounts of equity, the fixed costs are a high proportion of the total costs, including the actual cost of the finance.
- To be successful, the fixed costs and the finance costs must both be paid from the returns earned by the investment. So, on average, in order to provide the same return to investors’ activities that require small amounts of equity (e.g. SMEs) the investment should be capable of delivering higher rates of return than similar risk profile equity provided in large amounts to larger firms.

In the UK market this has impacted on firms wanting to raise between R1m and R2.5m, with the upward trend in venture capital deal sizes indicating that amounts up to R5m may also be increasingly difficult to raise.²⁵

6.6 Public policy interventions

The UK Government has long recognised the problem of the equity gap for SMEs, as well as the brake it can put on SME growth through its taxation policies. The government has therefore made various attempts to correct for market failures *inter alia* through public intervention policies that seek to offset the high transaction costs and risks associated with investments of this size.

The public interventions fall in two categories:

- Debt-oriented interventions
- Equity-oriented interventions

The **debt-oriented** public policy interventions are listed below. Note that an advantageous tax treatment is often a feature of the public policy intervention.

- The establishment of a Small Firms Loan Guarantee Scheme (now integrated with DTI’s Enterprise Fund in the UK).

²⁴ Cruickshank, para 6.14 and 6.15.

²⁵ Cruickshank, para 6.16.

- A range of interventions aimed at enabling innovative knowledge-based businesses to secure bank finance. These interventions include a “Knowledge Bank” (i.e. a special fund created by issuing bonds to private-sector institutions, which in turn would be lent on to eligible businesses); a loan guarantee for bank lending to knowledge-based start-ups; and a “Challenge Fund” under which private-sector financiers could bid for government support for finance provided to knowledge-based firms.

The **equity-oriented** public policy interventions are:

- An Enterprise Investment Scheme, which involves tax relief on investments in SMEs to help overcome the problems small companies face with raising small amounts of equity finance.
- “Corporate venturing”, which is an umbrella term for the establishment of mutually beneficial relationships between companies commonly, though not exclusively, between a large and smaller company in the same line of business. There was a proposal on introducing a tax incentive to stimulate the accelerated development of corporate venturing in the UK.
- Venture Capital Trusts (VCTs) which were established to encourage individuals to invest via VCT investment trusts in a portfolio of smaller, higher risk trading companies.
- Establishment of a network of Regional Venture Capital Funds (RVCFs), by supplementing private finance with public resources for investments in the range £100 000 to £500 000, where market failure is frequent.
- Establishment of the UK High Technology Fund (UKHTF) that will operate as a “fund of funds” and will invest in venture capital funds specialising in early stage high-technology investments. It is to be started with a government investment of £20 million.

6.7 Assessment of public policy interventions

The combined cost of these public-sector initiatives is in the region of £35 million per year and about £50 million in preferential tax treatment.

The Review concludes that improving the UK risk capital market calls for public policy in four key areas.

- Debt finance for higher risk SMEs
- Venture capital funds
- Tax treatment of “business angel” and other entrepreneurial investments
- Public equity markets for smaller companies.

The Review assessed the interventions against the following criteria:

- Does the initiative focus efficiently on the market failure?
- Does it follow the US mantra of “low, simple capital gains tax; easy exit”?
- Does it align the interests of entrepreneurs and equity backers?

- Does it align the interests of those receiving government funding with the objectives of government intervention?

With regard to the specific support mechanisms in the UK market, the Review concludes that support should be switched away from debt-oriented interventions such as the Small Loans Guarantee Scheme and Knowledge Banks to initiatives that support or facilitate the provision of equity to SMEs. It should therefore support the Venture Capital Fund and the establishment of regional venture capital funds. The rationale of the Review in this respect is as follows:

*“Commercial trends in the UK are tending to raise the average deal size, increasing the number of companies who may be adversely affected by the equity gap market failure between bank and business angel finance on the one hand and formal venture capital on the other. This is precisely the market in which venture funds consistently and for good economic reasons find it difficult to make sustainable returns. The market failure occurs because the transaction and running costs of funds aiming to provide around £500,000 of equity are higher than the recipient firms can reasonably support. The US market, where the Small Business Administration has been instrumental in developing small-scale venture capital for the past 40 years, shows that long-term commitment to public-private financing is necessary”.*²⁶

The Review notes further “The US regime has been widely acknowledged for its contribution to the enterprise growth climate”, and in this context recommends a capital gains tax structure that would incentivise *entrepreneurial investment*. “Investment at this end of the risk capital market is primarily for growth rather than income and so is crucially affected by the taxation of capital gains.” The development of “second tier markets” such as the Alternative Investment Market, which has lower entry requirements than the main market, and recent moves by the London Stock Exchange to develop a fast entry route to the market for technology-based companies, are further positive developments.

6.8 Relevance of the regulatory environment

The regulatory philosophy appears to be of considerable relevance for the Task Group’s assignment. For instance, the Review finds that the regulatory framework for equity markets can support or stifle access to SME capital. The ability of the US markets to raise capital for innovative, high-return projects is related to: *“NASDAQ’s favourable regulatory and trading environment has succeeded in attracting investors to fund the continued growth of venture backed enterprises. Between 1992 and 1997 there were 1,200 venture backed IPOs in the US, 244 in the UK and only 156 in the rest of Europe.”*²⁷

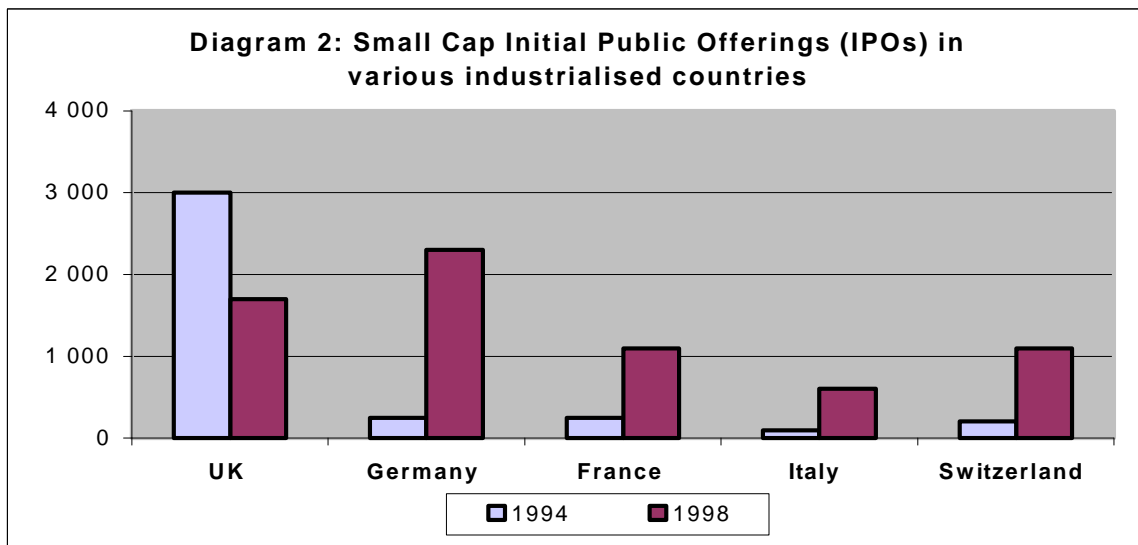
²⁶ See Cruickshank, para 6.47. The Review goes on to indicate a number of principles that would have to be followed in structuring and managing such funds.

²⁷ Cruickshank, para 6.19.

The Review further notes that the UK regulators may well give too much weight in their objectives to their role in securing market confidence and protecting consumers, without a counterbalancing obligation to promote competition and efficiency.

6.9 Impact of market changes in the short term

Small cap IPOs²⁸ on the UK market have decreased from 3 000 in 1994 to 1 700 in 1998. This trend contrasts sharply with developments in Germany, Switzerland, France and Italy, which have all shown remarkable increases in such offerings. In total, the offerings in these countries increased from 800 in 1994 to 5 100 in 1998.



7 Limitations on debt finance

Only companies of some minimum size have access to venture capital on the stock market or debt financing in the securitised assets market. Therefore for the vast majority of SMEs, private investors willing to finance directly small or micro- businesses with equity or debt finance remain crucial. Fiscal assistance may be required to encourage such investment more meaningfully. Moreover, the appropriate balance between equity and debt finance is not easily solved for SMEs. In this respect Cruickshank makes the following important remarks on the limitations of debt finance:

- *At each stage in the cycle, the firms need to structure their balance sheet to reflect the underlying risks in the business.*
- *Traditional debt finance is structured in such a way that lenders receive a fixed return and expect to get their original stake back at the end of the loan period. The likely rewards are set at the time the loan is made. This outcome cannot be guaranteed, because*

²⁸ "Initial Public Offerings".

there is a risk that the borrower will be unable to make full repayments. To allow for this, lenders anticipate a certain level of default and add a premium to the interest rate to cover the default losses. So non-defaulting borrowers pay for the few who default.

- *The more accurately lenders can group loans with the same probability of default, the closer they can match interest rates to the risks of that particular loan group. For example, interest rates on residential mortgages are on average 1 per cent or so above base rate. Loans to SMEs, which have higher default rates, average about 3.5 per cent above base rate. As the risk of failure and the rewards of success increase, these loan groups become more difficult to construct. The lender may be able to determine an average risk – and therefore a price – but does not know at the outset which firms in the group will fail and which will be spectacularly successful. This will become evident only over time. But at this later stage, successful firms may switch lender to take advantage of a better rate, or they may refinance the debt, leaving the first lender with the poor risks. The lender could factor this into the initial price, but to do so would be likely to attract only the riskiest activities, leaving some economic activities unfunded. This contrasts with equity where pooling throughout the period of risk is possible and the failures can be compensated for by high returns on successful firms.*
- *So for firms wishing to fund high risk, high return propositions, small amounts of external equity are often the most appropriate source of finance. But there are well known and long established problems in the private provision of small scale risk capital in the UK and elsewhere. These problems have at their heart the information asymmetry between investors and the firms, the degree of risk involved in financing relatively fragile firms, and the costs for the investor in obtaining information and structuring finance accordingly.²⁹*

Accordingly the important role for equity-based financing, and therefore the possible role therein by the venture capital markets and private investors, should not be underestimated.

8 Implications for the Task Group

In view of the work already done by the Cruickshank Commission, the Task Group will have to consider *inter alia* the following aspects in particular:

8.1 Differentiation between access to banking services and access to equity

Cruickshank differentiates between SMEs access to banking services, under which he includes access to debt and access to equity. Access relates to different markets, with different factors impacting upon SMEs access to each of these markets. The Task Group's investigation relates to

²⁹ Cruickshank, para 6.5 to 6.8.

SME access to equity and it did not pursue the issues emanating from Cruickshank's conclusions on access to banking services.

However, the issues which Cruickshank raises on access to debt and banking services deserve noting, as they are of major significance to the general question of SME access to finance and may well justify specific investigation:

- Cruickshank's conclusion in the UK market that the "quantum of debt finance" meets demand may have to be tested in the South African market for SME debt finance, as debt finance is important in the growth of nearly all SMEs;
- Although he finds that the amount of debt finance is adequate, Cruickshank also finds that the market does not function efficiently. Barriers to entry by new providers of SME finance and obstacles to SMEs changing from one financier to another are two such market inefficiencies. The requirement for "local presence", access to information about SME credit risk and "interlocking markets" were all found to play a role in preventing market entry.
- There has been considerable interest from non-bank retail and financial institutions to enter the market for provision of personal financial services. However, it is not unlikely that the dependence upon transmission facilities, in which banks have a monopoly, would limit these competitors to competing in the provision of debt to SMEs. This is of particular concern if those potential competitors may have other competitive advantages, such as better branch networks. The control that banks have over clients' bank accounts may furthermore give banks an undue advantage in the recovery of repayments on debt.
- In South Africa, banks have been rationalising branch infrastructure. Banks are losing their "local presence" with its importance in servicing SMEs. It is therefore important to allow other entities (not necessarily banks) to compete in providing these services to SMEs.
- Significant "pockets" of information about SME credit risk are currently not available to all credit providers, are sometimes shared only between banks and sometimes not even between banks. Such information deficiencies would obviously be a major obstacle to the provision of SME debt.

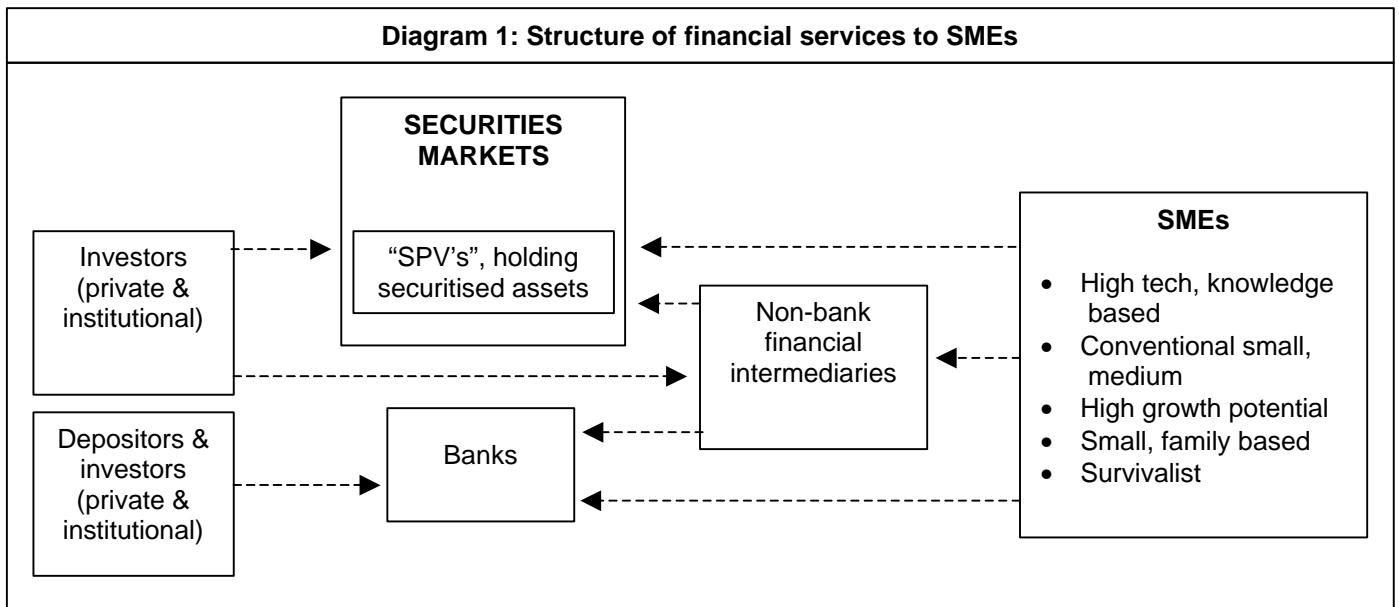
Lastly, note that the access to and effectiveness of the market for personal financial services are critical to SME access to finance. In the start-up phases many, if not most, owners of SMEs, will obtain finance in their **personal capacity**. Therefore, any intervention that will lower barriers to entry and competition in the markets for personal finance will directly benefit SME finance too. In the South African context, this draws micro-lenders into the debate, since they are the entities that have made the most dramatic inroads in extending more finance to lower income groups than ever before.

8.2 Implications of recognising value of high growth potential SMEs

Following Cruickshank, the importance of high growth potential SMEs must be recognised as deserving attention for the important role that they could play in increasing production and

employment. Therefore, the Task Group will take cognisance of the requirements of this group, despite the fact that it may be a relatively small minority of the total population of SMEs.

As indicated, greater access to the securities markets should make a difference to the access and cost of finance for small and micro- enterprises as well as middle and low-income South Africans. As illustrated in the diagram, greater access to more competitively priced capital through access to the securities markets would enable non-bank financial intermediaries (including micro-lenders) to improve the rates at which they provide finance. To the extent that access to capital is a constraint on the growth of these intermediaries, greater access to competitively priced capital may lead to increased entry of such entities into SME finance.



8.3 Other issues raised by Cruickshank

Note that in his recommendations Cruickshank gives considerable attention to issues such as SMEs access to information and access to redress. Regarding the latter, he includes considerations of access to facilities such as the banking adjudicator and the possibility that it may be necessary to create special facilities to receive and act on SME complaints. **The access of SMEs to information with which to compare the cost of products offered by different financial service providers remains of prime importance.**

The Task Group did not consider these as falling within its Terms of Reference, although they are obviously important. Nonetheless Cruickshank concludes that in some of these areas, weaknesses could only be addressed through government intervention, but that such improvements could in some instances be achieved at a minimal cost.

8.4 Review of policy interventions

Cruickshank did an extensive analysis of a range of policy interventions in the markets for SME debt and SME equity. The Task Group notes that a great number of these interventions reviewed by Cruickshank also occur in South Africa. Although this topic lies outside the Terms of Reference of the Task Group, it may well be worthwhile to similarly review the efficiency and effectiveness of the multitude of interventions in the financial markets, in order to optimise resources and to ensure that the interventions are actually effective.

8.5 Underlying principle: importance of competitive markets

Underlying much of Cruickshank's analysis is a philosophy that recognises the importance of "increasing competitiveness" as one of the core regulatory objectives. Like Cruickshank's conclusion for UK, the Task Group suggests that this might deserve explicit recognition in South Africa too.

9 Proposed research approach by the Task Group

The table of contents of the proposed research project is expected to be roughly as follows:

The promotion of the securities markets to support small and medium sized enterprises and micro-lending associations

1. Introduction
2. The relative importance of SME finance in the South African economy
3. Equity-based financing of SMEs
4. Debt-based financing of SMEs
5. The creation of collateralised loan obligation (CLO) funds
6. Consumer protection and systemic risks of SMEs
7. Required legislative changes to facilitate CLO finance to SMEs
8. Public-sector incentives to support SMEs
9. Summary

Only after the Task Group has finished this first report (which concentrates on the securities markets), will attention be given to the role of banks in SME finance. This will constitute the second Report.

EXECUTIVE SUMMARY

1. Banks operate on a huge scale at the heart of the modern economy. Scale is often hard to grasp. To give an illustration, in 1998, three UK banks each made more profit than the UK's five major publicly traded supermarket companies added together. The top 10 banks together made 10 times the profit of all these supermarkets, and are, collectively, worth £200 billion. However, it is the banks' control of the money transmission systems - cash, cheques, cards, electronic payments - that makes their innovation and efficiency crucial to the UK economy as it competes in an e-commerce world. It is this feature of banks, more than anything else, that is the focus of the Review.

OVERVIEW

2. It was from this perspective that the Review defined the scope of its investigation against the terms of reference set by the Chancellor in November 1998:

- to examine the banking industry in the UK, excluding investment banking;
- to examine levels of innovation, competition and efficiency in various sub markets, including relationships with small and medium sized businesses;
- to look at how these compare with international standards; and
- to consider options for change.

3. Unusually for a review of competition, the report begins by examining the policy framework within which banking services are supplied. In its investigation of competition, the Review continually encountered issues which pointed back to the policy framework. Banks are treated differently from the rest of the economy in many respects. Regulatory barriers to entry are high, producers are represented on the board of the industry's regulator, their exposure to competition law is diluted, and in many areas banks are allowed to write their own rules.

4. Historically, the most likely explanation for this special treatment lay in the existence of an informal contract between successive governments and banks, designed to deliver public confidence in the banking system. In return for cooperating in the delivery of Government objectives, the banking industry escaped the rigours of effective competition. This contract cannot coexist with desirable levels of innovation, competition and efficiency in UK banking markets.

5. The essential first step towards increased competition in banking services is therefore to develop the new policy framework for the relationship between Government and the banking industry. In this new regime, the Government needs to set out clearly and transparently what it wants, determine a framework of explicit rules to achieve it, and

then let free and fair competition between suppliers deliver it, within the constraints of sound prudential regulation. Only then will consumers reap the benefits of vigorous competition for their custom.

6. Most of the report describes an investigation into the level of competition in the main UK banking markets. The Review was not a legal inquiry and did not have any formal powers to demand information from suppliers. In some areas, this created problems as suppliers were either unwilling or unable to provide the necessary information about, for example, the profitability of specific activities. However, the Review was able, in all markets, to gather enough information to come to robust conclusions.

7. In selecting areas for detailed scrutiny, the Review looked for those markets in which banks are major players and where there was a likelihood of competition problems. Application of these criteria led the Review to exclude many of the services supplied by the firms commonly described as banks. Among the exclusions were services to large corporates, advice and brokerage, insurance, equity based savings products and personal asset finance.

8. The markets which the Review did investigate in depth can be split into three groups:

- **money transmission.** This is the flow of money between firms, individuals and Government through the payment systems. The Review looked at all of the main methods of money transmission, including cash machines, credit and debit cards, cheques, direct debits and standing orders as well as high value payments;
- **services to personal customers.** The main services investigated were current accounts, savings products, personal loans, mortgages and credit cards;
- **services to small and medium sized businesses (SMEs).** The main services considered here were current accounts and external finance.

9. For each of these three groups of markets, the Review posed the following questions:

- is competition effective?
- will the future change things for the better?

10. The answer to the first question was ‘no’ for all three groups: competition problems were found in all markets investigated.

11. Money transmission services are supplied in the UK through a series of unregulated networks, mostly controlled by the same few large banks who in turn dominate the markets for services to SMEs and personal customers. This market structure results in the creation of artificial barriers to entry, high costs to retailers for accepting credit and debit cards, charges for cash withdrawals up to six times their cost, and a cumbersome and inflexible payment system that is only slowly adapting to the demands of e-commerce.

12. In the supply of services to personal consumers the Review found significant information problems. Many consumers are unaware of even basic details of financial services. Barriers to switching accounts are perceived to be high and many services are sold off the back of current accounts, the supply of which is dominated by a few large firms. If customers have a complaint, the systems for redress are inadequate.

13. Many of these information problems apply also to SMEs. However, the levels of market concentration in the supply of banking services to SMEs are much higher than in the corresponding markets to supply personal customers. Prior to the Royal Bank of Scotland/NatWest merger, the big four banks' share of the supply of banking services to SMEs was 83 per cent. SME banking markets are local and market shares at a local level are often higher still. The result of this market structure is high profits and high prices, in particular for money transmission services.

Market dynamics

14. The extent to which the problems identified by the Review will be resolved by the dynamics of the marketplace varies across the three groups. The prognosis is: hardly at all for money transmission and banking services to SMEs; quite a bit for personal customers.

15. The lack of competition identified in the money transmission market are caused by the underlying economic characteristics of payment systems. Network effects mean that there is a natural limit to the extent to which competition is possible between payment systems. As a result, inefficiencies can persist for years, and payment systems can be run in the interests of those who control them rather than the public interest. The Review's findings are echoed in the experience of many other countries. To deal with these fundamental problems requires sustained intervention.

16. The market for the supply of banking services to personal consumers is now showing some encouraging signs of new entry and increased competition. These developments will, themselves, help drive better information and customer service. However, some well targeted intervention by government would drive these changes forward more rapidly.

17. The markets for the supply of banking services to SMEs fall between these two extremes. Effective competition between suppliers is a feasible outcome. However, the concentrated market structures that have resulted from successive mergers, combined with high barriers to entry and expansion, mean that this will not take place by itself. To produce competition in this market may require a one off structural solution, after which behavioural remedies, better information and redress should be sufficient to protect SMEs' interests.

18. Not all problems can be resolved through increased competition, however. The Review also considered how Government might best tackle market failures in the supply of small scale high risk capital to SMEs, and banking services to low income consumers respectively. The Review's analysis in these areas shows how it is possible for Government to achieve its public policy objectives, without perpetuating the old contract with the banks.

19. The rest of this executive summary describes the detailed recommendations made by the Review.

THE NEW POLICY FRAMEWORK

20. The first set of recommendations establishes the ground rules for the new framework for Government policy in relation to banking markets; one that recognises the special nature of banks without unnecessarily distorting competition.

21. The main elements of this new policy framework are to:

- increase transparency in banking supervision;
- get the institutional incentives right;
- deliver effective competition scrutiny; and
- eliminate regulatory distortions.

Increase transparency in banking supervision

22. Transparency is a cornerstone of effective regulation. Putting into the public domain accurate and timely information about the actions of regulators, in this case the Financial Services Authority (FSA), and of regulated firms, reduces information imbalances, lets everybody know where they stand and can reduce the need for intrusive regulation of firms' behaviour. The Review recognises that greater transparency can cause difficulties, but considers that the benefits outweigh the costs. The Review recommends that:

the Government should encourage the FSA in its efforts to make the regulatory process more transparent in the UK. It should also work with the FSA internationally to promote the importance of information disclosure in prudential regulation, for example through the European Union, and the Basel Committee on Banking Supervision.

the Government should examine the costs and benefits of requiring authorised firms to publish disclosure statements of their risk exposures and risk strategies, across all activities, in advance of the implementation of the new Basel Capital Adequacy framework. The statements should also include details of regulatory requirements such as capital asset ratios.

the Government should examine the benefits of introducing a requirement making all lender of last resort operations subject to public disclosure, within a fixed time limit, say one year, after the event.

Get the institutional incentives right

23. A key factor in devising a policy framework that will stand the test of time is to put in place the right institutional incentives for all parties charged with delivering policy. The

three key institutions in banking regulation and supervision are the FSA, the Bank of England and the Treasury.

24. Changes are required to ensure that the FSA is sufficiently independent from government and industry pressures. The Review recognises that the new regulatory regimes needs time to bed down. The Financial Services and Markets Bill¹ (FSMB) is a complex piece of legislation and so it will remain once it becomes an Act - the Financial Services and Markets Act (FSMA) - after parliamentary approval and Royal Assent, expected in spring 2000. All of its consequences cannot be predicted in advance. The Review recommends that:

the Government should monitor the impact of the FSMA on competition in financial services markets, and conduct a formal review, two years after commencement of the legislation.

25. This review should pay particular attention to the principle that the FSA needs to be seen to be independent from the industry which it regulates, and from government. The Review recommends that:

in reviewing the operation of the FSMA, the Government should give consideration whether to:

- *continue to appoint to the FSA members who are, or recently have been, employed by any of the firms authorised by the FSA;*
- *give ministers a general power of direction over the FSA, to be used only in appropriate exceptional circumstances, with all directions subject to public disclosure;*
- *restrict the grounds for removal of members of the FSA to ‘incapacity or misbehaviour’;*
- *separate the roles of chairman and chief executive of the FSA.*

26. Regulation influences how competition takes place. It is vital that all regulators, including the FSA, are aware of the impact that their actions have on the markets which they regulate. The Review therefore recommends that:

the Government should direct the FSA to assess the following in its annual report:

- *the degree of effective competition within financial services markets;*
- *the effects of regulation on competition in, and particularly entry into, financial services markets;*
- *the direct and indirect costs associated with any distortion to competition which have been estimated in the course of cost benefit analyses;*
- *progress towards greater transparency, especially in banking supervision.*

¹ All references are to the Bill as introduced in the House of Lords on 10 February 2000, HL Bill 32.

27. The Treasury also needs to adjust its own objectives and ways of working to take into account the establishment of the FSA as a regulator independent of Government. The Review recommends that:

the Treasury should re-examine its relationship with the FSA, in particular, ensuring its objectives, operations and staffing reflect the fact that the FSA is a regulator independent of Government.

the Treasury should amend its fourth objective to make clear that its scrutiny of the economy applies to all sectors, including financial services and banking.

the Treasury should give its competition and regulation team specific responsibilities for examining the Treasury's own initiatives in financial services regulation, and for providing the Treasury's advice on competition in financial services to external bodies such as the OFT and to interested parties within government.

the Government should ensure that the Memorandum of Understanding between the Treasury, Bank of England and FSA reflects the new policy framework.

Deliver effective competition scrutiny

28. It is essential that banks and other financial services firms are exposed to the full rigours of competition law, and are not able to shelter behind special exemptions or regulatory protection. The Review made a number of recommendations for improvement in its interim report². These were that:

the financial services sector should not enjoy any unnecessary exclusion from general competition law.

the FSA's rules should be within the scope of scale or complex monopoly investigations by the OFT and the Competition Commission.

while the OFT should not legally be required to scrutinise every rule issued by the FSA, its role in overseeing the financial services sector should be strengthened.

the FSA's rule making decisions should be open to review and especially their impact on competition.

the Competition Commission, not ministers, should be the final arbiters of the public interest in scrutiny or review of procedures.

29. In response to the interim report, the Government said it was committed to 'ensuring the FSA gives full weight to competition concerns'. It subsequently brought forward a number of amendments to improve the competition regime in the Financial Services and Markets Bill (FSMB).

² Banking Review Competition and Regulation in Financial Services: Striking the Right Balance, July 1999. Included at Annex F

30. The Review considers further action is necessary, in particular to prevent anticompetitive mergers. The Review found the structure of several banking markets, most notably the supply of banking services to SMEs and the supply of current accounts to personal customers, to be highly concentrated. Further increases in concentration in these and, potentially, other markets, should be looked at extremely carefully. The Review recommends that:

the Government should, in its reform of merger law, ensure that the proposed new competition based test for assessing mergers takes full account of the desirability of:

- *maintaining and promoting effective competition;*
- *facilitating the entry of new competitors into existing markets;*
- *improving the production of goods and services and promoting technical or economic progress*

so as to ensure that consumers receive a fair share of the benefits.

until UK merger law is reformed, the Government should:

- (a) refer all mergers between financial suppliers to the Competition Commission for investigation if the merging entities have material shares of the relevant market, or if each has material shares in related markets from which there is the real possibility that one might enter to compete with the other; and*
- (b) not approve any merger where the Competition Commission has produced an adverse report unless the merger:*
 - *maintains and promotes effective competition;*
 - *does not reduce the potential for entry of new competitors into existing markets;*
 - *improves the production of goods and services and promotes technical or economic progress*

so as to ensure that consumers receive a fair share of the benefits.

31. Competition should also be encouraged at a European level, so that UK suppliers are able to compete and expand overseas and that regulations set at a European level take enough account of competition issues.

the Government should encourage the European Commission to:

- *deliver a framework for competition scrutiny of proposals brought forward by the European Commission's directorate responsible for financial services (DGXV); and*

- *expand and accelerate the work of the European Commission's competition directorate, DGIV, in investigating competition concerns in the European banking sector, including state aids.*

Eliminate regulatory distortions

32. The Review identified a number of specific areas in which regulation was having, or was likely to have, an adverse effect on competition. Most regulatory distortions are not deliberate. They tend to arise because regulations are not kept up to date or because too narrow a view is taken of their impact at the time of implementation. It is not just government imposed regulations which have the scope to distort competition. All too often, self regulatory initiatives have given banks special treatment in return for undertaking tasks which should really be the responsibility of government. The introduction of the new policy framework will help to ensure that banks are given special privileges only when strictly necessary and that regulations minimise distortions to competition. As a general principle the Review therefore recommends that:

the Government should:

- *apply competition scrutiny systematically to all its policies and regulations in the financial services sector to ensure that they are proportionate and minimise distortions to competition;*
- *ensure that banks are not accorded exclusive participation or preferential treatment in the development of government initiatives unless there are legitimate reasons for doing so, having special regard to e-commerce developments.*

33. This principle should be applied specifically in: the developing area of digital signatures, where there is a danger of banks being given special treatment; deposit protection, where the danger is of over regulation; and the VAT treatment of financial services, which risk distorting financial firms' decisions to contract out activities or undertake them in house. In these areas, the Review recommends that:

the Government should ensure that the self regulatory 't-scheme' proposed for approving digital signature suppliers does not distort competition. It should subject all suppliers to the same, objective approval criteria and approvals process and, in particular, not favour suppliers who happen to be regulated for other purposes.

the UK deposit protection scheme should adopt all the exclusions permitted by the Deposit Guarantee Directive.

the Government should review the definition of financial services for the purposes of VAT, to ensure that there is no discrimination between in house provision by financial suppliers and outsourcing.

34. Money laundering is another area in which the Review has identified potential distortions to competition from over regulation. This is an area in which the banks have effective discretion to decide how to apply EU legislation in the UK. Of particular concern

are the rules that apply when a customer opens a bank account without making face to face contact with the supplier. This risks holding back the development of distance banking, and of increasing barriers to entry. The Review recommends that:

the Government should ensure that its money laundering requirements are proportionate and minimise distortions to competition and, in particular:

- *reassess the requirement that customers opening an account by a non face to face method should provide four separate pieces of identification;*
- *investigate the scope for one financial supplier to verify the identity of an individual to another supplier;*
- *examine the role of new technological developments, such as digital signatures, in providing alternative means of identification;*
- *subject its new proposals to a rigorous cost benefit analysis, including both the direct and indirect costs on competition.*

the Government should ensure that the FSA uses its powers under the FMSA to assume full responsibility for both the rules and guidelines on money laundering.

35. These recommendations describe the new policy framework to apply to all banking markets. This will drive increased competition and better targeted government policy across the board. The recommendations that follow are aimed at correcting the specific competition problems found by the Review in the various economic markets studied.

MONEY TRANSMISSION

36. The Review uncovered profound competition problems and inefficiencies in the market for money transmission services. Some of these problems will be only too familiar to bank customers: slow clearing cycles for cheques and automated payments, and high charges for cash withdrawals. Others are less evident, but just as important: for example the three quarters of a billion pounds of interchange fees paid in the UK each year, and the way in which full participation in payment schemes is nearly always restricted to banks. Innovation is stifled and the system has proved slow to adapt to an e-commerce environment. Many of these problems can be traced back to the structure of the UK payment systems market which consists of a series of unregulated networks, mostly controlled by the same few large banks who in turn dominate the markets for services to SMEs and personal customers.

37. Changes in the external environment, such as European Monetary Union and increasing internet use, are likely to have a significant impact on the supply of some payment services. But they cannot be relied on to resolve the competition failures as they will not affect the underlying structural problems.

38. There is an overwhelming case for robust and decisive government intervention in these markets based on the following three actions:

- set up a payment systems commission - PayCom - a new regulator with strong powers to deliver competitive outcomes;
- avoid being the source of regulatory distortions; and
- act as an intelligent consumer of payment services.

PayCom

39. The existing framework of competition law is not sufficient to deal with network industries such as payment systems. The incentives and scope for abuse by firms, or groups of firms, with significant market power are simply too strong. To achieve effective competition in this type of industry requires the Government to set down a series of ex ante rules, in addition to the normal provisions against anticompetitive agreements and abuse of a dominant position. The most effective way of achieving this is to set up a licensing regime, similar to that in place for other utilities, and to establish a new body to supervise this regime. The Review recommends that:

the Government should bring forward legislation to establish a payments systems commission (PayCom), charged with supervision of a payments system licensing regime. It should be independent of the competition authorities, other regulatory commissions, and of the industry.

the licensing regime to regulate competition in payments markets should have the following features:

- *participation in payment systems should be a licensed activity. All participants in payment systems should be subject to a class licence, written by the Treasury;*
- *PayCom should be granted effective powers to monitor compliance with the class licence and to impose sanctions. The sanctions should be in line with those contained in the Utilities Bill, currently before Parliament;*
- *there should be a process of appeal.*

the Government should put in place licence conditions to secure the following outcomes:

- *price transparency;*
- *good governance;*
- *non discriminatory access;*
- *efficient wholesale pricing;*
- *fair trading.*

Avoid creating regulatory distortions

40. Government itself can be a source of competitive distortions in the payment system. The Review therefore recommends that:

the Government should ensure that it does not unnecessarily stifle competition by restricting access to UK payment systems, either through its direct regulatory activities or in negotiating international agreements with other Member States.

Act as an intelligent consumer of payment services

41. The Government can also drive efficiency by acting as an intelligent and proactive consumer of payment services. Increased competition in payment markets will make it easier for government to do this. The Review therefore recommends that:

the Government should develop a strategy for acting as an intelligent consumer of payment services across all of its functions. The Office of Government Commerce should be responsible for monitoring performance.

RETAIL MARKETS: PERSONAL AND SME

42. The Review carried out detailed investigations of competition in the supply of the banking services to personal customers and SMEs. The Review found that competition was not working effectively in any of the markets studied.

43. In the markets to supply banking services to personal customers, the Review found that:

- the supply of current accounts is highly concentrated and holds the key to competition between suppliers in many other product areas;
- consumers perceive significant barriers to switching current accounts;
- few consumers are aware of the terms and conditions of the products they hold, pointing to significant information problems;
- consumers have inadequate representation and redress.

44. However, there are some encouraging signs of increasing competition and new entry in some product groups, for example mortgages, personal loans and credit cards. As yet, however, entry has only had a limited impact on the prices charged by the established banks.

45. The markets to supply banking services to SMEs are much less competitive than those which face personal customers. The problems associated with switching, information, representation and redress are more significant there. Furthermore the markets to supply these services are extremely concentrated, and barriers to entry are high. In the absence of government intervention, the prospects for effective competition in these markets are remote.

46. The Review formulated its recommendations for retail markets in the light of the above competition assessment. The following principles apply with equal force to both personal customer and SME banking markets:

- avoid over regulation;
- ensure adequate redress and customer representation;
- empower consumers through information.

Avoid over regulation

47. The Review did not consider there to be a good case for detailed product regulation in the supply of banking services to either SMEs or personal customers. This type of regulation imposes higher costs for the industry which then feed through to higher prices for consumers. It stifles innovation and blunts incentives to compete. The Review recommends that:

the Government should announce an intention not to designate the supply of banking services as regulated activities under the provisions of the FSMB.

the Government should, in the near future, publish objective and proportionate criteria for determining whether particular banking services should, in exceptional circumstances, be designated as regulated activities. These criteria should be used to evaluate any future demands for regulation. In its review of the operation of the FSMA, the Government should reappraise its decision to designate the sale of mortgages as a regulated activity against these criteria.

Ensure adequate redress and consumer representation

48. The current arrangements for customer redress and for customer representation to bodies such as the FSA and the Financial Services Ombudsman need strengthening. There is a need for a strong, independent consumer voice at the heart of the regulatory system. The structure of the new Financial Services Ombudsman scheme needs reforming to reduce the role played by the banking industry, and to enable banks from outside the UK to join the scheme on a voluntary basis. The Review therefore recommends that:

in its review of the operation of the FSMA the Government should consider establishing an independent Financial Services Consumer Council covering all financial services, not just those which are supplied in the course of carrying on activities regulated by the FSA.

the Government should ensure that the rules of the new Financial Services Ombudsman Scheme specify that the Ombudsman will draw up consumer guidelines, after consultation with interested parties, including consumers, the OFT, the FSA and the industry. The Ombudsman should then use these guidelines to determine whether a banking supplier's actions are 'fair and reasonable'.

the Government should ensure that the new Financial Services Ombudsman Scheme allows voluntary membership to firms offering banking services to UK consumers, by whatever means, from outside the UK.

49. There needs to be greater recognition that small businesses often experience similar problems with their banks to personal customers and require a similar system of redress. To this end, the Review recommends that:

the Government should ensure that small business access to the Financial Services Ombudsman Scheme is not restricted by imposing a limit on the number of staff employed by the business.

the Government should ensure that the turnover limit for determining small business access to the Financial Services Ombudsman Scheme is at least £5 million.

the Government should ensure that the rules of the new Financial Services Ombudsman Scheme specify that the Ombudsman will draw up SME guidelines after consultation with interested parties, including small businesses, the OFT, the FSA and the industry. The Ombudsman should then use these guidelines to determine whether a banking supplier's actions are 'fair and reasonable'. This applies equally to personal consumers and small businesses.

Empower customers through better information

50. Knowledgeable consumers provide the best incentive to effective competition. With the right information, consumers can take responsibility for their own financial well being, shop around and exert the pressures on suppliers which drive a competitive and innovative market. There are a number of actions that government can take to improve information conditions in retail markets. The costs are small, and the potential gains from catalysing competition large.

51. There are a number of ways in which information provided to customers could be improved. For example, the Government has already introduced standard CAT products for some products such as Individual Savings Accounts. These apply to those products which meet Government standards for Cost, Access and Terms. Another approach is to produce tables of comparative performance. A third is to require specific disclosures to be made to customers at particular time. The key is focused information that helps customers choose between competing suppliers. Consumer education also has a vital role to play in producing active and informed consumers.

The FSA's scope to publish the most informative data on financial services is limited. In particular, it is not clear that it can require firms to provide information for publication. The Review recommends that:

in its review of the operation of the FSMA, the Government should consider giving robust legal powers to the FSA to acquire information from suppliers of retail financial services, including information relating to those services which are not supplied in the course of carrying on regulated activities, for the purpose of publication for the benefit of consumers.

52. There is nevertheless much the FSA can do to build on its existing information initiatives, using the idea of a benchmark. There is, however, an important difference between the Government's CAT standards and the Review's proposal: the Review does not

believe that the Government should set a price guide or limit for benchmarks. This can only serve to distort competition, rather than illuminate the choice between the offerings of different suppliers. In the supply of banking services to **personal customers and SMEs**, the Review recommends that:

to facilitate price comparison, the Government should introduce benchmarks for a wide range of retail services. Unlike the current CAT standards, these benchmarks should not specify price caps.

the FSA should publish comparative tables which, among other things:

- *rank all benchmark services by supplier, according to price;*
- *group non benchmark services into categories and rank these according to price, highlighting any material differences between services.*

For SMEs, these tables should additionally:

- *rank SME current account services (at standard tariff and a range of negotiated prices) according to price;*
- *show prices and terms for relevant geographic markets and not just on a UK basis.*

53. Better information relating to complaints against firms would also help consumers to make judgements about which supplier to choose. The Review recommends that:

the FSA should compile and publish comparative tables of, among other things, the number of complaints by personal customers or SMEs:

- *received by firms;*
- *received by the Ombudsman about individual firms;*
- *upheld by the Ombudsman against individual firms, including the total value of settlements made against each firm.*

To the extent this information cannot be obtained by voluntary means, it underlines the need for the FSA to have robust legal powers to require firms to disclose information which is of value to consumers.

54. In the supply of banking services to personal customers, the Review also recommends:

the consumer guidelines set by the Ombudsman should, where necessary, include disclosure requirements for all banking services. Given the particular information problems the Review has identified, the Review recommends that these include:

- *redemption penalties on mortgages and loans, which should be clearly expressed to the consumer in monetary terms at the time of purchasing the loan;*
- *information relating to credit card statements, which should state clearly that if the account is not fully cleared, interest will be charged on the total value of the statement, not just the outstanding balance; and that interest payments increase the longer payment is delayed (even before the monthly payment date). Statements should also make clear that interest will be charged on a daily basis, and show actual daily and equivalent yearly interest rates. Finally, the front of all credit card statements should state the amount of interest payable if the minimum payment is received on the last day for payment;*
- *standards of service for switching current account supplier.*

And, for SMEs:

- *agreed margins and the basis on which interest payments are calculated in all bank statements. This should make explicit the average cleared balance; and APRs should always be stated so that rates are comparable;*
- *standards of service for switching current account supplier.*

the Government should encourage the FSA in its promotion of financial awareness amongst the population. Such promotion should provide consumers with a means of making informed choices about allocating their finances between different types of financial services and different suppliers.

In order to discharge these recommendations, and in recognising that some groups of consumers need more help in making choices than others - specifically small businesses and those who are currently excluded from financial services - the Review recommends that:

the FSA should rebalance the resources it devotes to consumer awareness, to give more attention to the information problems experienced by SMEs, and people on low incomes, especially those currently excluded from banking services.

55. As well as providing better information to SMEs about banking services, competition could also be sharpened by making more information about SMEs available to potential suppliers. This would help to reduce entry barriers into banking markets by making it easier for new entrants to construct credit scoring models. The Comprehensive Business Register currently under consideration will provide a useful platform for this. The Review recommends that:

the Government should publish the Comprehensive Business Register as soon as possible and it should include: location of business, sector, date the business began trading, turnover and VAT record.

Take action in monopoly markets

56. The Review considers that the recommendations so far, combined with the encouraging market dynamics, will be sufficient to drive forward competition in personal customer markets. It is not possible to draw this conclusion about SME banking markets. Unlike in the personal sector, there are just a few firms dominating local markets throughout the UK with no real prospect of entry. The competition problems are so significant that a change to the market structure may be the only way of achieving an effectively competitive marketplace. The only mechanism for delivering such a change to the structure of an industry is action following a complex monopoly reference to the Competition Commission.

57. It is to be expected that a complex monopoly investigation would have a range of outcomes. At a minimum, an investigation would provide a framework for the consideration of merger proposals in the form of firm conclusions on the definition of the relevant economic markets and problematic degrees of concentration. An investigation could also recommend a range of behavioural remedies, for example: preventing firms extending the scope or the density of their activities in specified geographic markets; obliging a firm to offer money transmission services to competitor's customers on a non-discriminatory basis; or the disclosure of prices paid to particular groups of SMEs in the relevant geographic market.

58. An investigation would also consider structural remedies in the form of divestment. These could require that, in the problematic local markets, the one or two firms contributing most of the concentration problem divest a viable SME money transmission and lending business; or that all the SME business of a firm should be divested. The Review considers that behavioural remedies are essential in all SME markets and that the structural remedy of divestment may be required in some.

59. The Review recommends that:

the Secretary of State should exercise his powers under section 51(1)(b) of the Fair Trading Act 1973 to refer the matter of the existence, or possible existence, of a complex monopoly situation in relation to the supply of money transmission services and other related banking services (including the provision of debt and savings services) to small and medium sized business in the UK.

MARKET FAILURES

60. The Review identified two possible failures in retail markets that might not be addressed by more effective competition in banking markets: the provision of small scale equity to high potential SMEs and access to basic banking services by those on low incomes. The following recommendations outline how the Review considers Government should address these issues.

Tackle the underlying market failures in SME finance

61. The Review found two main weaknesses in the supply of finance to high potential SMEs in the UK:

- there is insufficient supply of small scale risk capital for high growth companies; and
- public equity markets for smaller companies are insufficiently vibrant.

62. By contrast, there is no evidence of a shortfall in the supply of debt finance to SMEs. Yet many of the initiatives set up by successive governments in this area, such as the Small Firms Loan Guarantee Scheme (SFLGS), are aimed at increasing the supply of debt, rather than equity. The Review considers that Government policy should be refocused in order to better target the areas of market failure: insufficient small scale risk capital and illiquid equity markets for small firms. To this end, the Review recommends that:

the Government should progressively switch financial support from the SFLGS towards a greatly enlarged venture capital fund (VCF) programme. This should be put on a permanent financial footing.

the Government should examine all of its current and proposed policy interventions that are inappropriately focused on debt, such as bank finance for knowledge based businesses, with a view to redirecting the resources to equity support for SMEs.

the Government should significantly enlarge the Regional Venture Capital Fund scheme and make it a permanent feature of support for SME financing. The scheme should have the following characteristics:

- *VCFs should operate on as commercial a basis as possible, and so offer strong incentives to attract growth firms;*
- *VCFs should have to satisfy strict quality and financial probity tests, focused on relevant venture capital and specific sector knowledge and experience;*
- *the scheme must be run by experienced venture capitalists, free to recruit and motivate a talented team, and operate to a framework legal contract negotiated with the DTI.*

the Government should consider privatising the stakes which it will build up in VCFs.

the Government should make further moves towards a low, simple, CGT regime.

the Government should ensure that there is in place a procompetitive listing regime, consistent with governing EC directives. This should provide a minimum level of statutory regulation and so enable exchanges to compete on the type and degree of market regulation they impose for commercial reasons.

Provision of basic banking services

63. The Review also considered the competition issues associated with the supply of banking services to customers on low incomes, often on benefit. In particular, the Review investigated whether the increased competition in banking markets that would follow the implementation of the Review's other recommendations, would be sufficient to ensure an adequate supply of basic banking services to low income customers.

64. The lack of information on the provision of basic banking services is a particular problem. To remedy this, and to help speed the delivery of this service, the Review recommends that:

the Government should give top priority to developing a benchmark for basic banking services.

65. There should be no need to intervene in the provision of basic banking services, but any intervention should seek to bring competition gains, and not distort competition by engineering permanent cross subsidies. Nor would it be beneficial to consumers if the Government sought to negotiate with the banks to deliver a 'free' service, for the reasons outlined in Chapter 2. The Review therefore recommends that:

if the Government considers it necessary to intervene in the provision of basic banking services, it should define a universal service and tender for the lowest subsidy required to deliver the defined service.

Government as purchaser and provider of services

66. The Review recommends that, as part of its strategy for acting as an intelligent consumer of payment services:

the Government should ensure that:

- *the delivery of benefits, where not made through automated credit transfer, uses existing electronic networks - for example ATM and cashback;*
- *Government agencies which make payments to individuals are allowed to make the investment necessary to allow all recipients the option of receiving benefits through ATMs or cashback facilities.*

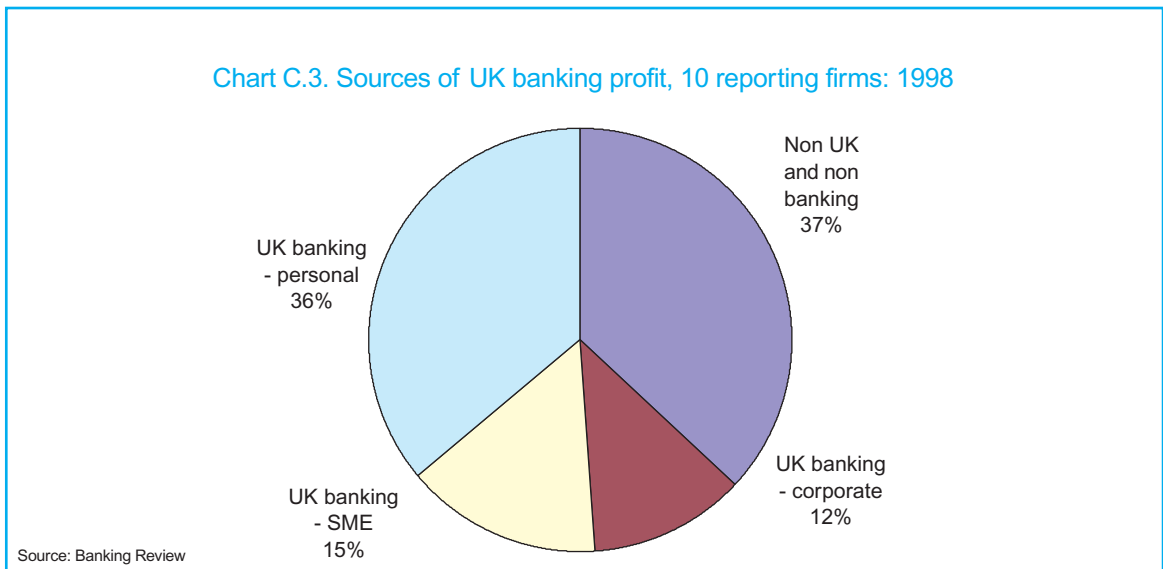
Appendix 3 : Measuring Profitability

UK Banking - the financial performance of services supplied to SME and personal customers

C.103 The review received no indication from any of the firms providing accounting information that the source of any excessive profits lay outside the broad activities that are the concern of the Review. They either claimed that there were no excessive profits, or that any that existed in the late 1990s were transient.

C.104 As set out above, in 1998 the 10 firms that returned accounting data made profits of £14.6 billion (after interest payments and exceptionals but before corporation tax). This

represents a pre tax accounting rate of return on equity of 28 per cent. Chart C.3 below shows approximately how this profit breaks down between activities outside the scope of the Review; and between corporate, SME and personal customers within these activities. Subject to some uncertainty because of data availability problems, about half the profit (around £7.4 billion) arises from banking services to personal and SME customers; around another £1.8 billion from corporate customers; and around £5.4 billion from non UK or non banking services.



C.105 As there is no straightforward way of assigning shareholders' funds to particular activities, the capital required for each could be financed by equity, debt (in the form of commercial paper), or in the case of banks by customer deposits. As the funding costs (that is, the interest paid) of these different forms of capital are different, and the cost of equity is higher than the cost of debt in particular, the return to shareholders' funds can be altered by arbitrarily assigning more or less equity to that activity, with a compensating change in the proportion of debt. As more equity is assigned, the profit after interest goes up slightly but the rate of return on the equity employed falls.

C.106 But because the total equity and debt for the firm is fixed, these changes to the apportionment of equity and debt require a compensating change in some other activity. So excessive profits cannot be eliminated, just moved around by assigning equity to different activities.

C.107 Although the absolute level of the rate of return on equity may not mean very much when calculated on part of a firm's activity, it can still provide pointers to the source of any excessive profits by looking at the relative rates of return under equity assignments which reflect the underlying economics of those activities.

C.108 A number of considerations are relevant here:

- when banks operate in non financial services markets it would seem appropriate that they should employ approximately the same proportion of equity as an efficient non bank company doing the same thing;

- within financial services, shareholders' funds are primarily used to provide a buffer so that when income is unexpectedly checked - say because of a failure to repay a loan - the firm does not immediately go bankrupt. So a bank holds shareholders' funds (as opposed to returning them to shareholders) to ensure its long term survival. The need for shareholders' funds is therefore proportionate to the risks facing the projected income stream of the activity concerned.

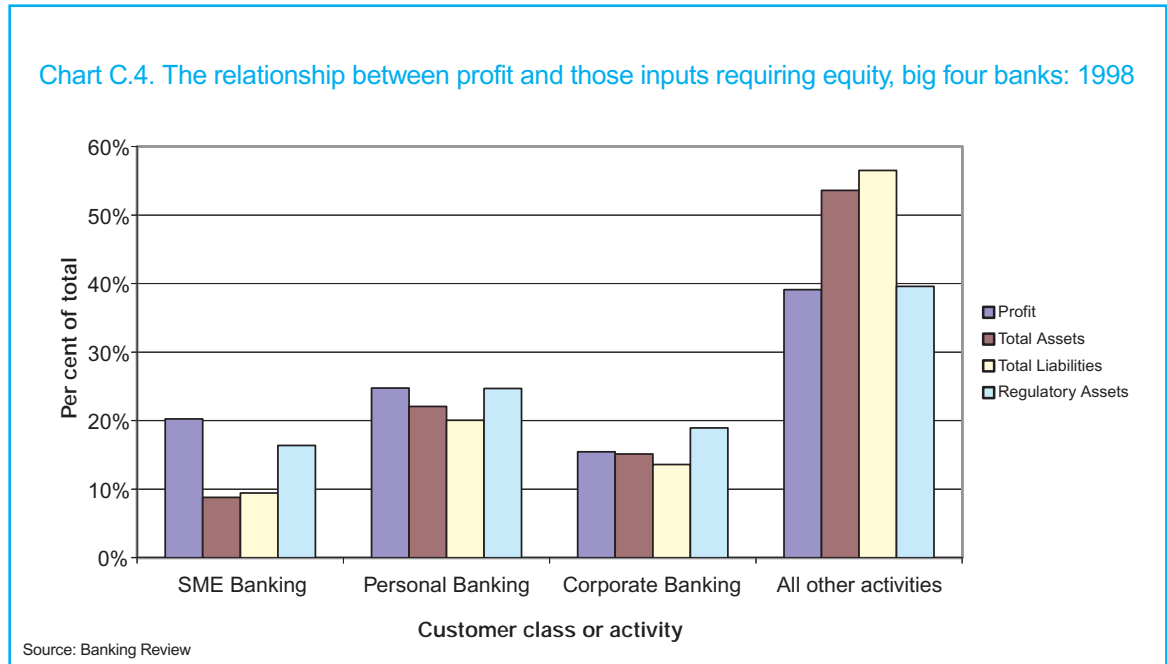
C.109 The regulation of banking services recognises this last effect and assigns different risks to different activities. In effect it demands that a bank holds minimum amounts of shareholders' funds according to how much risk there is to the income (and therefore profits) stream.

C.110 The regulatory assignment of these risks is rather crude and does not reflect very accurately the risks underlying different activities. The banks are developing much more sophisticated rules that try to capture these risks more accurately. Although some of the UK banks claim to have such models they were either unable or unwilling to give this analysis to the Review in a way that would have allowed its application to the aggregated data. Nor would they all consistently assign their own equity to their different activities on this basis, to identify the source of the excessive profits, even though this is done systematically by most, if not all, of them. US banks were more forthcoming and took the Review through equity allocation models used to calculate the profitability of individual customers. The banks used these models to make the individual pricing decisions they needed to remain competitive, both to attract new customers and, crucially, to retain existing ones.

C.111 A further complication is that the regulators are primarily concerned with the risks to income from loans and similar banking products which create short term liabilities out of assets that can be liquidated only in the long term. Bank regulation is not directly concerned with the income streams from transactions, say, although these clearly require some capital and would, under normal circumstances, require some proportion of this capital to come from shareholders' funds. So the prudential regulatory requirements will show some relationship to relative risk, but will be incomplete from the viewpoint of economic causality.

C.112 Another method of analysis would be to simulate a firm that undertook certain activities only and to calculate the amount of equity it would need to employ. This amount of equity could then be assigned to those same activities undertaken by the diversified supplier. Unfortunately, such non diversified firms do not really exist in the UK.

C.113 A first approximation to such a firm would be to assume that, except for the default risk, the total risks of serving different customer classes are the same over all the relevant activities (including transactions and so on). Equity would thus be distributed according to two measures: a factor proportional to the risk of the financial assets, and a factor proportional to the use of the other inputs that could be expected to require some equity - fixed assets, liabilities (ie deposits) and so on. Chart C.4 below compares the proportion of these different inputs with the proportion of profits for 1998.



C.114 The measure of assets that are required by regulation is likely to be the closest available measure of the actual need for equity to provide different services. For banking services this relates to the ratio of risk weighted assets, for insurance services (which is a significant proportion of ‘all other activities’) this relates to a regulatory requirement to hold specific amounts of equity. Table C.3 below shows the return on equity when allocated on this basis.

Table C.3. Pre tax rate of return on equity when allocated in proportion of regulatory requirements, big four banks 1998

	UK BANKING			ALL OTHER	FIRM
	SME	Personal	Corporate	ACTIVITIES	
Rate of Return on Equity - %pa	36	30	24	29	30

Source: Banking Review

C.115 The results in Table C.3 need to be treated with some caution. In particular the use of regulatory weights is only a proxy for the need for equity in providing these services. Equity that might be required for non financial activities is ignored, which is likely to materially underestimate the equity required for the ‘all other activities’ category (and, therefore, overestimate its true profitability), and some of the relative weights are rather arbitrary. The relative weight assigned to loans to SMEs probably underestimates the actual need for equity, while the weight to residential mortgages probably overestimates the need. It is also important to remember that the results in Table C.3 are for a single year - 1998 - in which bad debt provisions were low by historic standards. However, even within this limitation, the pattern of returns for 1998 is fairly clear. Within UK banking, services provided to corporate customers have a lower rate of return; those provided to personal customers, a higher rate; and those provided to SMEs a higher rate still. The return on non UK banking and other activities approximates the return at the level of the firm but, because the methodology is likely to underestimate the equity required for these activities, in reality the return is likely to be below this.

C.116 Although this pattern tends to match the apparent state of competition and market concentration for these services, it is still necessary to try to identify alternative explanations. The question is: do the results show real differences in economic profitability? And are the 1998 results 'normal' in the context of the full business cycle? Only with answers to questions like these can any conclusions be drawn about whether services to personal and SME customers make excessive profits.

Alternative explanation 1. Even the allocation of equity on a risk weighted basis contains a systematic bias which results in SME and personal customers being assigned too little equity.

C.117 This argument runs as follows. Most of the financial assets used to provide services to SMEs are commercial loans or overdrafts, which have a risk weight of one. These assets have historically been subject to significant bad debt and, more importantly, fluctuating bad debt rates through the economic cycle. Crucially, this variability is higher than loans to corporate customers, which also have a risk weight of one. The same is true of (unsecured) personal loans.

C.118 There is some truth in this argument. But there may also be systematic biases working in the other direction. Residential mortgages have a much lower bad debt volatility than unsecured loans or SME lending. Although this is reflected in the risk weight - 50 per cent - the actual risk may be considerably lower than this. International lending, on the other hand, has proved to have a rather bumpy track record. Financial firms get involved in novel trading, which turns out to be risky but has no regulatory risk weight attached to it. Non financial activity has no risk weight - but can still lose the firm money. In the absence of a better evaluation of real risks, it is not possible to say with any certainty what the net position would be in relation to services provided to SME and personal customers, but it must be acknowledged that the existing risk weights may underestimate the required equity for SME and, possibly, personal services.

Alternative explanation 2. Joint costs and economies of scope

C.119 The information presented in Table C.3 is derived from the firms' accounting returns. These are based on management information systems that allocate the firm's total costs between customer classes in a way that is 'fair' between activities. This allocation is not based on an analysis of the economic costs of producing services. If services to different customer classes share significant and real joint costs, a competitive market would produce prices somewhere between the stand alone costs of supplying only one customer class, and the incremental costs of supplying that class in addition to others. Any set of prices between these limits could be considered 'normal'.

C.120 The firms supplying information to the Review were unable to supply detailed information on the relationship between customer classes and true joint costs which could be used to estimate the magnitude of this issue. So insights into the likely magnitude of this issue have to be derived from fairly crude observations of the market.

Non financing costs

C.121 The largest non finance cost facing banks are staff costs. For traditional banks, the cost of the physical branch network is also significant. From the way the firms are organised, it seems that there are minimal economic joint staff costs between serving corporate customers on the one hand, and SME and personal customers on the other. Both staff skills and organisation suggest that providing services to these two groups are kept separate.

C.122 Corporate customers tend not to use the branch network. So there are unlikely to be economic joint costs here either. The fact that specialist banks without branch networks or personal and SME customers can compete effectively for these corporate customers also suggests that there are no significant joint costs.

C.123 The split is less clear cut between SME and personal customers. Both the bank branch network and front line staff are shared between these customer classes. Shared use of resources is a necessary but not sufficient condition for economic joint costs to arise. These arise only when average unit costs are lower if both customer classes are served.

C.124 Discussions with the firms suggest that there are some economies of scale in the provision of individual bank branches. Thus unit costs are lower in a large branch with a high throughput of customers. It is also apparent that customers (especially SME customers) tend to use branches close to them. Existing banks claim that because (mainly personal) customers now make less use of physical branches, they currently have 'too many' branches or branches are 'too big'. Under these circumstances there are likely to be apparent economies of scope between providing services to SMEs and personal customers. Joint suppliers can have 'bigger branches' (and therefore lower costs) while keeping branches at the same density (close to their customers). The potential number of personal customers means that 'personal only' firms may be viable, but an 'SME only' firm with an extensive branch network would have higher unit costs than one serving both groups.

Financing costs

C.125 The major cost of providing banking services is the cost of money, and that cost relates primarily to the risks involved in getting it and, more importantly, lending it out again. Economies of scope will arise if the risks involved can be reduced by serving the different customer classes together rather than separately. This will happen only if the average risks associated with each class are inversely correlated with each other. A significant inverse correlation does not appear likely between personal, SME and corporate customers, as all are subject to the UK's economic cycle.

Alternative explanation 3. Leverage effects of the cycle

C.126 The analysis showed a strong cyclical effect on profitability at firm level. The higher rates of profitability in 1998 in services to personal and SME customers could result from a stronger business cycle effect in services to these customers rather than others. If this were true, then results for these customer classes in the low profitability years (1989 to

1993) would be worse than for the other groups. Unfortunately the firms could not provide disaggregated data for these years. So it is not possible to check directly whether and to what extent this possible explanation might contribute to the relatively high profitability rate in 1998.

C.127 It is, however, possible to get some indication of this effect by looking at variations in bad debt rates. The bad debt rate for SMEs varied more widely through the cycle than did either personal or corporate customers. On the best information available to the Review the bad debt rate for SMEs peaked at around 6 per cent in the early 1990s, and was higher than the peaks for personal customers, corporate customers, or the other activities of the banks. Thus in the good times it would be expected that returns made in the provision of services to SMEs would be better than for services to other customers - and in bad times, worse.

C.128 Some indication of this effect can be obtained from looking at average bad debt levels over the cycle, and applying that to a single year. On the limited information available to the Review this has the effect of bringing the returns closer together and changing the ranking of profitability, but is very dependent on the future looking like the past. In the case of lending to SMEs - which has the biggest swing - the circumstances of the late 1980s and early 1990s are unlikely to be repeated. Even if there is a severe downturn in the economy in the near future the bad debt rate or its impact on profitability is likely to be less severe than that experienced in the early 1990s. In addition, the average bad debt rate is declining as the lower bad debt rates of the more recent past are included. Thus, although there is some leverage effect, it is unlikely to explain all the higher rates of profitability that are being generated now in services provided for SME and personal customers.

C.129 In addition, there is some indication that within the services being provided to SMEs it is **not** the provision of debt finance that is generating the excess profit, although it is the provision of debt finance that generates the bad debt costs in an economic downturn. (See the note on Individual Economic Markets below.)

Alternative explanation 4. Systematic bias in the cost allocation model

C.130 It was put to the Review that individual firms had needed to create novel cost and revenue allocation models to disaggregate the accounting data in the way requested by the Review. As a result, cost figures were subject to a systematic bias that meant they were underestimated for personal and SME customers, and overestimated in some other category. The profitability figures calculated for personal and SME customers using the resulting profit numbers were therefore systematically too high.

C.131 This is, of course, possible. It is also possible that the bias works in the opposite direction, given that when the firms supplied the data, they knew the focus of the Review.

CONCLUSION

C.132 Recent accounting data suggest that services to SME and personal customers have largely produced the excessive profits evident at the firm level. This conclusion tallies with the relative market concentration in their supply. Although these accounting

data are subject to a number of uncertainties, it is unlikely that this conclusion arises from either errors in the data or any mismatch between accounting data and the underlying economic reality. The most likely explanation for most of the excess profits evident at the firm level for the last few years is that the prices charged to UK personal customers and UK SME customers are higher than short run costs. Given the nature of the likely biases in the data, the profitability in 1998 for these activities is if anything likely to be understated in the above analysis.

C.133 The interpretation of this result in respect of the economic cycle is more complex. Poor firm level results in the early 1990s were also likely to have been caused by poor performance in both the SME and personal sector. The data are, however, insufficient to calculate if the excessive profits evident now are matched by excessive losses in the early 1990s. But more important is the implication of this finding for the future.

C.134 If UK banking profits continue at their present levels, then firms overall will continue to make excessive profits. The source of the excess will be largely, but not exclusively, SME and personal customers. Only if relative costs for these two customer classes rises significantly compared with other services would this not apply. Some change in this direction is possible, for example if SME and personal customers experience a relative rise in their bad debt rates. But the banks were at pains to stress that better risk management made any repeat of the lending mistakes of the late 1980s unlikely, even if the economy underwent a downturn.

C.135 So these are the conclusions that emerge from the accounting information and the market return analysis:

- the banking sector is currently earning significantly more than its cost of capital;
- if this continues for any length of time consumers will be paying materially higher prices than necessary;
- the major source of the excess profit are personal and SME customers;
- the costs of serving these customers are unlikely to rise in the short term to absorb these excessive profits;
- if these excess profits are not to be made over the short to medium term, prices should fall.

C.136 Estimating the magnitude of the excess profits currently being earned from UK banking (banking services provided to personal customers, SMEs and corporates) is more uncertain than the estimation for the total output of the firms. However, subject to some uncertainty, the analysis set out above suggests that of the £4 billion to £6 billion per year of excess pre tax profits identified at the total firm output level it is very unlikely that less than half - around £2 billion to £3.5 billion - are being generated from services supplied to UK personal and SME customers.

NOTE ON INDIVIDUAL ECONOMIC MARKETS

C.137 The accounting data provided by the firms is too unreliable and too incomplete to generate many useful insights into the relative profitability of individual activities by further disaggregation. Even within these limitations, however, some light may be shed on the characteristics of individual markets through further analysis of the accounting data. In particular, subject to a quite wide margin of error, it may be possible to identify where profits are arising, without being able to say anything sensible about relative profitability. There are two relevant conclusion that arise from this further analysis.

C.138 The first relates to personal current accounts. The accounting data indicates that the supply of this service is profitable for the banks. The combination of the value to the banks of the positive balances that are held in current accounts (and on which the banks pay no or little interest), fess and charges for overdrafts and other fees that are charged for some services (for example, disloyalty fees when an ATM is used) more than covers the costs of supplying current accounts.

C.139 The second relates to the function of providing loans to small businesses. This function is profitable at current levels of bad debt, but at current prices is not profitable if the 10 year average bad debt level is applied. The implication from this finding is that the excess profits in the supply of services to small businesses is unlikely arise from the supply of loans, and must therefore arise in one or more of the other services supplied - essentially money transmission services or savings services.

INTRODUCTION

The role of international price comparisons in a competition enquiry

E.1 In line with its terms of reference, the Review conducted a study of the terms on which banking services are available to personal customers and SMEs in the UK, and in five other comparator countries. Such a study serves two main purposes. The first is to provide a description of how UK consumers fare overall compared to their counterparts in other countries. The second is to illustrate best practice.

E.2 The results of any international comparisons study should be interpreted with care. The price of any particular good or service is determined by a multitude of factors, which include not only the intensity of competition in the market in question but also many other features of the economic and regulatory environment. This is especially true of the banking sector. Market structure, pricing and profitability in a country's banking markets are all dependent on factors such as the regulatory framework in force, the degree of Government support for small businesses, tax regimes, insolvency laws and attitudes to risk. Thus, a 'good' performance in an international comparison does not by itself show that a particular market is competitive. Low observed prices may be a consequence of non competition factors, such as tax breaks. Moreover, even where price differentials can be traced back to differences in competition, this does not necessarily mean that the market with the lowest prices is perfectly competitive. It may simply be less inefficient than its peers. Similarly, prices may appear comparatively expensive due to lower distortionary subsidies relative to other countries.

E.3 Therefore, it would be wrong to draw firm conclusions about the levels of competition, efficiency and innovation in a market solely on the basis of an international comparison. However, if used carefully, information collected from overseas studies can provide valuable insights when used together with more specific detailed information about the UK.

Methodology

E.4 This study makes a cross country comparison of selected financial service markets in the UK, the US, Canada, France, Germany and Australia. These countries have some of the largest and most developed banking systems in the world.

E.5 A crucial aspect of the methodology was to ensure that like was being compared with like. Following extensive consultation, a standard product and standard customer type were established for each of the financial products surveyed. These are shown in Tables E.1 and E.2. Where banks were unable to provide rates and charges for the precise

'standard product', every effort was made to provide information for very closely related financial service products. Important caveats were noted.

Table E.1. Personal sector banking services: definitions of standard products

Product type	Standard product definition
Current Account	An account having the following activity: 300 EFTPOS initiated transactions, 100 cheques, 60 standing orders, 100 automated cash withdrawals, and 50 credits per annum. The account is held by a customer in full time employment with an average income of £18,000.
Deposit Account	An instant access deposit account with chequeing facilities and £1,000 deposited. The account is held by a customer in full time employment with an average income of £18,000.
Savings Account	An account with 3 months notice of withdrawal with £1,000 deposited. The account is held by a customer in full time employment with an average income of £18,000.
Consumer Loan	A consumer loan of £1,000 over one year for the purchase of a personal computer. This loan is assumed to be taken out by a customer in full time employment with an average income of £18,000.
Credit Card	A credit card offering a £1,000 credit limit, with an interest free period of 50 days and where the outstanding balance each month is £500. Introductory low interest rate credit card offers were excluded from the analysis of the standard product as were premium cards which come with a range of additional benefits for the card holder.
Mortgage	Variable rate mortgage and a five-year fixed rate mortgage. New (not first time buyer) mortgages of £50,000 with repayments over 25 years. These mortgages are assumed to be taken by an individual in full time employment with an average income of £18,000 and assets of £10,000.

Source: Banking Review

Table E.2. SME banking services: definitions of standard products

Product type	Standard product definition
Current Account	10,000 BACS collections, 8,000 BACS payments, 2,000 cheque payments, 10,000 cheques collected, 100 standing orders, 300 cash withdrawals and 450 credits per annum.
Secured loan	A loan of £80,000 for a factory / office conversion / extension over five years at a fixed rate of interest with 120% security.
Unsecured loan	A loan of £50,000 for the purchase of computer equipment over three years at a fixed rate of interest
Hire purchase	A hire purchase agreement for plant and equipment valued at £50,000.
Leasing	A lease for a van costing £20,000, 20,000 per annum mileage, on a 3 year fixed operating lease.
Invoice discounting	A standard invoice discounting facility for a company with a good quality debtor book with recourse for a maximum of £500,000.
Factoring	A standard factoring facility for a company with a good quality debtor book with recourse for a maximum of £150,000.

Source: Banking Review

E.6 The information used to compile this report was assembled using survey and desk research in each of the six countries. The sample of banks and other financial organisations was chosen to be representative of the financial services sector in each country and included major universal banks as well as smaller financial organisations serving regional markets. The survey used a combination of postal, telephone and face to face interviews with product market specialists in each of the different organisations. This was preceded by a pilot survey in the UK and a detailed literature and secondary data survey spanning each of the survey countries. More than 100 banks were interviewed in conducting this research.

E.7 Information was collected on interest rates, fees and charges, innovation and the factors influencing competition in each product market. To take account of differences in base rates across countries, interest rates were defined as margins over prevailing money

market rates. Charges and fees were converted to sterling equivalents at a given exchange rate and were combined with interest rates to provide the full discounted cost to the customer of purchasing various banking services.

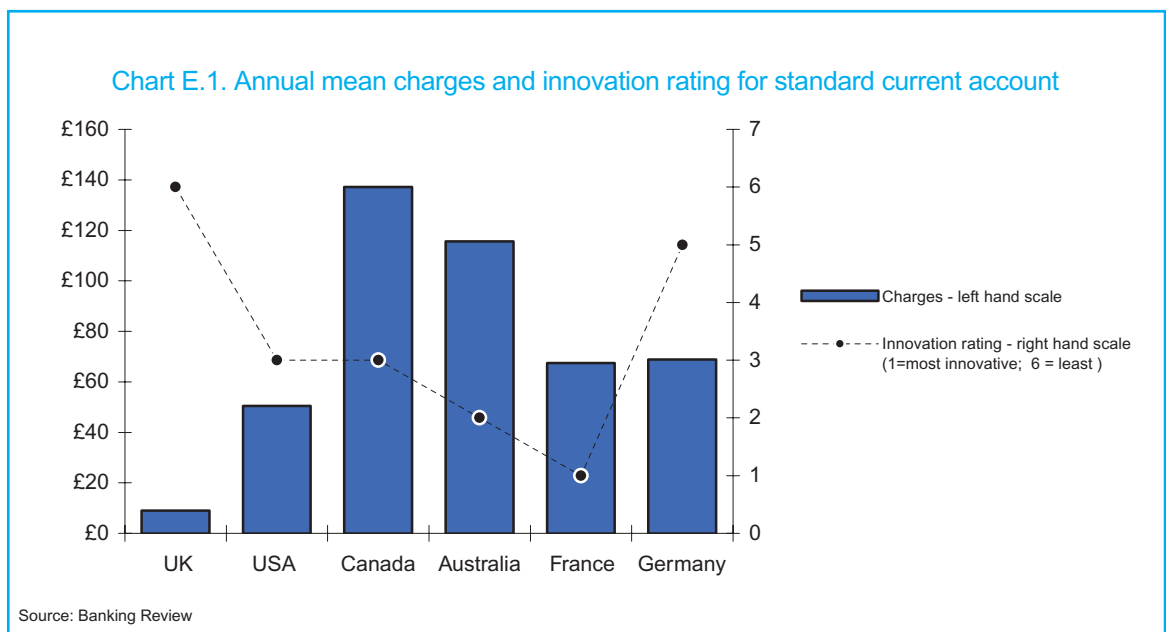
PERSONAL SECTOR FINANCE

Personal current accounts

E.8 The current account has a primary economic role in any economy as the main way in which customers make and receive payments. Current accounts include several products and services, and what is offered as a basic package varies extensively across countries.

E.9 The current account permits a range of cashless payments. The main forms of non cash payments vary considerably between the six countries in the survey. Different payment methods have different levels of cost, with cheques being the most expensive item to process. Therefore, banking systems and individual banks with a low cheque use and a higher level of electronic transactions operate with substantially lower costs than those with a high level of paper transactions. This has potentially important implications for current account charges.

E.10 The annual charges for the standard personal current account in each of the study countries are shown in Chart E.1, along with an assessment of innovation capability in this market. In the UK the banks impose no charges, provided the account is not overdrawn. By contrast, Australia and Canada are both comparatively expensive, their mean charges being over £100. In these two countries all current account services attract a specific charge.



E.11 The extent to which banks make explicit current account charges, and the type of charge levied, varies considerably both across and within countries. Many German banks charge their current account customers a monthly fee which covers all transactions,

although some German banks are now introducing free or low cost current accounts, subject to conditions such as minimum monthly deposits and a minimum balance. In France there are no administration fees, cheques are free by law, credits are not charged for and cardholders can make unlimited free EFTPOS payments and ATM withdrawals. In the USA, monthly administration fees account for the greater part of current account charges. These fees typically allow a certain number of transactions per month, with any additional transactions typically attracting further charges. Some US banks offer free banking, for example if customers pay their salary into the account. Australia and Canada charge on an itemised basis for most current account facilities. Details of the itemised charges by country are given in Table E.3.

Table E.3. Average charges by type of transaction (£)

Country	Type of transaction					
	300 EFTPOS initiated transactions	100 cheques	60 standing orders	100 automated cash withdrawals	50 credits	Other (e.g. admin fees)
UK	0.00	0.00	0.00	1.68	0.00	0.00
US	n/a	4.49	n/a	10.47	0.00	32.04
Canada	62.64	21.56	10.81	27.72	4.16	10.25
Australia	43.43	22.37	14.64	40.26	4.07	0.00
France	0.00	0.00	50.72	0.00	0.00	16.71*
Germany	**	**	**	**	**	**

*debit card annual fee **separate charging data not available

Source: Banking Review

E.12 In all countries, the supply of current accounts has been greatly influenced by technological change. Important developments include the growth of ATM and EFTPOS networks; new payment methods such as smart cards; and various forms of direct banking such as telephone and internet banking.

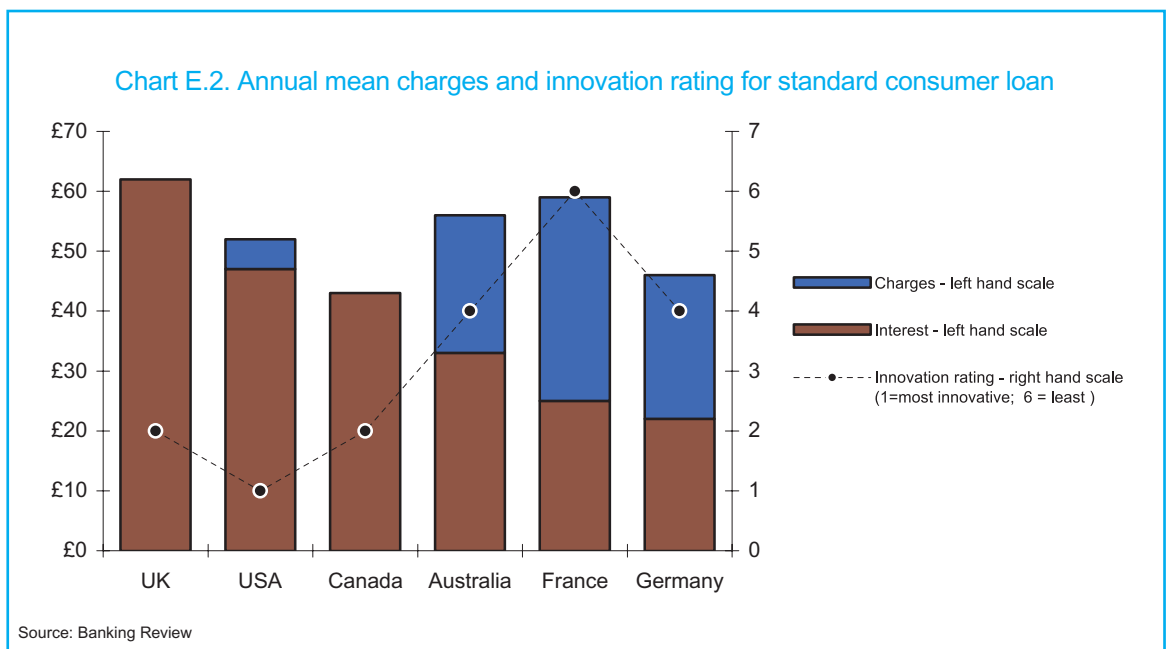
E.13 The pattern and pace of innovation differs widely across the study countries. France has a relatively high density of ATMs and EFTPOS terminals. However, French banks have been relatively slow to develop internet banking, almost certainly because of the early adoption of Minitel. The UK is relatively advanced in the development and introduction of new delivery channels in particular telephone and interactive TV banking services, although internet banking has been slow to take off. Germany ranks highly on payment instruments driven by e-commerce, although EFTPOS accessibility is the lowest of the six survey countries. Canada and the USA are the least innovative in developing new payment instruments - although both countries banks are well advanced in introducing new distribution channels and have mainly concentrated their investment on internet banking. This is especially true for the US where many smaller banks serving local markets have bought packaged systems to support internet banking even though they have relatively limited resources to develop such applications inhouse. The growth of e-commerce, which is also at a relatively early stage of development, will provide a stimulus for the growth of internet banking.

E.14 In summary, explicit charges on current accounts are low in the UK compared with other countries. There has been substantial innovation in this area of banking services and there are significant differences across countries in the pattern and pace of innovation. Although the UK is well advanced in the development of new delivery

channels, it is lagging some other countries in the widespread introduction of important innovations (such as internet banking and smart cards).

Consumer loans

E.15 The cost of unsecured personal loans in the UK is high by international standards. While UK banks do not charge fees for granting loans, interest margins are relatively high. Banks in France, Germany and Australia increase the cost of loans by loading on fee and application charges; nevertheless, even adjusting for this the UK remains the most costly unsecured consumer loan market. Chart E.2 shows cross country comparisons of loan costs to the consumer, calculated as the present value of all charges and loan repayments discounted at the money market rate, minus the amount of the loan.

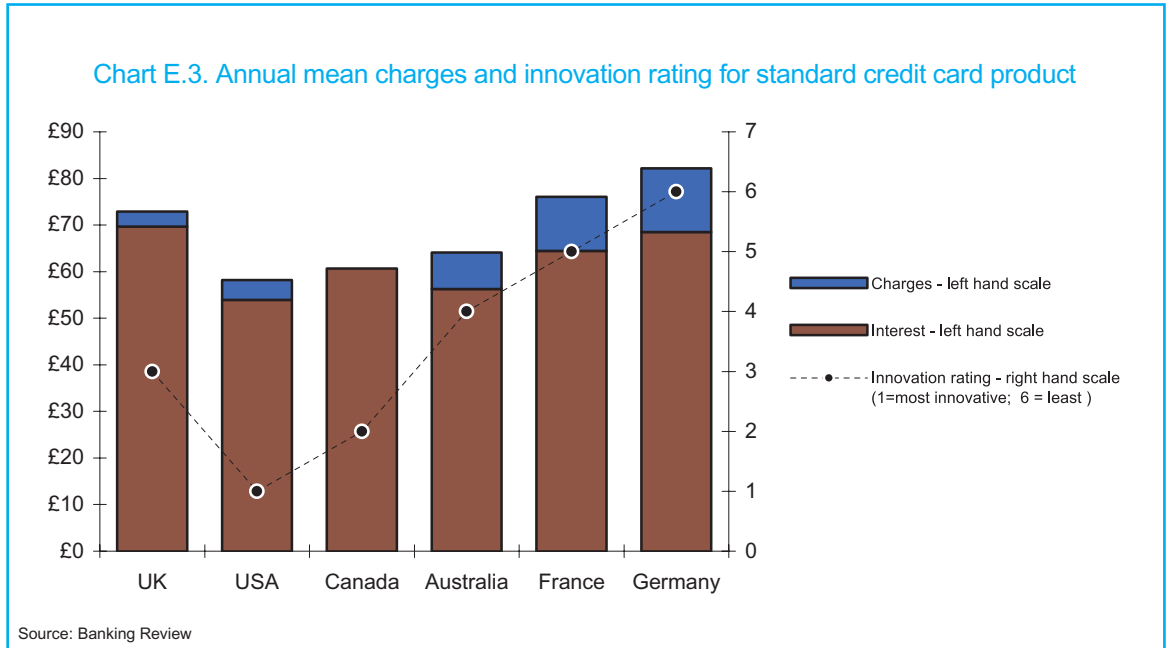


E.16 The main source of innovation in this market has been the development of new delivery systems such as internet based loan application and processing systems. US and German banks are more advanced than those in other countries in offering loan application facilities via the internet. UK banks are more advanced in telephone loan business, especially compared with French and German banks. Other developments include the creation of products with greater repayments flexibility, and loans targeting specific market segments such as home improvement and student loans.

E.17 UK banks have a similar ranking to Canada and Australia in terms of innovation, all of which lag the US. All the UK banks appear strongly committed towards harnessing new technology in order to improve their customer service, which may partly compensate customers for the relatively high cost of loans. However, their lack of development in the area of internet based loan application and processing is marked, especially compared with the US.

Credit cards

E.18 Chart E.3 shows cross country cost comparisons for the six countries. Credit card costs are calculated by applying the interest rate margin to the monthly balance of £500 over a twelve month period and adding any normal monthly charges. Overall, customers in the UK pay more for their credit cards than their counterparts in the US, Canada and Australia but less than in France and Germany.



E.19 Credit card markets worldwide show increasing levels of market segmentation, product differentiation and technology led innovations, eg co-branding and rewards programmes. Table E.4 shows recent innovations in each of the six countries surveyed.

Table E.4: Credit card innovations

Country	Innovation
Australia	Co-branding and rewards programmes.
Canada	Co-branding and rewards programmes, cross-border affinity credit cards.
France	Internet based credit cards, limited co-branding.
Germany	Low introductory rates, initial co-branding DBA, Visa Lufthansa co-brand.
UK	Co-branding and rewards programmes, development of chip card fraud protection, bonus rates for selected customers, low introductory rates.
USA	Co-branding and rewards programmes, Internet based credit cards, chip card fraud protection, differential bonus rates for selected customers, low introductory rates, discounts on purchases.

Source: Banking Review

E.20 The US credit card market has witnessed the most rapid pace of product innovation of the six countries surveyed. Product innovations in the US include cashback, reward points and discounts co-branded with a wide range of consumer products. Issuers in the other countries are also increasingly using rewards programmes as part of their strategy to build loyalty. Recent surveys suggest that they are a primary factor influencing credit card choice. In the UK the major issuers are co-branding with airline companies, utilities, car manufactures and offering a range of discounts.

E.21 The credit card market in the UK is the most developed in Europe, accounting for a very significant proportion of European credit card borrowing. In France the banks prefer to promote deferred debits, and French non bank consumer credit specialists like Cofinoga and Cetelem are now the dominant players in the supply of credit cards. The cooperation between many players via the Groupement Carte Bancaire has tended to contain competitive pressures, but has enabled them to build the payments infrastructure and share the costs of investment including the development of smart cards. In Germany the banks have also tended to ignore the credit card market, preferring instead to offer borrowers low interest loans on current accounts. Of the estimated 14 million credit cards in Germany in 1998, only about 1.5 million offer revolving credit, the remainder being deferred debit cards.

E.22 The decision to introduce chips onto UK issued plastic cards was taken by the banking industry in July 1998. One advantage of the chip card over magnetic stripe cards is increased security against counterfeit fraud. France adopted chip cards much earlier than the UK and all Cartes Bancaires (CB) combine a microprocessor with a magnetic strip, and the much lower levels of fraud in France (one sixth of that in the UK) testify to the benefits of the chip technology. In comparison the United States is behind France and the UK in the introduction and application of chip technology for credit cards, in part reflecting lower rates of fraud and the more comprehensive authorisation procedures in the US.

E.23 The internet and the growth of e-commerce are major drivers of the use of credit cards. Morgan Stanley Dean Witter (1999) estimate that US e-spending could rise to \$500 billion by 2003 compared with \$29 billion in 1998. As much as three quarters of the increase could be attributable to credit cards for consumers and small business. Issuers in a number of the study countries are already using the internet as an advertising and distribution medium.

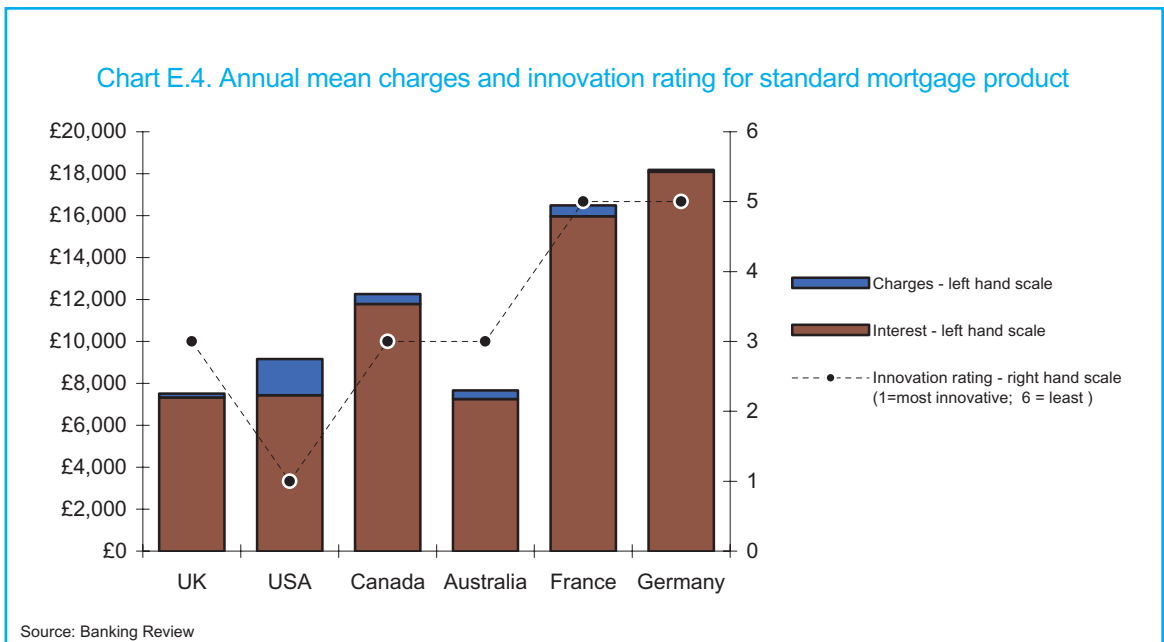
E.24 In summary, UK credit card customers pay more than their counterparts in the US, Canada and Australia but less than in France and Germany. A wide range of products are available in the UK, reflecting the growth of new entrants and more aggressive market penetration strategies. The market in the UK is characterised by a relatively high degree of innovation, with a variety of co-branding and rewards programmes widely available, although internet based activity has been relatively slow to develop.

Mortgages

E.25 Chart E.4 shows the mean overall cost of a mortgage to the borrower in each of the six countries studied. This is calculated as the discounted present value of monthly payments and charges at the money market rate over the term of the loan, minus the value of the mortgage loan. The charges primarily cover set-up administration and valuation and appraisal. Legal charges borne by the purchaser and various types of insurance such as building and contents insurance are excluded. It should be noted that these can be sizeable components which vary from country to country.

E.26 The highest costs are in France and Germany which are more than double the costs in the UK, although mortgage costs do vary considerably across banks in the former. In France, settlement and establishment fees are common and certain types of insurance are compulsory. In the US mortgage buyers incur a wide range of charges that are not

faced by house buyers in the UK. For instance, firms charge for title searches, document presentation and application fees. In addition, various products such as disability and redundancy insurance are charged for by lenders on standard variable rate mortgage offerings. The lowest costs are found in the UK and Australia. Charges in the UK are mainly related to valuation, legal and settlement/establishment fees. These fees may be waived if, for example, a mortgage is being transferred from one lender to another or if the customer's current account is transferred to the mortgage lender. In Australia document preparation and legal fees also constitute an important source of first year charges.



E.27 Table E.5 provides an indication of the main innovations in supply of mortgages in the survey countries.

Table E.5. Main mortgage innovations

Country	Innovation
UK	Euro mortgages, equity lines, shared appreciation mortgages (SAMs) and Protected Appreciation Mortgages (PAMs), collared and capped mortgages, fixed rate mortgages without extended lock-ins, self build mortgages, internet/on line mortgages
USA	Internet/on-line mortgage approvals, wider range of capped and flexible rates, wider range of fixed rate, balloon mortgages, teaser mortgages
Canada	Internet/on-line mortgage approvals, 24 hour approval, choice of repayment frequency, wider range of fixed and adjustable rate mortgages
Australia	Interest offsets against savings, access to other credit lines, telesales, Internet/on-line mortgage approval
France	Increased flexibility of repayments, combination loans, wider range of variable rates
Germany	Euro-mortgages, combination loans, wider range of variable rates, mortgage/insurance bundles

Source: Banking Review

E.28 In the UK market the wide range of mortgage products and the levels of new entry both suggest increasing levels of innovative activity, highlighted by the growth of new products such as PEP, discount and cashback mortgages. There has been less innovation in terms of delivery. Although mortgage lenders use the internet to advertise their products, none of the major providers has yet used it to conduct the entire mortgage

transaction. However, some large mortgage brokers in the UK have recently started to offer such a service.

E.29 The structural features and innovative capacity of the US mortgage market are strongly influenced by the large scale of the US secondary mortgage market. Although commercial banks, savings banks and mortgage brokers account for over 90 per cent of loan origination, well over 50 per cent of the total mortgage market is securitised in the secondary market. Loan applications are virtually standard across originators – mainly because uniform information has to be compiled to meet the demands of the secondary mortgage market. This standardisation provides the industry with sufficient relevant information to package bundles of similar mortgages. In general, the US mortgage market is viewed as a commodity market with product development being characterised by a proliferation of pricing structures and loan originators.

E.30 The German housing finance system is highly segmented by regulation. Borrowers generally have to provide a substantial capital sum towards the purchase of property, up to 30 per cent (100 per cent mortgages are unknown in Germany). Further, as German mortgage banks can only issue a maximum loan to value mortgage of 60 per cent, more than one loan is necessary to make house purchase possible. This has resulted in the creation of the packaged loan scheme, in which a single institution arranges a number of loans from other financial firms. In Germany fixed rate mortgages predominate, although instruments with interest rates fixed over the entire mortgage term of 25 to 30 years have disappeared from the market in the absence of refinancing possibilities.

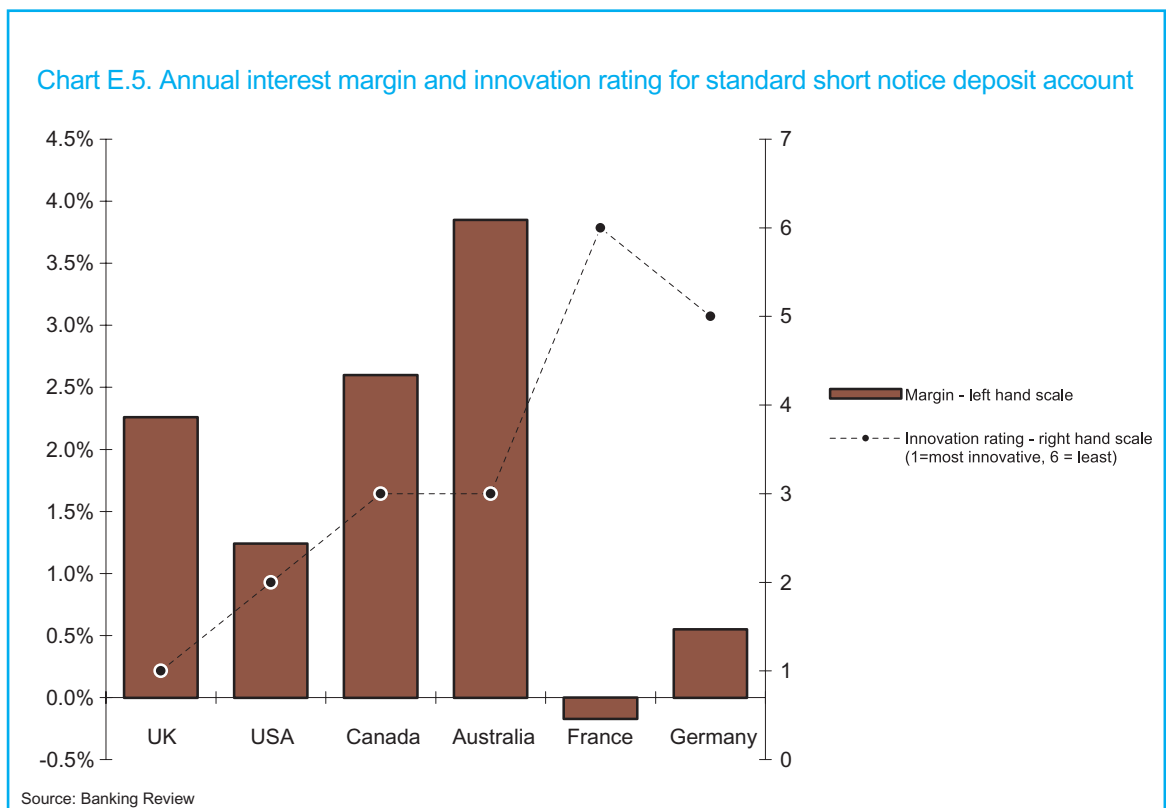
E.31 Current mortgage products available to French home buyers fall into two distinct categories: regulated and unregulated loans. The regulated Epargne-Logement scheme is a loan linked savings plan available through commercial banks. It has a minimum savings period of 18 months and tax credits are provided to savers in such schemes. Other subsidised schemes are also available through the banking system. Around 40 per cent of total housing loans are subsidised. As in the regulated market, unregulated mortgage loans are typically fixed rate, although variable rate mortgages have become a significant part of the market since the mid 1990s. Most variable rate mortgages are capped; the majority of lenders allow borrowers to change to a fixed rate mortgage quite easily.

E.32 The evidence collected by the Review suggested only limited product innovation in the French and German mortgage markets. Innovative capability appears inhibited by barriers to entry in both markets, raised by the substantial role played by subsidised mortgage products and their relatively complex structure, especially in Germany. Recent innovations in both markets relate to the growth of variable rate products linked with various types of insurance as well as some more flexible fixed rate deals. In Germany, some banks have been offering internet mortgage shopping facilities, redundancy insurance, mortgages on foreign property and fixed rates for up to twenty years.

E.33 In summary, the UK is among the most competitive mortgage markets, with relatively low margins. In terms of innovative capability the UK lags the US, but is similar to the Australian and Canadian markets. Overall, the UK mortgage lenders perform well in this international comparison.

Personal sector deposits and savings

E.34 The relevant measure of price for this market is the amount received on a bank deposit compared with the prevailing money market rate in each country. The smaller this margin the greater the benefit to the customer. The difference between the money market rate and the deposit rate for savings accounts with 3 months notice of withdrawal for each of the selected countries is shown in Chart E.5. France, the US and Germany have the lowest margins, with the UK roughly in the middle of this range. In France, banks offer a limited range of products other than those regulated by the central bank, the savings rate on which exceeded the money market rate at the time of this survey. Chart E.6 compares terms and innovation for instant access interest bearing accounts. France and Germany are again the outliers with the lowest margins, indicating more competitive rates than those in the other countries surveyed.



E.35 Suppliers in all the survey countries offer similar additional services with their savings and deposits accounts. These services typically include credit and debit cards as well as telephone and internet account facilities, although consumer take up of these services differs. Internet banking, for example, is more limited in France and the UK compared with Germany and the US. French retail customers in particular appear to have a marked preference for personal contact. Only US banks appear to levy mandatory charges, with many levying charges relating to account activity and for statement issue.

E.36 Table E.6 lists some of the main innovations in the savings and deposit markets of the countries under study. Typically, innovations relate to the introduction and development of new delivery channels and the broad array of rate products tailored to specific customer segments.

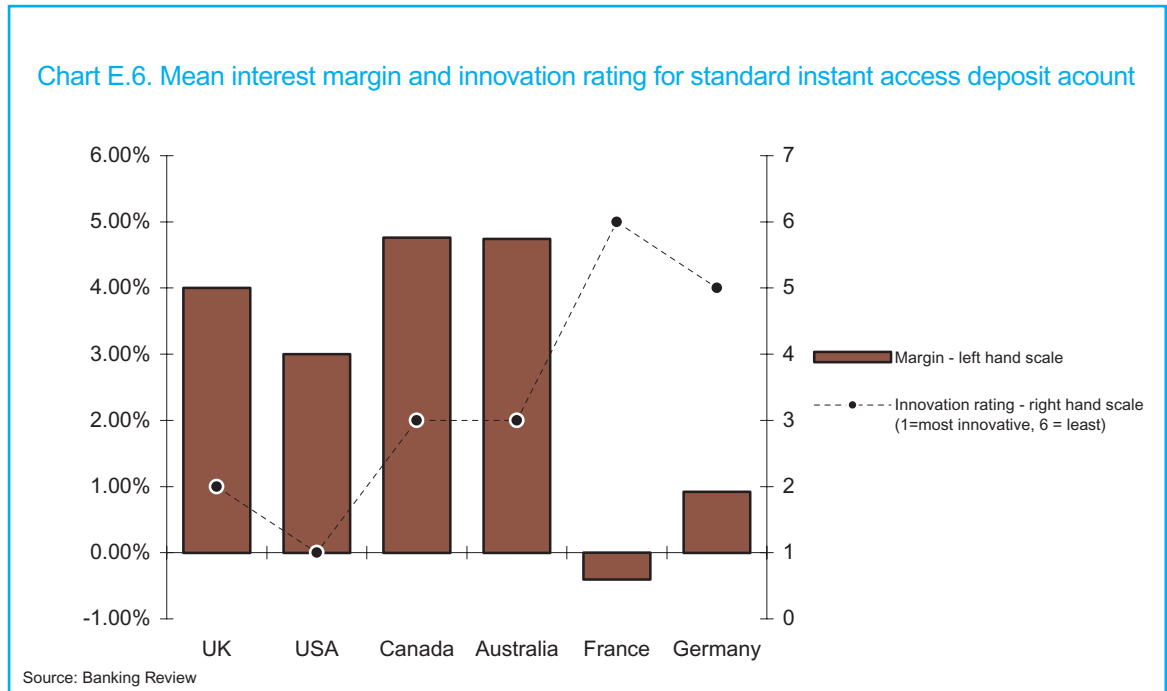


Table E.6. Main product innovations in the savings and deposit account market

Country	Innovation
UK	Internet banking, phone banking, debit cards, fixed rate bonds, loyalty products eg air miles, proliferation of savings products according to market segment
US	Internet banking, phone banking, Jumbo CD's, IRA's, money manager accounts, saver reward schemes (limited withdrawals), loyalty products eg air miles, proliferation of savings products according to market segment
Canada	Internet banking, phone banking, air miles reward schemes, wide array of saving products
Australia	Internet banking, pensioner accounts, travel/shopping/leisure benefits (currency, insurance), telephone banking, bonus saver schemes, proliferation of savings products
France	Phone banking, internet banking, wider array of products
Germany	24 hour banking, staged interest rates on certain products, graduate savings products, debit/savings/Spar cards

Source: Banking Review

E.37 Overall, UK rates on savings and current accounts are not very competitive, particularly when compared with France and Germany. This difference might reflect non price characteristics such as product differentiation and service quality differences.

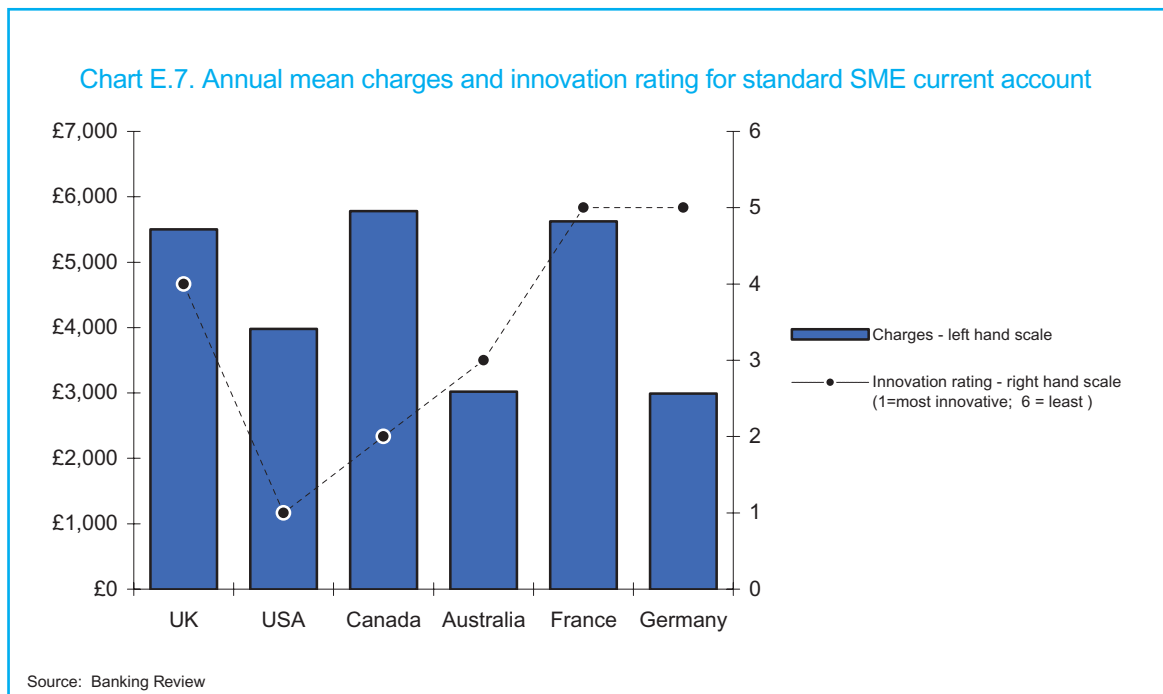
FINANCIAL SERVICES FOR SMALL AND MEDIUM SIZE ENTERPRISES (SMES)

E.38 SMEs purchase a wide variety of financial products. Of these, the Review surveyed three main categories of external finance - secured and unsecured loans, leasing and hire purchase and invoice discounting and factoring - as well as the money transmission services supplied through current accounts. In all countries loans from banks are the most important source of external finance, although the relative importance of different sources of finance varies from country to country.

SME current accounts

E.39 The basic services provided to SMEs as part of a current account generally comprise automated payments (automated direct credits, direct debits and standing

orders), cheque payment and collection, and cash handing facilities. A range of other services may also be provided to SME current account holders, which may or may not attract an explicit charge. Average SME current account charges for the benchmark product are shown in Chart E.7. These are highest in Canada, France and the UK. The lowest charges are to be found in Germany and Australia, with the US in between.



E.40 It should be noted that the mix of transaction mechanisms actually used in any one country departs from that specified in the definition of the standard product. Table E.7 shows how charges for different transaction mechanisms used by SMEs vary across countries. The UK emerges as relatively expensive for cash withdrawals, credits and cheque payments. The high overall level of charges in Canada - which was also a finding of the recent Canadian Task Force Study - are attributable in large part to relatively high cheque collection charges and in France to relatively high charges for the use of automated credit and debit facilities. By comparison the low charges in Germany are largely due to relatively low costs of automated payments and of cheque collection.

Table E.7. Average charges by type of transaction (£)

Country	Transaction mechanism						
	10,000 automated collections	8,000 automated payments	2,000 cheque payments	10,000 cheque collections	100 standing orders	300 cash with-drawals	450 credits
UK	936	801	960	2,088	43	435	231
US	917	1,038	208	955	12	25	153
Canada	1,143	915	624	3,160	27	81	142
Australia	1,045	837	202	1,011	73	13	29
France	2,123	1,486	31	200	84	112	180
Germany	846	506	658	812	8	91	150
Mean	1,147	982	372	1,190	47	132	146

Note: all prices exclude VAT

Source: Banking Review

E.41 Differences in market structure go some way in explaining variations in charges. In the UK, the big four banks accounted for more than 80 per cent of the market in England and Wales in April 1999, and the total share of the big four has changed little over the last seven years.

E.42 Australia and Canada have similar market structures, although with some key differences. In Australia, as in the UK, there are four main providers of small business current accounts, and charges for electronic payments are broadly similar to those in the UK. However, there is a perception that it is easy to switch provider, which is an important factor influencing prices. It was also suggested that the Australian big four banks have lowered charges to counter the strong loyalty generated by local and regional banks. In Canada, non bank providers such as Newcourt Credit are starting to emerge, and branching has now been opened up to foreign banking organisations, in line with Canada's commitment under the 1998 round of WTO financial service negotiations. Several US companies such as Wells Fargo are also starting to offer SME services north of the border.

E.43 In Germany and the US, by contrast, the level of concentration is very low. For example, the four largest banks in Germany have only 15 per cent of the market, and the savings and local cooperative are banks also important players. Although the large number of suppliers depresses prices, such fragmentation can bring problems: for example, access to services outside the area of operation of the local bank is often limited, despite initiatives by some large banks to offer space on their distribution platforms to other banks.

E.44 Similarly, in the US, even the largest banks do not have the broad geographical and sectoral coverage that the big four enjoy in the UK. Strategies for tapping the potential of the small business market generally focus on a particular geographical area or customer segment, or offer either expensive highly tailored or very low cost no frills services. Even in this fragmented market, size and geographical coverage do have an impact on prices. A recent survey conducted by the Federal Reserve of members of the Bank Insurance Fund and Savings Association Insurance Fund found that in the SME market, larger institutions tend to charge higher prices than smaller institutions and multi state institutions tend to charge higher prices than single state institutions.

E.45 Innovative activity linked to SME business accounts has been closely associated with developments in delivery systems. These changes in delivery channels have mainly been taken up by personal customers and have been less beneficial for SMEs. In many countries, SMEs tend to be more reliant on traditional branch services including cash handling and management services. However, this may be changing with pressure to introduce new delivery mechanisms, such as the internet. US, Canadian and Australian businesses seem to be more advanced in the adoption of new delivery channels such as online banking than their European counterparts.

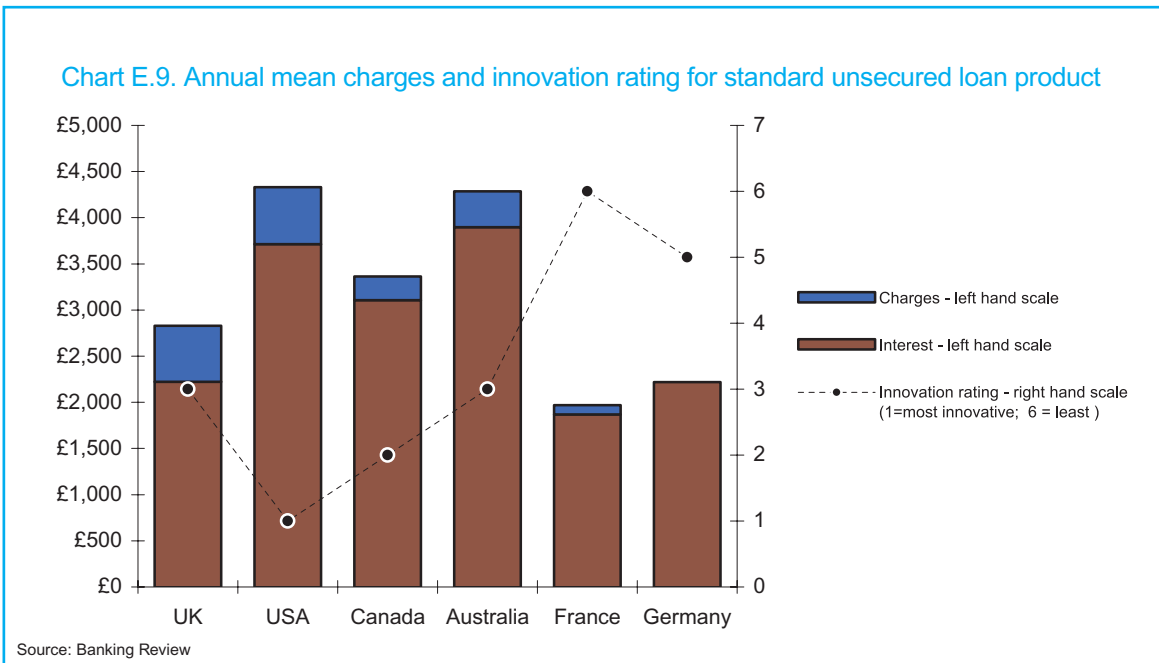
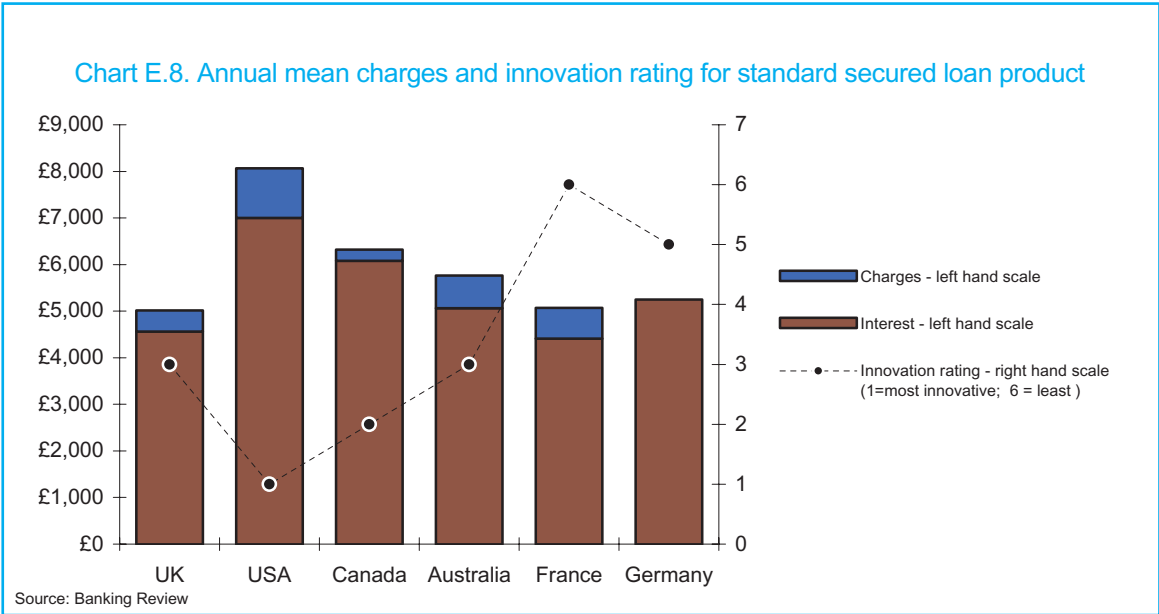
E.46 In summary the UK is among the most expensive of the countries surveyed for SME current account charges. UK banks levy high charges for cheque processing, cash withdrawals and credits. In addition, the SME money transmission services offered by UK banks are not particularly innovative.

Secured and unsecured loans

E.47 Secured and unsecured loans, together with overdrafts, are the traditional SME lending products and remain the most widely used source of external finance for small

businesses in the UK. SMEs rely heavily on bank loans as a source of finance in Europe, especially in France and Germany. However, bank lending is facing increasing competition from other sources of external finance, particularly in Australia, the US and Canada. Equity finance also plays an important role in the US.

E.48 The data in the cross country comparison combines charges and interest rates (adjusted for base rate differences) to provide a discounted present value of total cost over the term of the loan. The price of both secured and unsecured loans to UK SMEs are low compared with the other five study countries, as shown in Charts E.8 and E.9. For secured loans, UK SMEs enjoy the lowest loan costs; and for unsecured loans costs are lower only in France and Germany. The highest costs for secured loans are in the US where SMEs are charged over 60 per cent more than their counterparts in the UK. Unsecured loans are again most expensive in the US and costs exceed those in the UK by over 50 per cent. Examination of charges and interest rates separately shows the US to be the most expensive country for SME loans on both counts and the UK to be competitive on rates relative to the other countries.



E.49 Small business loan innovations are numerous, particularly in the US, Canada and the UK, but the take-up of many product innovations is low. The most common innovation in the product features of term loans are optional capital repayment holidays, flexible repayments, interest posted monthly or quarterly, capped and floored variable-term loans, and loans tailored to different market segments (eg start ups).

E.50 New delivery channels have had some effect on the relationship between SMEs and lenders, though not to the same extent as in personal customer markets. US banks already offer online services to SMEs, and this is now being introduced in other countries as well. An interesting feature in the US and Canadian SME loan markets is the development of direct debt financing. Thanks to early adoption of credit scoring leading to quick approval by large banks (sometimes down to 15 minutes), businesses can apply for a term loan through the internet, a service which banks in the UK have begun to offer. These loans are, however, for relatively small sums, typically up to \$60,000 in the US. In France and Germany, internet delivery is less well advanced: while most banks have an internet site, it is very much a shop window rather than a sales point. In these two countries loan prices, terms and conditions are very seldom advertised over the internet and direct SME loan applications are not offered through new delivery channels.

E.51 The cost of secured and unsecured lending to SMEs in the UK is lower than in the US, Canada and Australia. Although not as innovative as the US and Canada, the UK market is more innovative than Germany and France. Overall, this suggests that UK SMEs are comparatively well served by international standards.

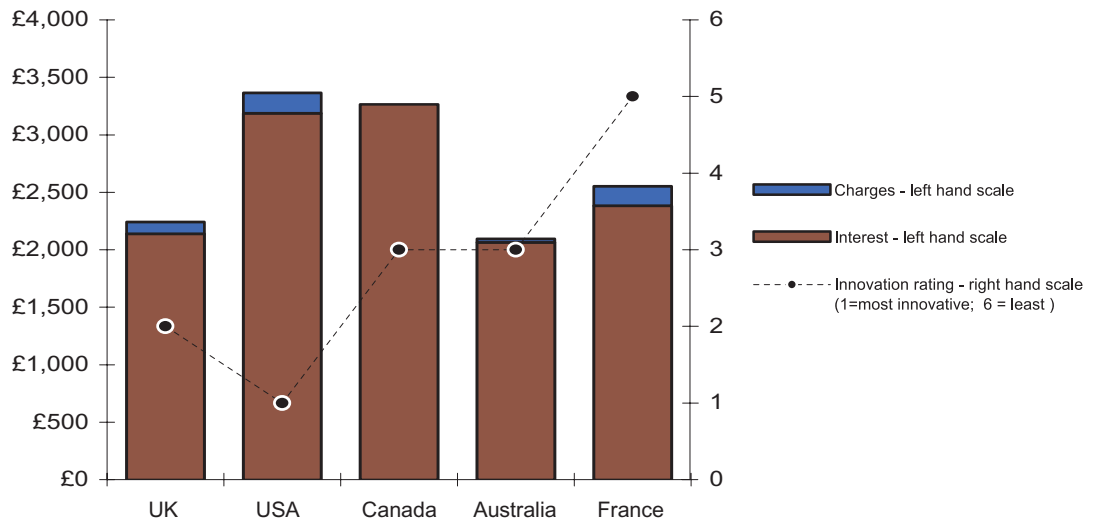
Hire purchase and leasing

E.52 A lease is an agreement where the owner (lessor) conveys to the user (lessee) the right to use equipment and vehicles in return for a number of specified payments over an agreed period of time. It is an asset-based financing product, with the equipment and vehicle leased usually the only collateral security for the transaction. Hire purchase (HP) differs from other types of leasing products in that it is a full payout finance facility. The customer pays for the cost of the asset together with the financing charges over the hire period, and takes legal title to the equipment on payment of a nominal purchase option fee at the end of the period.

E.53 Leasing has a number of key attractions for SMEs relative to other sources of finance. First, customers are able to obtain better terms, because the lender has some assurance that payments will be maintained by the customer. Second, for many smaller business customers, leasing is often more easily available. Bank overdraft facilities may not be immediately obtainable for the amount required, whereas a lease agreement provides up front finance for the whole cost of the asset concerned. Third, and most important, a lease once obtained will provide guaranteed continuity of credit over the agreed hire period. By contrast, a bank overdraft facility can usually be withdrawn at any time.

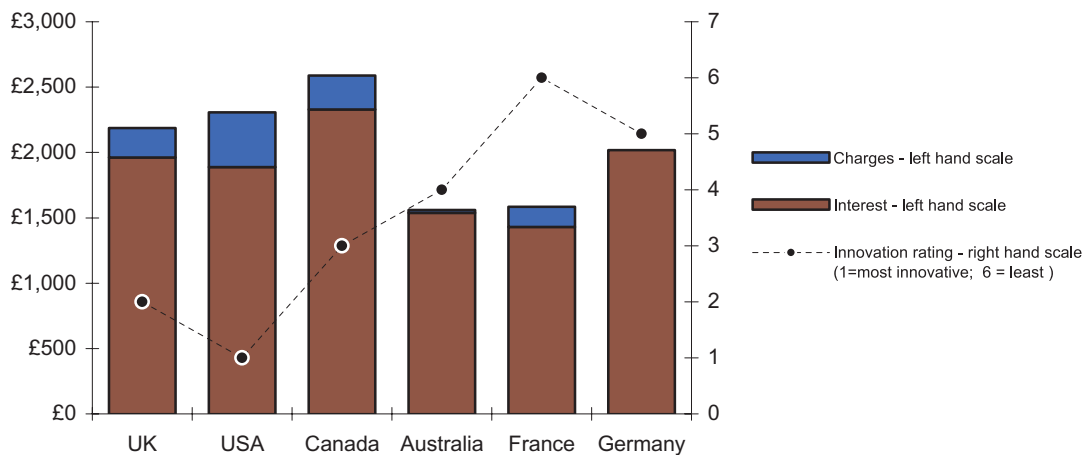
E.54 The mean overall costs for the lease and hire purchase products are shown in Charts E.10 and E.11.

Chart E.10. Annual mean charges and innovation rating for standard hire purchase product



Source: Banking Review

Chart E.11. Annual mean charges and rating innovation for standard leasing product



Source: Banking Review

E.55 The range of services provided by lessors varies within each of the countries studied, but a number of services such as vehicle and asset insurance were common to all. UK lessor firms offer the widest range of additional services to SMEs. Canadian and US lessors also provided a wide range of additional services, including vehicle maintenance programmes and hire car provision. The introduction of electronic leasing (e-leasing) in the United States is the latest innovation in that market. A smaller range of additional services is available with leasing and HP agreements in France and Germany.

E.56 The development of e-leasing and the supply of standardised leasing contracts via the internet is the most important innovation in all countries. A related development is on-line credit scoring systems, which are used to check the creditworthiness of customers. Credit scoring provides a superior appraisal of creditworthiness by focusing on the borrower's track record, rather than less effective traditional metrics such as cash

flow and collateral, reducing the cost of underwriting by eliminating most of the complicated analysis. The online facility enables SMEs to access information on the lessor's web site, and apply for leasing finance online. This removes the inconvenience and reduces the time associated with traditional approval processes: response time for this type of application is usually less than one hour. In addition, many lessors provide discounts to those customers applying online, reflecting lower costs of online approval. The US and Australia are at the forefront of many of these developments, with Germany and France trailing and the UK somewhere in between.

E.57 Another important area of innovation has been the development of pricing software. Such software facilitates choice of pricing models, price setting to secure financial objectives, solutions for complex rent structures, ability to price for different tax regimes, accounting for and administering a variety of lease types etc. Default management software is another area where sophisticated IT support infrastructure is proving very effective. More and more leasing firms are becoming financial and/or technical service companies, providing solutions for companies and educating customers on the benefits of technology.

E.58 The United States is at the forefront of product development in leasing and hire purchase. The most recent example is venture leasing, which is focused on emerging growth and early stage venture capital backed companies. This allows companies to leverage their working capital, in order for them to manage growth by taking advantage of 100 per cent financing. Many venture leasing companies also provide free additional services in the form of advice and introduction to key contacts such as venture capitalists, investors, bankers and service providers.

E.59 Within the United States and Canada, there has been increasing use of securitisation by companies. The main attraction of securitisation is access to lower cost capital and increased cash flow. Whilst the larger equipment lessors were among the first to adopt this financing technique, small independent lessors are now securitising their portfolio. In addition, through services offered by some lessors, they are able to benefit from economies of scale by pooling their assets and selling them off as one consolidated block. UK lessors have pioneered the shift from outright purchase of vehicles into lease or contract hire arrangements.

E.60 Prices in the UK leasing market are noticeably higher than those in the United States, but the range of prices in the latter is relatively wide. Australia offered the lowest prices, but was among the least innovative. For hire purchase, the United States and the UK markets were judged to be relatively innovative compared with the other countries, although costs in the US were the highest of the countries studied. By contrast, Australia combined the lowest costs with relatively high innovation levels. The Canadian market offered least value for money to SMEs, combining high costs with modest levels of innovation.

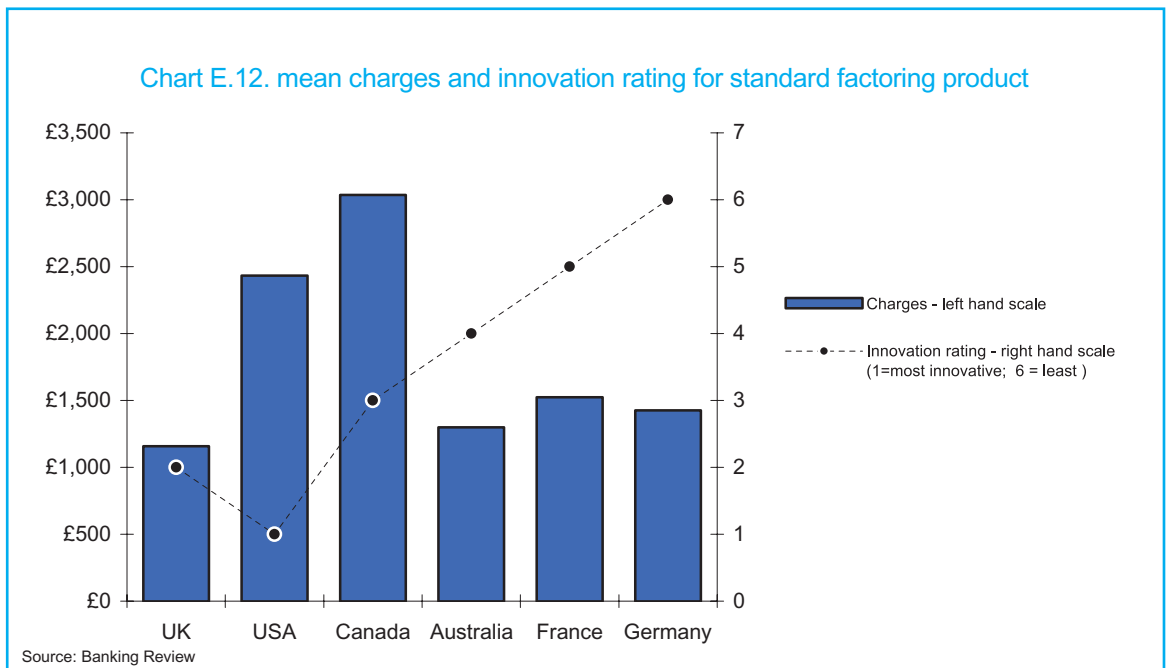
Factoring and invoice discounting

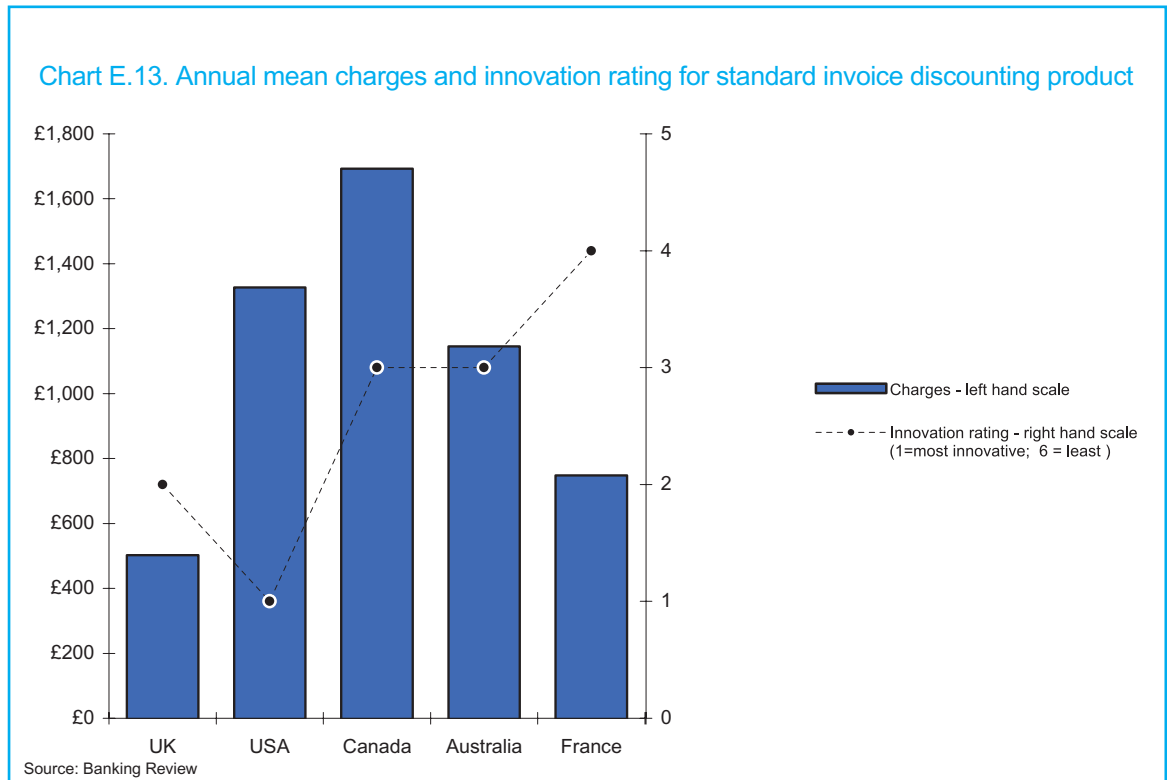
E.61 Factoring is a lending product which enables a company to collect money on credit sales. The factor purchases the company's invoice debts for cash at a discount, and subsequently seeks repayment from the original purchaser of the company's goods or

services. The factoring business in many countries occupies a unique niche, providing working capital for companies that traditionally do not qualify for overdraft lending. Factors in the United States have become a crucial source of lending to industrial sectors such as the clothing and textile industry as conventional credit arrangements contract during a slump. Accordingly, the price of factor credit tends to be countercyclical through the business cycle. In Europe, by way of contrast, factoring is a common form of asset based finance across most manufacturing and service sectors, and also a major component of foreign trade finance.

E.62 Factors and Invoice Discounters provide an advance to the company, usually about 80 per cent of the total value of the invoices. When the factor/discounter receives the invoice payments it releases the 20 per cent residual to the client, less the factor's charges. The main charges are an administration charge, sometimes called a service or commission charge, and a discounting or finance charge (ie interest). The size of the administration charge depends partly on the range of services for which the charge is made. The difference between factors and invoice discounters lies in the fact that the former offer a wider range of services and therefore have higher commission charges.

E.63 The mean charges with innovation rating for factoring and invoice discounting business are shown in Charts E.12 and E.13.





E.64 The relatively high costs of factoring and invoice discounting in North America may partly be explained by the willingness of factors and invoice discounters in those countries to price for and take on higher risk. Although the above cost information relates to standardised products, various survey respondents suggested that the sector typically financed businesses with higher risk profiles. In the UK the relatively low costs of this type of finance is partly explained by the different relationship between the small business and the provider, in that in the UK factoring and invoice discounting agreements are based on longer term and somewhat closer relationships than in North America. The relatively high market concentration in the UK also makes for greater standardisation of the services and at the same time permits scale economies to be exploited. By contrast, in North America the markets are more regionalised and suppliers more fragmented. One other important feature of the UK market is the perception that factoring or invoice discounting is a viable alternative to loans and other sources of external finance. This is much less the case in Canada and Australia.

E.65 The countries studied fall into two groups: a relatively low cost group of which the UK is the lowest, closely followed by the Australia, Germany and France; and a high cost North American group with particularly high prices in Canada which are primarily the outcome of very high factoring rates rather than high charges. A similar pattern of cross country differences in cost emerges from the analysis of invoice discounting costs.

CONCLUSION

E.66 The relative value for money obtained by UK consumers of banking services compared with international counterparts varies according to the customer type and the product in question. All comparisons relate to the standard product specifications considered by the Review.

E.67 In the personal sector the UK provides the lowest cost mortgages and current accounts. However, UK consumer loans are the most expensive and credit card customers pay more than cardholders in the US, Canada and Australia. UK deposit accounts are average in international terms: France and Germany offer the best deal with Australian and Canadian banks offering the lowest returns. The UK banking sector offers a relatively innovative range of banking services to both the personal and SME sector. In the personal sector, the main source of innovation relates to developments in the distribution of banking services, such as the wider use of EFTPOS systems, telephone banking and more recently internet and interactive TV services. There is widespread segmentation and product development across a broad range of deposit and credit product areas. In most areas the UK ranks ahead of France and Germany in providing an innovative range of products and services in the personal banking sector. However, in the majority of product segments innovation typically lags the US, most noticeably in the area of internet delivery.

E.68 UK banks typically offer lower cost lending services to SMEs compared with their Australian, Canadian and US counterparts. In the leasing and hire purchase market UK SMEs are offered lower cost services than SMEs in the US and Canada. The UK is also the lowest cost provider of factoring and invoice discounting services, although it is among the more expensive of countries surveyed when it comes to SME current accounts.

E.69 The UK market also provides a relatively innovative range of products and services to its SME customers, although new delivery channels have not altered the traditional relationship between banks and their SME customers to the same extent as in the personal sector. For example, phone based account information and loan delivery services are well developed in the UK, which also has a wide range of innovative loan products tailored for specific market segments. In the hire purchase, leasing, factoring and invoice discounting sectors the UK market is one of the most innovative in the world, offering a wide range of additional services.

E.70 Bringing together the information on pricing and innovation the international evidence suggests that overall, SME and personal customers get reasonable value for money from the UK banks. However, retail customers appear to get relatively good value from mortgage and money transmission services at the expense of poor value from consumer lending and deposit services. The picture is reversed for SMEs, with relatively high current account charges, and low lending rates.

REVIEW OF BANKING SERVICES IN THE UK

c/o Room 20/3
HM Treasury
Parliament Street
London
SW1P 3AG

20 March 2000

BETTER BANKING, MORE COMPETITION

Don Cruickshank today published his report to the Chancellor on competition in UK banking. He found that, in general, neither personal or small business customers are getting a fair deal from banks. They are paying up to £3-5 billion a year too much for their banking services. This amounts to between £40 and £400 for most households in the country; more for small businesses. He makes a number of recommendations to Government to address these problems.

Announcing these, Mr Cruickshank said :

"I am saying to the Government that there are real problems with the way banks control the networks which allow money to flow around the economy, whether it be cheques, credit and debit cards, or electronic transfers, big and small. And there are real problems with the way banks serve small businesses. New banks and new technology are not solutions. So, Government, step in;

But new banks and new technology can deliver better, cheaper, services to personal customers. Banks will have to fight for new customers, and treat their existing ones better. This is beginning to happen. So, Government, stay clear."

His main recommendations to Government to deal with these concerns are:

- a stronger policy framework for Government's approach to banking services which:
 - increases transparency in banking supervision
 - does not give banks preferential treatment
 - improves competition scrutiny, including within the Treasury
 - eliminates regulatory distortions;
 - prevents anticompetitive mergers in the banking industry
- a new payments regulator (PayCom) to supervise a licensing regime for

banks' cash and payments networks.

- specifically for small and medium sized enterprises (SMEs), a monopoly reference of banking services supplied to them.
- better information to help customers - particularly those excluded from banking services, and SMEs - to find the best banking deal available for them.
- measures to help consumers make sense of this information, by setting up benchmarks, including a basic bank account for the many people who do not have one.
- an opportunity for everyone, especially those on low incomes, to have access to affordable basic banking services.
- better complaint handling procedures for personal customers and SMEs, with clear and objective standards for banks to be judged against by the new Financial Services Ombudsman.

Don Cruickshank also recommends that the Government should review the impact of the Financial Services and Markets Act on competition in banking markets two years after commencement of the legislation, with particular emphasis on the governance of the Financial Services Authority (FSA), and the impact of regulation on competition.

NOTES TO EDITORS

1. Don Cruickshank's report *'Competition in UK Banking : A Report to the Chancellor of the Exchequer'* (ISBN 011 560 0752) can be obtained from Stationery Office Bookshops (price £49.50). It is also available on the Banking Review website at www.bankreview.org.uk.
2. Chancellor of the Exchequer Gordon Brown announced the setting up of the banking review in his Pre-Budget report on 3 November 1998. Its terms of reference were to:
 - examine the banking sector in the UK, excluding investment banking;
 - examine the levels of innovation, competition and efficiency in various sub-markets, including SMEs;
 - look at how these levels compare with international standards;
 - consider whether there are options for change which the industry or Government should consider.

The review was undertaken by a team of Treasury officials under Don Cruickshank's direction, with advice from outside experts.

2. The Banking Review Team's interim report, '*Competition and Regulation in Financial Services: Striking the Right Balance*', was published on 22 July 1999. The interim report, the initial consultation document, responses to it, and banking review press releases are available on the Bank Review website.
3. Don Cruickshank was Managing Director of the Virgin Group Plc (1984-89); Chief Executive of the NHS in Scotland (1989-93); and Director-General of OFTEL (1993-98). He was Chairman of the Government's Action 2000 Millennium Bug campaign and is Chairman of Scottish Media Group plc.

ANNEX

This annex explains the impact of, and thinking behind, the main recommendations in the report.

I POLICY FRAMEWORK

What this covers: the relationship between banks, the Treasury and the FSA; competition scrutiny

Main recommendations:

Strengthen policy framework in a way which:

- increases transparency in banking supervision;
- does not give banks preferential treatment;
- improves competition scrutiny, including within the Treasury
- eliminates regulatory distortions;
- prevents anticompetitive mergers in the banking industry

What this means in practice

The recommendations would ensure there was systematic scrutiny of the effect of policy towards financial services on competition. Among other things, the recommendations would result in financial services being treated the same way with respect to competition within the Treasury as is the rest of the economy.

In two years time the operation of the Financial Services and Markets Act would be reviewed, to examine its effect on competition. The review would place particular emphasis on the principle that the FSA needs to be seen to be independent from the industry which it regulates, and from government.

The recommendations on increasing transparency would put into the public domain information on how the FSA makes its decisions; on the riskiness of individual firms in the market; and on lender of last resort operations.

Why recommend this?

Historically, banks have traditionally had a close relationship with government and regulators. Having just a few, big, banks has made the regulator's life easier and delivered the Government's objectives on the soundness of the financial system. This became a problem when the privileges accorded to banks went beyond what was necessary to deliver systemic soundness. This exchange of privileges for cooperation in policy making is referred to in the report as the "old regulatory contract". Telltale signs were statements which began "The Government is working with the banks to..." or "The Government has invited the banks to...".

The old regulatory contract contributed to a dearth of new banks, with almost none

offering personal current accounts or services to SMEs. Most of the new entry in recent years has not been independent: all the supermarket banks started out as joint ventures with one of the major high street banks and most still are. Incumbent banks have made very high profits out of UK personal and small business customers, who have paid high prices and generally received poor service from their banks.

It also means that the banks have been allowed to write their own rules. For example, the identity requirements for opening a new bank account are more onerous than European law requires, and even more so when the account is opened remotely. This has had the effect of preventing some people on low incomes from opening accounts, because they do not have the proof required. It has also muted new entry from internet banks.

II MONEY TRANSMISSION

What this covers: ATMs; the payment systems underlying credit and debit cards; standing orders, direct debits and other low value transfers of funds; cheque clearing; high value payment systems

Main recommendations:

The Government should bring forward legislation to establish a payment systems commission (PayCom), charged with supervision of a payments system licensing regime. It should be independent of the competition authorities and other regulatory commissions, and of the industry.

The licensing regime to regulate competition in payments markets should have the following features:

- participation in payment systems should be a licensed activity. All participants in payment systems should be subject to a class licence, written by the Treasury;
- PayCom should be granted effective powers to monitor compliance with the class licence and to impose sanctions. The sanctions should be in line with those contained in the Utilities Bill, currently before Parliament;
- there should be a process of appeal.

The Government should put in place licence conditions to secure the following outcomes:

- price transparency;
- good governance;
- non discriminatory access;
- efficient wholesale pricing;

impacts particularly on smaller retailers, who do not have negotiating power, and raises the prices of a wide range of products and services across the economy as a whole;

- development of e-commerce is stifled. Most people want to pay by credit or debit card over the internet. To offer this service, web based retailers have to have a contract with a bank (merchant acquirer) to accept payments. The only merchant acquirers for this service are big banks - dominated by Barclays - and they often require a track record before letting internet retailers offer credit card payments.

Some of these problems might individually be soluble by using existing legislation. But many of the competition problems arise as a result of the inherent economic characteristics of payment systems. Reacting to complaints, or to individual agreements as they arise will not reach the heart of these underlying problems. Moreover, potential new entrants need to know that they can make investments without the fear they might be denied access to payment systems, or allowed access only on punitive terms. This requires a series of *ex ante* rules, so that everyone knows where they stand.

III BANKING SERVICES TO PERSONAL CUSTOMERS

What this covers: competition in current accounts, personal loans, credit cards, mortgages, savings.

Main recommendations:

- don't regulate products;
- give consumers, particularly those on low incomes, better information to compare products;
- publish more information about complaints against firms;
- establish more objective criteria against which the Ombudsman can make decisions about complaints;
- give access to basic banking services to those currently without access to any form of bank account.

What this means in practice

These recommendations would make available to consumers through the FSA a lot more information which they could use to shop around when buying financial products. The Government would set up some benchmark products - like CAT standards but without the prices - including a basic bank account. These would not be compulsory. The FSA would publish the prices charges for these benchmarks so that consumers could see who offered the best deal. The FSA would also publish prices of non benchmark products, showing material differences in terms.

They would also publish information on complaints received by banks; both the nature of the complaint and the outcome.

- fair trading.

What this means in practice

The recommendation would do two things:

- make the operation of a payment system a licensed activity, analogous to running a network. The Treasury would issue the licences, which would be set up to secure price transparency, etc. All the payment systems operating in the UK would be covered;
- set up a payment systems commission (PayCom) to monitor compliance.

Primary legislation would be required.

Why recommend this?

Payment systems are central to the economy. Because they are networks, there is most benefit when everyone has access. For example, a credit card is most useful when everyone has one, and all retailers accept the card as payment. And the ATM network is of most benefit when everyone can use every machine to withdraw cash. These underlying economics mean competition between payment systems tends to be weak.

Added to this, the major banks have control of all the UK payment systems. They determine who can be a member of each scheme, and on what terms. This leads to several problems:

- new, or smaller, banks, face higher costs than big traditional banks. This makes it difficult for them to compete for the supply of services which use payment systems, particularly current accounts. The supply of current accounts is in turn dominated by a few, big, players. The big four (prior to the RBS/NatWest merger) supplied nearly 70 per cent of personal current accounts in Great Britain, and over 80 per cent of banking services to SMEs;
- consumers get a slow and inflexible service. For example, cheques and even electronic payments typically take three days or more to clear. It is not the case that the banks make huge amounts of money on this "float", as the money usually leaves the sender's account on the same day it arrives in the recipient's. But the delay is inconvenient, and costly for small businesses banking their takings;
- charges for ATMs have been excessive - typically £1 or £1.50. Customers are not told in advance how much they are being charged;
- retailers pay too much for the facility to offer credit card payments. This

There would also be objective criteria for making decision about complaints. At present, the Ombudsman uses the Banking Code, which is drawn up by the banks and is not sufficiently specific.

Why recommend these?

Competition in personal banking services is improving, especially in the supply of mortgages. Expensive regulation is not needed. But consumers are still confused about the prices and terms of products. There are also around 3 million people in the country without access to basic banking services. They suffer particularly from a lack of information about what is available.

IV SMEs

What this covers: banking services to SMEs; equity for high growth SMEs.

Main recommendations:

- make a monopoly reference;
- give SMEs better information to compare products;
- publish more information about complaints against firms;
- establish more objective criteria against which the Ombudsman can make decisions about complaints;
- widen the criteria for giving SMEs access to the Ombudsman;
- publish a comprehensive business register;
- switch Government support for SME finance away from loans to the supply of small scale equity

What this means in practice

Under the monopoly reference the Competition Commission would examine whether a complex monopoly under the 1973 Fair Trading Act existed, and, if so, what should be done about it. The remedies may be behavioural or structural. It is possible, for example, that the big banks would be required to divest part of their SME business in local areas where there were not enough banks offering services to SMEs.

The information recommendations mirror those for personal customers, but would in addition give more SMEs than are currently eligible access to the services of the Ombudsman.

The comprehensive business register would give potential lenders to SMEs more information on which to build credit risk models, including turnover and VAT record.

On equity, the balance of Government support would be shifted away from subsidising loans to SMEs, to enhanced, and permanent support for equity. The current regional capital venture scheme would be expanded, and put on a more professional footing.

Why recommend this?

Unlike in personal markets, there is little new entry into the provision of banking services to SMEs. The markets are very concentrated - far above the levels that would be allowed by law in the US, and the banks make huge profits from supplying services to SMEs. The underlying economics mean it is difficult for new banks to set up. To do so requires a dense network, and the new bank has to acquire knowledge about the local business environment and develop models for calculating credit risk. The Government cannot act directly to address the structural problems: this requires a prior investigation by the Competition Commission.

The information recommendations will in the meantime be of some help.

On external finance for SMEs, there is no evidence that SMEs do not have access to debt, and at a reasonable price. But there are problems for SMEs with growth ambitions, who did not have sufficient access to relatively small amount of equity.