

Small and Medium Enterprise (SME) Lending in South Africa – A suggested way to boost productivity and access through the encouragement of an E-Finance Model

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1 South African Background

South Africa's Minister of Trade and Industry, Alec Erwin, is on record as saying that "one of the most striking features of the South African economy is the underdevelopment of Small and Medium Enterprises."

This underdevelopment has its roots in the past apartheid system when the majority of the population were actively discouraged from starting small businesses, a structural problem which the market is not going to easily correct.

As a result, one of the first priorities of the new government in 1994 was to begin a process of changing the environment in which Small and Medium Enterprises could operate.

One of the first Acts tabled by the Ministry was the "Small Business Act" out of which two important standpoints emerged: The first was to create a platform for advocacy where small and medium businessmen can articulate their positions. Secondly Government created two support institutions focussing on specific needs identified in the SME sector. (Access to finance and access to advice)

It was also recognized that in order to achieve a commercially driven financial sector supply of finance to SMME's three main things are required:

- The role of Government must be clearly defined and its programmes must be structured so that they promote the desired goal and do not introduce market distortions.
- There must be a conducive regulatory and legal framework with a specified focus on stimulating the development of financial services to the SME's while still maintaining a sound financial sector overall.
- The financial institutions must have the **capacity** and **desire** to lend to this sector which will enable them to develop the appropriate products and systems to serve the market.

The Government will be releasing a new small business policy document in the second half of this year that will re-address and refine the above issues, with particular reference to black economic empowerment. R323m (US\$36m) has been set aside for this purpose.

2 South African banks' Attitude to Small Business Lending

The perception amongst the general populace in SA is that most banks have neither the capacity, the competence, nor the will to actively and creatively manage SME loans to SA's emerging markets, emerging meaning potential customers who have not been seen as critical in the past, but who are seen as such in the future. In SA these are, largely, people of black African descent.

The facts are that the black population forms the largest banking group in SA , by number 6.16m or 58% of all banked customers.(Including SME's) The bulk of this market, however, still earns the lowest incomes – median income of R1420 p.m.(US\$160) compared to the white market which has a median income of R3760 p.m.(US \$420 p.m.)

A large proportion of this black banking customer base is under-educated with 41% not having completed their school career. Only 1 in 10 have achieved a college/technikon/university education.

3 Some facts and figures about Standard Bank of SA Ltd (SBSA)

Standard Bank was founded in 1862, operates in a number of centres throughout Africa and the rest of the world, and now has a market capitalization of R42134m (US\$4680m) and employs in excess of 30000 people, most of whom operate in the Retail Bank in South Africa where its SME activities are concentrated,

Some of the Banks major characteristics are as follows:

- Total Assets R310B (US\$35B)
- Headline earnings up 24% on 2000 to R2020m (US \$225m)
- 90% of the Banks customers earn less than R5000 per month (US \$560)
- 6 million accounts (mainly savings/transmission) with 4.7 million electronically linked (S.A. working population 10.6m)-High Income 1% Medium Income 28% Low Income 71%)
- SBSA Market share High Income 38% Medium Income 30%
Low income 35%
- SBSA's combined cost to income ratio for all markets is 57.8%(SME is much higher due to the labour intensive nature of the activities)
- Overall Provision for Credit losses in all markets 0.9% of total assets
- SME Provision for Credit losses presently 4% of total lending due to historical operating procedures when too much subjective lending authority was placed in the hands of Branch Managers .

Target for provisions is 1.5% of total SME lending within 3 years as a result of decision centralization having taken place, and move towards less “art” and more “science” lending using E-finance distribution channels.

4 Background to entrepreneurial lending in South Africa

The ingredients for creating wealth in any society are the effective combination and use of the four economic factors of production, namely land, labour, capital and enterprise.

By virtue of our political past in SA, the ability to achieve synergy amongst these four is still lacking, and each stakeholder in the country, including the commercial banks, has an obligation to help correct this situation.

The argument continues to be made in SA that we have much unemployed labour, which would like to seek the fashionable and very necessary route of entrepreneurship, but are in the classic mode of being “capitalists without capital” due to the country’s recent political past, and are therefore unable to raise borrowings from the Banks.

5 The A.S.K. principle

Another hidden agenda playing a large part, is what I call the A.S.K. principle- No real growth in successful entrepreneurship can take place until Attitude, Skills and Knowledge on both sides of the fence between Bankers and the new Entrepreneurs takes place.

By attitude I mean that far more trust needs to be built up prior and during negotiations for credit, and there should also be skills and knowledge available to meet the needs and circumstances facing each party. – No one can be further apart at present than the Banker and the Emerging entrepreneur, as their business and social circumstances are just so different from the recent past, the effects of which still have to be worked through.

6 The state of E Finance in South Africa

In terms of market usage in relation to the population, E-Finance is in its early growth stages in South Africa, in all market segments, including the SME segment.

A recent survey of Strategic and Emerging issues in South African Banking revealed the following:

1. The three most important measures of success of the four major banks in SA are Return on capital, Cost to income ratio, and Absolute Profit before Tax. Most banks believe that the Internet can be used to both reduce costs and generate revenues.
2. Of the nine banks that provided data on Internet customers, the consensus was that the number of Internet customers will grow dramatically by 327% from 582,000 in 2001 to 2,488,000 by 2004. Almost 1,000,000 of these additional customers are expected to come from the lower end of the market. It is significant to note that to date only one of the nine banks is running its Internet operations at a profit of more than 10%, while three are on record as saying that they are “marginally profitable (0-10%) and five are still running their Internet activities at a loss.
3. Several banks commented that they were using differential pricing to provide customers with an incentive to switch to Internet based transactions. Success in the upper end of the market, was more apparent than at the lower end.
4. Only three banks are currently addressing the following functional opportunities:
 - Internet and mobile phone connectivity
 - Internet used for credit cards
 - Internet used to rationalize channel costs
 - Internet used to lower barriers to entry.
 - Internet used to help customers to design and price services
 - Internet used to increase customer connectivity and
 - Internet used to personalize advice to customers

- 5 When asked about new entrants outside of the banking industry who may become a threat to banks through E-business activities, the response of the nine banks was as follows:
- Internet service providers
 - Mobile phone companies(MTN and Vodacom)
 - Telecom companies
 - Maverick pure E-bank entrants (20.twenty.com)
 - Micro-lenders

Given the above background, E-business is being seen in SA. as the biggest opportunity to grow business in many years, presenting limitless opportunity and boundless potential. Separation of the winners from the losers will transpire within years, rather than decades.

In striving to be amongst the winners, banks realize that the central component of any E-finance initiative is the creation of a model that enables financial institutions to focus on the risk profile and product needs of its SME clients. This in turn entails the integration of technologies that allow financial institutions to simultaneously collect and analyze significant amounts of client information on an ongoing/real time basis. The result is FI's being able to make considerably better credit decisions, and provide targeted financial products that meet the changing needs of a growing SME client base.

7 Standard Banks Virtual Banking experiences to date (all markets)

- Majority of home loans originated outside of branch infrastructure
- Auto-E savings account transactions increased by 19% during the past year
- Internet banking customers up 43% to 186000
- Internet transaction volumes up 82% during last 12 months
- Internet fee based transactions up 74% during past year
- Call centre volumes up 24%
- Virtual transactions account for 65% of total volumes

From the above it can be seen that a fair measure of progress has been made in the E-finance arena, but a lot more effectiveness lies ahead as more and more clients are encouraged to convert to virtual banking in the interests of time and cost saving. The fact that SBSA has the largest number of Auto Teller Machines in the country, has also helped encourage consumer conversion to yet another self help mechanism, namely Internet.

8 The specific critical success factors of E-finance to Banks engaging with SME clients in South Africa

From the customers point of view:

Experience has shown that in dealing with their bankers, clients (in particularly the less sophisticated clients) wish to have the following attributes present:

- Freedom from fear of being “talked down to” when negotiating with the Bank Manager for finance. (Avoidance of fight or flight response)
- Speed of decision making regarding success or otherwise of a loan application.(Fast turnaround times required)
- Ability to know exactly what information the bank is looking for when appraising a loan application.

- Standardized loan application can be effectively assembled by the applicant.
- Transparent bank borrowing/repayment requirements.
- To encourage and support first time borrowers within the SME market.
- All of the above major needs can be met through more use of E-finance

From the banks' point of view:

- Less labour costs spread over a wide area of the country (Reduced credit expertise required in branches)
- A lower bad debt ratio due to more accurate and timeous information
- Higher volume of business possible using a new sales culture
- Greater reward opportunities for staff based on new way of doing business
- Opportunity to reduce the subsidization of debtor balance business by credit balance business.
- Value can be added by applying a pragmatic, non-subjective approach to the evaluation of the customer's business idea and funding requirements.
- Provide encouragement to the client or a warning as to the success or otherwise of their business.
- Will help greatly to ensure that the "financial capacity parameters" of the borrowers is not wider than the "funding requirements parameters" of the financiers.
- Non viable business propositions are identified at source on a non-budget linked, objective and standardized basis.

The absence of many of these CSF's can be drawn from a study of the data in Annexure 1 of thirty-one Non Performing Loans taken from the records of Standard Bank.

Attending to these names during their last year of dealings with the Bank, led to substantial losses of money in the form of both bad debts and expensive labour costs.

9 E-finance attributes which can prevent this in future:

Sustained improvement in the three key factors, which according to the IFC will mostly ensure sustained profitability and customer satisfaction in SME lending in the future:

- Operating efficiency
- Asset quality
- Growth

To achieve the above three attributes, the IFC go on to point out that investment by financial institutions in the following three areas is necessary:

- Infrastructure
- Acquisitions
- Human Resources

Infrastructure investments are in turn divided into investments in

Systems, and

Distribution Channels

Systems

Existing lending systems for loans over R50,000 (US\$5560) are still based on more of a subjective than an objective approach by many bank decision makers resulting inter- alia in too many highly geared loans, loans to high risk industries, and little evidence of tangible security where such security was clearly necessary to be taken, at the time lending decisions were made.

Of the thirty-one Non Performing Loans examined, loss severity ratios were highest where tangible security held was nil, (18 names or 58%)

High risk industries in the form of transport related businesses, property owning entities and training concerns amounted to 42% of the sample- A statistic that could easily have been avoided if lending decisions had been more centralized amongst specialists following strictly objective rules regarding distinguishing between doing business with low/medium risk businesses and high risk businesses.

In addition it is noted that 45% had no financial statements to produce within twelve months of becoming non performing loan customers, while 39% could only produce financials which were more than one year old!

It is submitted that a rapid conversion to E-finance loan application and control procedures will help radically reduce bad debt casualties caused by the above features. The reason? SME clients will be encouraged for cost and accessibility to finance reasons to fall in line with the banks' insistence on proper management accounts to be prepared and maintained using Internet compatible software packages. This information could then be regularly downloaded to the bank by arrangement.

Distribution Channels

In South Africa these remain largely of the Bricks and Mortar type manned by expensive labour and resulting in long lead times between interviewing clients re SME loan requirements, and obtaining the final decision.

Genuine attempts are being made to overcome this by switching where possible to a Clicks and Mortar approach, but a long education road lies ahead for both staff and clientele before Clicks and Clicks becomes the order of the day. This challenge must however be overcome in the long term if strong bottom line earnings on SME lending are to flow through to the banks.

Acquisitions

This focuses on product and services, as well as on clients

Acquiring the knowledge to deliver products and services requested by the clients is necessary to maximize the client relationship by providing comprehensive product offerings.

In this regard, E-finance squarely meets the clients needs specified under Critical Success Factors mentioned from the customer's point of view above.

Human Resources

IFC believe, quite correctly, that Human Resources, and the correct deployment thereof, is a core element for the success of E finance and is one of the key limiting factors to growth.

Standard Bank has realized this, and has created a set-up where SME credit staff are acting as internal “outsourced credit specialists” to the Retail Bank sales delivery arm, and where the sales staff have no discretionary lending limits. The sales staff do however, still need to complete fairly extensive loan applications on behalf of clients before submission to Credit Division.

This division of duties does accelerate the need to go the full E-finance route as soon as possible, so as to enable customers to complete much of the loan application procedure on their own without tying up valuable sales force time needed for cross selling of the banks extensive product base.

11 Conclusion

The implementation of the above described E finance proposals is a high risk step for any bank to take after years of staff doing lending business on a more ‘hands on’ subjective basis.

However failure to take this step on a totally “no look back” basis, carries medium to long term risks for any financial institution not doing so.

This risk is twofold-

- A loss in market share to banks prepared to make the change,
- Little chance of reducing the vital operating cost to income ratio so valiantly striven for by financial institutions

Countering this is the major issue of cultural change required by bank staff to accept the new process- to a large extent their “expert” and “position” power is being eroded, and many see this as a threat to their jobs.

Careful management of the change process in terms of the ingrained culture of the organization is therefore vital. A good dose of A.S.K. training for affected staff will definitely not be out of place!

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