Briefing on Entrepreneurial Finance: Imperative for Growth and Employment by Sibusiso Gumede

PARLIAMENT
OF THE REPUBLIC OF SOUTH AFRICA

PURPOSE OF PRESENTATION

- To brief Members of the Portfolio Committee on Small Business Development re: access to finance for small enterprises;
- To provide guidance to the information they need in order to make effective decisions if certain matters of access to finance for entrepreneurs arises;
- In preparation for the forthcoming strategic plan sessions of the Department and the Committee, to ensure uniformity in our responses;
- To elicit discussion, comments and to encourage debate as access to finance is one of the major issue choking small enterprises.

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Problem Statement

- The topic of access to finance and financial inclusion has been of growing interest not only in SA but throughout the world, particularly in emerging and developing economies;
- Policymakers are increasingly concerned that the benefits produced by financial intermediation and markets are not being spread widely enough throughout the population (PIC, IDC, UIF, GEPF, Land Bank, DBSA) and across economic sectors (agriculture and agro-processing), with potential negative impacts on growth, income distribution and poverty levels, among others;
- Furthermore, they may also be concerned with the potential negative consequences for macro stability when financial system assets are concentrated in relatively few individuals, firms, or sectors (economic concentration, overcapitalisation, monopolies);

- Non-price barriers are often very important. For example, the design features of a product may discriminate against potential customers, or they may face barriers to access due to red tape. Some individuals will have no access to financial services because there are no financial institutions in their area, as is the case in many remote rural areas (village banks);
- Yet others may be excluded because of poorly designed regulations, for example, documentation requirements of opening an account, such as having a formal address or formal sector employment (Asian Journal of Business Management);
- Provinces with higher GDP such as Gauteng, KZN and the Western Cape have a large proportion of SMMEs with access to formal credit. On the other hand, SMMEs in poorer provinces such as Limpopo, Eastern Cape and North-West largely rely on informal credit (FinMark Trust).

Introduction and Background

- In recent years, the number of financiers that make funding available to small and medium enterprises (SMMEs) in South Africa has increased significantly. Yet in spite of this, each year sees countless SMMEs struggling to access business finance;
- Access to finance had been singled out as one of the major challenge impeding the survival and growth of start-up SMMEs in South Africa;
- Significantly low figures of start-up SMMEs who apply for financing succeed in getting financing. Surprisingly, although there seems to be sufficient funds available it remains difficult to access these funds, especially for start-up SMMEs;

- Access to finance is therefore a priority issue for developing and supporting the SMME sector as an engine for employment creation, poverty alleviation and socio-economic stability at large;
- The latest Finfind study of SMME funders and finance seekers estimates that the credit gap for SMMEs in SA is between R86bn and R346bn (contrast with **sefa** budget);
- SA has a sophisticated finance sector that displays a far greater level of financial openness than is the norm for middle-income countries, however, the problem is that millions of South Africans are unable to access credit of any kind, and that inequality poses a human rights problem. The conventional banking model deems the poor too risky for lending;

- Their credit processes require borrowers to show formal sector employment with payslips, collateral and a clean credit record. Those in the informal sector are therefore unable to acquire loans;
- The finance sector is leaving the have-nots behind. Their risk models seem incapable of lending of the kind done by Small Enterprise Foundation (SEF) or, on a far larger scale, by Grameen Bank in Bangladesh.

Financial Sector Composition and Contribution in South Africa

3. Financial Sector Composition and Contribution in South Africa

The four subsectors below dominates the financial services sector in SA.

- Banks (list attached as annexure A);
- Insurers (have begun venturing in banking space(Discovery));
- Pension Funds (GEPF extend credit via PIC to the few);
- Mutual funds (have begun venturing into banking i.e. Old Mutual.

3.1 For the purpose of this exercise, our focus is on lending/credit providers registered and regulated by Prudential Authority (SARB), Financial Sector Conduct Authority (SARB) and National Credit Regulator (**the dti**) –

- A (commercial) bank is defined as a public company registered as a bank in terms of the Banks Act and owned by its shareholders who are not necessarily depositors/customers of the bank. Banks are registered and licensed in accordance to the Banks Act, 1990 (Act No. 94 of 1990) as amended by the Financial Sector Regulation Act (2017);
- Mutual Banks are licensed in terms of the Mutual Banks Act (Act No. 24 of 1993) as amended by the Financial Sector Regulation Act (2017). Grahamstown Building Society ("GBS"), FinBond and now defunct Venda Building Society ("VBS") are some of the well-known mutual banks in South Africa and;

- Co-operative banks that are licensed in accordance to the Co-operatives Banks Act (Act No. 40 of 2007) as amended by the Financial Sector Regulation Act (2017). There are four (4) registered and licensed co-operative banks in the country, namely, Ditsobotla Primary Savings and Credit Co-operative Bank, OSK Koöperatiewe Bank Beperk, Webbers Employees Savings and Credit Co-operative Bank and Ziphakamise Savings and Credit Co-operative Bank;
- Co-operatives Financial Institutions as above.

3.2 Other Players are registered and regulated by Financial Sector Conduct Authority and National Credit Regulator that has 7420 registered credit providers in its database which sadly include loan sharks and therefore cannot be relied upon.

3.3 Challenges with the Banking Sector

- While SA's finance sector has come to dominate the economy over the last two decades, accounting for 23% of total GDP compared with 15% in 1995, the financial sector is not contributing much to economic growth, according to a paper on finance and human rights prepared by the Centre for Human Rights at the University of Pretoria and the Institute for Economic Justice;
- SA Reserve Bank figures show that despite steadily rising personal debt levels, 34.5% of total bank credit in 2018 went to households. Less than 1% went to construction. Investment in fixed capital has dropped to 13% of GDP in 2018 from 19% in 2010 (World Cup hangover?);
- Banks have moved away from their traditional function of lending to the 'real' economy – such as construction and manufacturing – to lending to households in an "exploitative and discriminatory" manner, according to the study;

- Whilst the South African Reserve Bank (SARB) announced in its last quarterly bulletin that household debt as percentage of disposable income was 72.7% as at the end of 2018. That is to say that almost 75% of household's available funds are spent on debt. A worrying sign for an economy whose consumers contributes almost 60% to the economy;
- Worryingly for South African policy makers (especially monetary policy makers) is the fact that debt servicing costs as percentage of disposable income is on the increase, showing consumers are becoming more indebted, so any interest rate increases will hurt consumers big time, and this in a economy where consumers are already struggling and the economy barely showing signs of growing.

The Role of Development Finance Institutions

National and international development finance institutions (DFIs) are specialised banks set up to support economic development. They do so primarily in developing countries, but also in advanced ones to address specific market failures in certain regions or sectors of the economy. They are usually majority-owned by one or several governments, but sometimes private sector operators participate as well. In many respects, DFIs follow the same rules and use the same instruments (loans, credit lines, equity investments, guarantees) as commercial banks.

- The difference lies in their mandate or mission, which focus on softer objectives such as economic development, poverty alleviation, economic integration, promotion of market economy, job creation, fighting climate change, gender equality etc. They usually take more risk and adopt a longer-term perspective on project return than regular commercial banks. Moreover, their shareholders do not require a specific return on equity, which relieves DFIs of the pressure linked to economic performance and profitability. Because of these differences, DFIs face specific challenges not encountered by commercial banks.

- South Africa has a number of Development Finance Institutions (DFI), some incorporated and registered as State Owned Companies (SOC) in terms of the Public Finance Management Act (PFMA), Industrial Development Corporation Act, Land and Agricultural Development Bank Act, and National Empowerment Fund Act to name the few e.g. Industrial Development Corporation (IDC), National Empowerment Fund (NEF), KwaZulu Natal Ithala Bank, Small Enterprise Finance Agency (**sefa**) and Rural Housing Loan Fund (RHLF) to mention the few;
- Each of these DFIs have tended to finance enterprises in line with their mandate or sector specific i.e. Land Bank only funds agriculture and agro-processing projects, NEF focus on transformation projects, **sefa** on the small enterprise sector (even though big businesses have benefited from **sefa** funding), while and others are not sector specific;

Key Challenges

- Unlike commercial banks, whose objectives can be simply expressed and measured in monetary terms like profitability and shareholder value, DFIs have political mandates, with often soft or qualitative objectives by nature difficult to measure. Assessing their relative success or failure in accomplishing their mandate is therefore difficult.
- Fragmentation of the DFIs and mandate obfuscation is not sustainable;
- Funding products are located in different DFIs, situated in different offices, away from each other and communities/small businesses and co-operatives they meant to service;

- In spite of the referral system between/among different DFIs and some government departments, financial services is cumbersome and frustrating;
- DFIs do not guide their clients properly to enable them to manage their finances efficiently so that they can meet the set requirements. Instead they punish their clients for lack of business acumen and financial skills;
- Products offering that do not speak or address funding requirement for small enterprises;
- DFIs source their equity capital from governments or benefit from government guarantees. All DFIs receive their allocation from fiscus and based on their performance, the question may be asked, are they still relevant? At what expense to the taxpayer? Should we instead not prioritise partnerships with the private sector capital?

- Lack or absent of remedy mechanism (rejection of applications);
- The amount of red tape compared to commercial banks is excessive, see annexure C re: application form and requirements e.g. Ithala bank and **sefa**;
- DFIs are expected to operate at the forefront of societal and economic change.

Recommendations

The current economic state is certainly a major contributor to the challenges that SMEs experience in securing funding when they need it. South Africa's low economic growth over recent years has negatively impacted the future forecasts of most companies and SMMEs especially, find it more difficult to show proof that they can remain solvent for the foreseeable future. This is of course one of the qualifying criteria set forth by funding institutions:-

- In deepening its comprehension of the sector, the Portfolio Committee should call together a Financial Sector Symposium (FSS) where relevant stakeholders would be called to present their services and amd product offerings, with a particular focus to dismantling barriers to accessing capital and red tape, measures to overcome onerous application requisites such as collateral and improve application turnaround

- The Portfolio Committee must urgently engage other Portfolio Committees/ Standing Committee on Finance to discuss the issue of cession of income, cession of contract and invoice discounting specifically to i) those financial intermediaries registered and regulated by the South African Reserve Bank (Prudential Authority, Financial Sector Conduct Authority and National Credit Regulator) and, Development Finance Institutions created by an act of Parliament. This will greatly assist small enterprises from resorting to loan sharks and adequately deal with their cash flow problems;

- It is a concern that those that applied for funding would wait for 12 weeks for a decision, and they had mountains of bureaucracy to get through. Owing to the time that small enterprises may need to spend on the required paperwork and the substantial amount of information required, some businesses may drop out in the initial application stages, this require intervention such as the development of an automated credit model. The Chinese company Alibaba, the world's biggest e-commerce company, their customers can apply for a loan in three seconds and get approval in one minute;

- In its annual performance plan to the Portfolio Committee the Department tabled what it termed: A THEMATIC APPROACH TO SERVICE DELIVERY with a particular section dedicated to Finance (Financial Sustainability, Risk Cover and Business Rescue, Model Funding Agreement, SMME Contracting models, SMME Payment and Funding Facilities (**sefa**));
- While recently there has been much focus on blended finance for small enterprises, including social enterprises and not-for-profit enterprises e.g. co-operatives;
- Also, there has been an indication that the Department, in collaboration with National Treasury, is crafting a National Funding Policy for small enterprises;
- The Portfolio Committee should invite the Department to provide briefing on these and other initiatives that may be on the pipeline in order to ensure alignment with state priorities.