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Credit financing for SMMES in the Free State: development financing institutions versus commercial banks

By

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A dissertation submitted in fulfilment of the requirements of the

Masters in Commerce

in

Business Management

in the

Faculty of Economic and Management Sciences

at the

University of the Free State

Supervisor: Dr Johan van Zyl

May 2010

I declare that:

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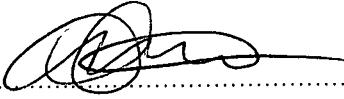

05.04.2010

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Abstract

Access to credit finance is a challenge that faces SMMEs in developing economies such as South Africa. This challenge has been a burning issue to a number of researchers and policy makers alike. The development of SMMEs is important because the sector is an alternative solution to unemployment reduction and poverty eradication. Without enough financial resources, achieving this developmental goal becomes very difficult for SMMEs. The study helps to illustrate the roles played by both private sector (banks) and public sector (DFIs) in affording SMMEs access to credit finance. The results show that there are some challenges facing FIs that prohibit them to achieving the goal. The study, however suggests the possible solutions in addressing the problem.

Key words

Credit finance, SMMEs, FIs, banks, DFIs

Acknowledgements

I am grateful to my heavenly Father who gave me the strength to complete this project. I wish to express my sincere gratitude to those who have assisted me in the compilation of this dissertation.

In particular I would like to thank the following people for their distinguished contributions

- Dr Johan van Zyl who courageously, patiently and professionally guided me through during the study. I highly appreciate the support he provided
- GOOT Management for affording me the opportunity both for my personal and academic development
- Professor van Aardt Smit for his support he provided
- Professor Annett Wilkinson for her expert support and guidance
- Ms Liezel Kotze for her support and assistance
- Dr Nthabeleng Rammile for her support and for being there for me at time of need
- Ms Juliet Ramohai for the support during hard times, for being the best friend and a sister, you are my hero
- My loving husband Shabby, my handsome sons: sweet Tesfa and little Midas; and lastly my beautiful daughter Mmeme for being my daughter. Thank you guys for all your understanding when I spent a long time away from you. You are all the reason I live and the pillars of my live
- My colleagues in the department of Business Management for their support

To my adorable late mother Mma-Anna

Abbreviations

ABSA	Algamated Banks of South Africa
BBBEE	Broad- Based Black Economic Empowerment
BEE	Black Economic Empowerment
FNB	First National Bank
FCA	Farm Credit Act
NCA	National Credit Act
NYDA	National Youth Development Agency
SA	South Africa
SMMEs	Small, medium and micro enterprises
SBCS	Small business credit scoring
DTI	Department of Trade and Industry
NCR	National Credit Regulator
NEF	National Empowerment Fund
SAMAF	South African Micro Apex Fund
SARB	South African Reserve Bank
FDC	Free State Development Corporation
IDC	Industrial Development Corporation
UYF	Umsobomvu Youth Fund
OECD	Organisation for economic co-operation and development
FS	Free State
FSVC	Financial Services Volunteer Corps

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Table of contents

Declaration i
Abstract ii
Acknowledgements Iii
Abbreviations iv

Chapter 1 Introduction

1.1 Background 1
1.2 Problem statement 7
1.3 Research objectives 8
1.4 Research methodology 8
1.4.1Literature review 8
1.4.2 Empirical study 9
1.4.2.1 Sampling 9
1.4.2.2 Data collection 11
1.4.2.3 Data analysis 11
1.5 Ethical considerations.. 11
1.6 Outlay of study 12
1.7 Terminology 13
1.8 Rationale of the study 14

Chapter 2 SMMEs, Credit financing and the role of banks

2.1 Introduction 15
2.2 the contribution of SMMEs in the economy 16
2.2.1 Employment 16
2.2.2 Economic growth 17
2.2.3 Social responsibility 17
2.2.4 Innovation and Efficiency 18
2.3 Constraints of SMMEs 19
2.3.1 Impact of regulatory environment 19

2.3.2 Access to finance: is it a major challenge? 21
2.4 History and evolution of micro credit/microcredit 22
2.5 Credit finance and SMMEs 25
2.6 Commercial banks as source of finance 27
2.6.1 Regulation of banks 28
2.6.2 Operations of banks on issuing credit 31
2.6.2.1 Loan pricing 32
2.6.2.1.1 Types of pricing methods/ models 35
2.6.2.2 Credit scoring 38
2.6.2.3 Credit assessment 39
2.6.3 Commercial banks of SA 39
2.6.3.1 ABSA 40
2.6.3.2 FNB 42
2.6.3.3 Nedbank 44
2.6.3.4 Standard Bank 44
2.7 Gaps facing SMMEs in credit financing arena 48
2.8 Factors behind financing gaps 50
2.8.1 Gender and age factors 51
2.8.2 Educational/ skills shortage factors 52
2.8.3 Size of the bank 53
2.8.4 Size of the business 54
2.9 Conclusion 54
Chapter 3 Government intervention : operations of DFIs
3.1 Introduction 56
3.2 Khula Enterprise Limited 57
3. 2 1 Use of credit guarantee schemes 58
3.3 SAMAF 64
3.4 IDC 66
3.5 NEF 69

3.6 FDC ... 71

3.7 UYF/NYDA ... 73

3.8 Conclusion ... 75

Chapter 4 Research Methodology

4.1 Introduction ... 76

4.2 The role of literature review ... 77

4.3 Empirical study ... 78

4.3.1Validity and reliability ... 79

4.3.2 Sampling ... 80

4.3.3 Data collection ... 81

4.3.4 Data analysis ... 82

4.3.5 Conclusion ... 83

Chapter 5 Data presentation and analysis

5.1 Introduction ... 84

5.2 Data presentation ... 84

5.2.1 Main themes ... 85

5.2.1.1 Special programs for SMMEs ... 86

5.2.1.2 Target market ... 96

5.2.1.3 Lending requirement ... 101

5.2.1.4 Loan pricing ... 105

5.2.1.5 Partnerships ... 109

5.2.1.6 Challenges ... 111

5.2.1.7 Solutions ... 120

5.3 Conclusion ... 121

Chapter 6 Synthesis of the findings, conclusions and recommendations

6.1 Introduction ... 122

6.2 Summary and overview of the study ... 122

6.3 Objectives ... 125

6.4 Main findings ... 126

6.4.1 Operations of the FIs 127
6.4.1.1 Banks 127
6.4.1.2 DFIs 129
6.4.2 Funding requirements 130
6.4.2.1 Banks 130
6.4.2.2 DFIs 130
6.5 The extent to which the FIs supplement and complement each other 131
6.5.1 Supplements 131
6.5.2 Complements 131
6.6 Shortcomings of the study 140
6.7 Contribution of the study 141
6.8 Final overall recommendations 141
6.9 Conclusion 143
Bibliography 145

Appendices

Appendix A: Consent letters to FIs 158
Appendix B: Interview guide 159

List of figures and tables

Figure 1.1 Source of financing for EU-based SMMEs 3
Figure 1.2 the SA national SMMEs support strategy 5
Figure 2.1 Effects of financing obstacles of different sizes of firms 22
Figure 3.1 Khula lending model 59
Figure 3.2 SAMAF lending model 65
Figure 3.3 IDC lending model 68
Figure 3.4 NEF lending model 70
Figure 3.5 FDC lending model 72
Figure 3.6 UYF/NYDA lending model 74
Figure 5.1 Banks and DFIs respondents 85
Figure 5.2 The themes of the study 85

Figure 5.3Specific programs for SMMEs 87

Figure 5.4 Financial support offered by FIs in the Free State.................................. 89

Figure 5.5 Banks' target market 96

Figure 5.6 FDC's target market 97

Figure 5.7 Khula's target market 98

Figure 5.8 IDC's target market 99

Figure 5.9 NYDA's target market 100

Figure 5.10 SAMAF's target market 101

Figure 5.11 Banks' lending criteria.. 102

Figure 5.12 DFIs lending criteria 104

Figure 5.13 Loan pricing by banks 107

Figure 5.14 Loan pricing by DFIs 108

Figure 5.15 FDC's pricing model 109

Tables 1.1 Names of government DFIs in the Free State 6

Table 1.2 Projected versus actual study sample 10

Table 2.1 Maximum prescribed interest rates 34

Table 2.2 FNB strategic partnerships in SMMEs support 43

Table 3.1 Types of entrepreneurship support loans.. 70

Table 5.1 Market share of SMME lending between banks and DFIs 88

Table 5.2 Non financial programs offered to SMMEs by banks in the Free State 93

Table 5.3 Non financial programs offered to SMMEs by DFI s in the Free State 95

Table 5.4 Instruments/ tools used banks and DFIs in loan pricing 106

Table 5.5 DFIs strategic partners in SMME lending 110

Table 6.1 Financing challenges and recommendations: suppliers' perception 133

CHAPTER 1

1.0 INTRODUCTION

1. 1 BACKGROUND

Small Micro Medium Enterprises (SMMEs) contribute hugely to the development and the growth of the economy, both in the case of developed and developing economies. In the United States of America, SMMEs have, for example, been noted for contributing to the growth of the economy by creating more jobs and also helping the country to gain a competitive edge (Mutezo, 2005: 1; Swardt, 2006: 1; US Census, 2002). Likewise, in developing countries like Thailand, The SMME sector employs about 87% of the manufacturing sector while in Zimbabwe the sector only employs about 15% in the same sector (Beck, Demirgiic-Kunt & Levine, 2005: 206). In Ghana SMMEs represent more than 80% of the private sector with employment of 85% in the manufacturing sector (Abor & Nicholas, 2006: 69). Similarly in South Africa, SMMEs have had a remarkable impact on the economic growth by contributing more than 30% of the GDP and generating about 70% of employment. In Uganda small businesses accounted for about 58% of the GDP in 2002 (Ntsika, 2002: 111; Swimmey, 2008/9: 12).

With more small businesses in the country, more people will be employed. Employment of many people imply that income distribution increases, which lowers the incidence of poverty. Lower incidences of poverty decreases government spending on social grants and therefore crime levels can be reduced. The growth of small businesses will ultimately lead to more formal businesses that pay taxes. Government can convert these taxes into funds to use for improved social services, health services and infrastructure especially in the rural areas. The welfare in the country is, however, compromised by problems such as poverty and unemployment hence governments need to develop strategies that reduce these problems. These problems (poverty and

unemployment) give rise to crime leading to instability in the country. Government alone cannot eradicate these problems; it needs the co-operation of all the stake holders in the SMME sector to assist them, including SMMEs. SMMEs' role in the reduction of poverty and unemployment has been noted.

Given the importance of SMMEs towards economic growth and employment, it becomes fundamentally important to pay more attention to obstacles that hinder SMMEs development and growth. The main obstacles for the growth and survival of SMMEs are low Total Early-stage entrepreneurial Activity (TEA) and enabling environment, such as access to finance (Marais et al., 2007: 9; GEM Report, 2006: 44; Mutezo, 2005: 2; and Beck et. al., 2005: 200). From the study conducted for the Free State Premier's Office, it was also discovered that more than 50% of the SMMEs in the Free State identified the need for financial support as a crucial issue towards their growth (Marais et al., 2007: 9). In addition, a low TEA had been discovered as another factor contributing to a low incidence of performance and high business failure. When comparing South Africa with the other 43 participating countries, it ranks at position 23 with a TEA of 7.8%, indicating that SA's TEA is lower than the total average of 10.6% for all the participating countries. The SA's ranking is even than the average (11.4%) of all efficiency- driven economies and also lower than the average (13.2%) of all middle to low income economies. The report further shows that when it is compared to its per capita ratings, SA would be expected to have a TEA of 13% (GEM, 2008: 4).

The main source of finance for SMMEs is banks (Demyanyk, Ostergaarg, and Sorensen, 2007: 2763, Carey and Nini, 2007: 2971; Beck, Demirguc-Kunt, 2006: 2936; Expert Group Report, 2006: 6). OECD (2006: 4), as demonstrated in figure 1.1, reports that banks in Europe contribute towards 79% of financing for small businesses, followed by a low 24% financing from leasing or renting companies.

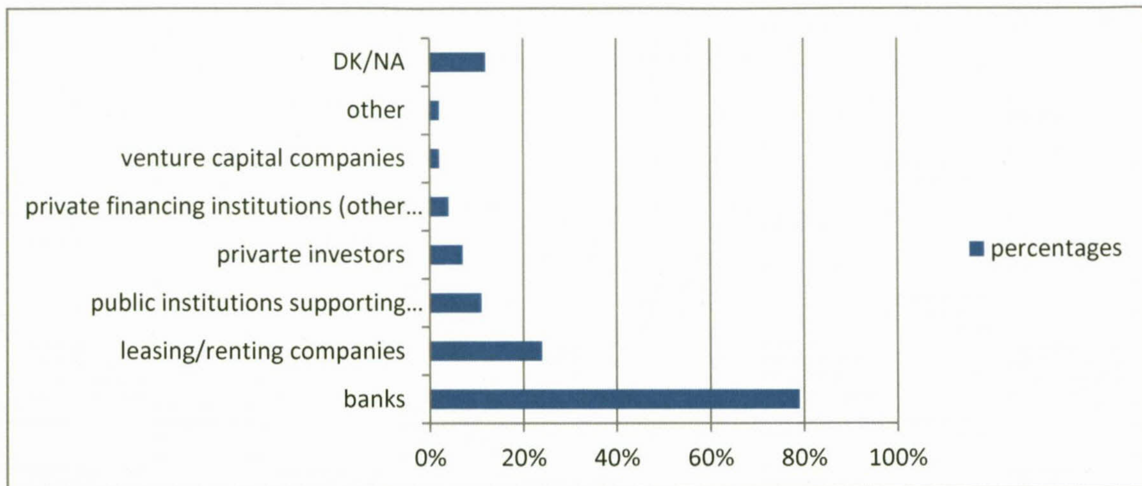


Figure 1.1 *Sources of financing for EU-based SMMEs*

Source: EOS Gallup Europe (2005) "SMME access to finance" Flash Euro-barometer 174, October, upon request of the European Commission (Directorate-General "Enterprise and Industry").

One of the functions of banks as financial intermediaries is to transfer resources from savers to investors. In transferring resources to investors, banks use savers' deposits to make loans to borrowers. Banks also offer other financial services for the development of financial markets (UN Report, 2007: 3; Rungsomboon, 2005: 163).

Banks in SA operate under the supervision of the South African Reserve Bank (SARB) as the bank of the last resort. This means that the SARB is a bank of banks in SA. SARB regulates the money supply in the country, controls credit and supervises and regulates commercial banks (Viljoen, 2009). Moreover, the SARB sets the framework guidelines that assist banks to guard against credit risk. The supervisory body expects banks to be more responsible and minimise risks as far as possible by pricing the loans. These loan prices must be based on the risk rating or credit quality of the loan applicant (Financial Regulation of South Africa 2004: 74; Basel Capital Accord II, 2008: 205; Peldec Decision Systems: 2004: 2 and European Commission, 2006:7). Furthermore, banks finance businesses have a track record, security, collateral and that are credit worthy. Therefore access to finance is difficult for economically marginalised SMMEs

who cannot raise their own capital or equity (Expert Group Report, 2006: 4; Russell & Edwardh, 2001: 23). Access to finance from banks is also difficult for SMMEs, because loan prices are high. This challenge of access to credit finance is even heavier for the start-up of businesses which have no relationship with any bank.

In South Africa, accessing credit finance is difficult for SMMEs, because the sector is very risky for banks to invest in. The banks are expected to guard against credit risk by the industry's regulatory body (Vanhanen, 2007: 9). Previous research argues that the costs of lending to SMMEs are high for banks due to the riskiness of the SMME sector (Beck, 2007:8). Furthermore, banks are confronted with asymmetric information where the entrepreneur has more information on the business than the banks. This information gap makes SMMEs not always reliable or credible. SMMEs (demand-side), however consider the fees and transaction costs charged by banks too high (Okeahalam, 2001:3). In addition, SMMEs themselves have limited information on how financial markets (banks) operate.

Based on the above-mentioned gaps between banks and SMMEs, the SA government had to explore other avenues of supporting small businesses in pursuit of its objective to fight against poverty and unemployment (Msimang, 2005: 28). Therefore the government developed a strategy that would help achieve the objective through support and development of small businesses.

In 1995 the White Paper on small business development (Small business development strategy) was established to create the enabling of the environment in support of small businesses in alleviating poverty as shown in figure 1.2. The paper gave rise to Act 102 of 1996, The National Small Business Act. This was enacted to support SMMEs in the areas of access to finance, access to the market and access to information. This was carried out by the Department of Trade and Industry through its Enterprise Development Unit (EDU) (DTI, 2005: 5;

White Paper, 1995). Other spheres of government, such as provincial and local government also came on board in addressing the apartheid-based legacy of disempowerment of black businesses and women and to create jobs (Nieman & Nieuwenhuizen, 2009: 197). More emphasis was put on the emerging and expanding SMMEs with more focus on the challenges facing previously disadvantaged groups, including black entrepreneurs as illustrated in figure 1.2. The figure presents a support model to create an enabling environment for small businesses in South Africa from different stakeholders such as: the economy, big businesses, Parastatals and multinationals. From the figure it can be deduced that if the environment is enabling enough, SMMEs can also be able to participate in the mainstream economy like big businesses and other international businesses do; furthermore SMMEs can be able to transfer services to other institutions.

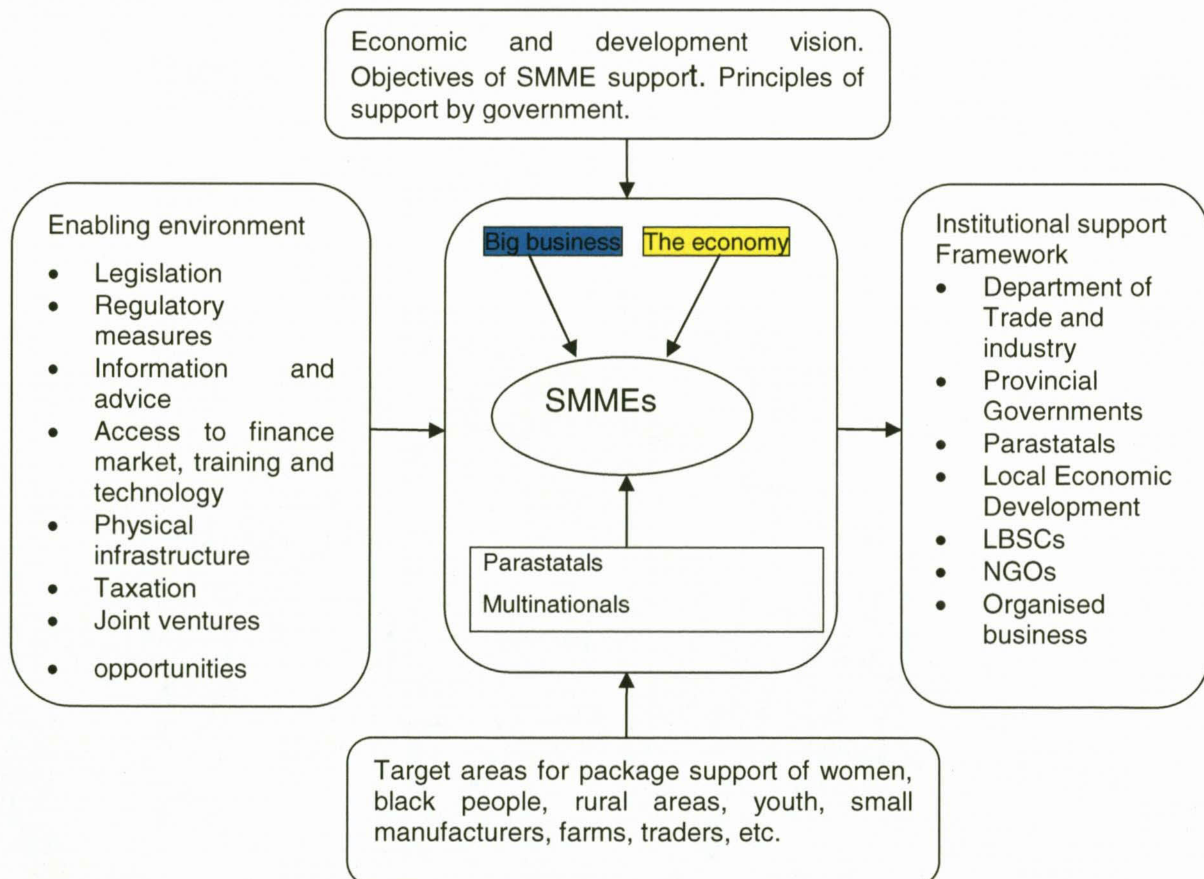


Figure 1.2 *The South African national SMME support strategy*

***Source*: Adapted from Nieman and Nieuwenhuizen, (2009: 197)**

Therefore, the EDU coordinated different strategies in order to develop the small business sector. One of these strategies was the coordination of access to finance. Implementing this strategy influenced the establishment of new and development of existing different institutions which are referred to as development finance institutions (DFIs). These institutions are illustrated in table 1.1 which also highlights the parameters within which the individual DFI operates.

Table 1.1 *Names of the government development financing institutions*

Name of the DFI	**Parameters**
Khula	National
NEF	National
IDC	International
FDC	Provincial
SAMAF	National
UYF/NYDA	National
Land Bank	National

Table 1.1 depicts that Khula Enterprise Limited (Khula), National Youth Development Agency (NYDA), South African Micro Apex Fund (SAMAF) and National Empowerment Fund (NEF) operate nationally and Free State Development Co-operation (FDC) only serves the Free State Province. Furthermore the table shows that (Industrial Development Corporation) IDC does not service South Africa alone, but also covers other 34 African countries (www.idc.co.za). These institutions are, however, available to serve the SMME market in the Free State regardless of their positioning. Umsobomvu Youth Fund (UYF) launched its new name: National Youth Development Agency (NYDA) on the 16th June, 2009.

Although sources of business funding are available, accessing them is often very difficult for SMMEs. Small businesses perceive high loan costs (bank fees) and requirements, such as collateral as making it difficult to access finance from

banks (OECD, 2006: 3). Therefore it has become crucial for the government to intervene in the process of stimulating the economy through DFIs. Nonetheless, SMMEs are still failing to access credit finance (GEM Report, 2006: 11, Mutezo, 2005: 12, Msimang, 2005: 28 and Drodkie, 2002: 19).

Previous research indicates that the lending programs of DFIs still benefit mainly established and larger businesses with a track record and collateral. The research further shows that DFIs have very few programs aimed at micro and small businesses (Mutezo, 2005: 38). The large established businesses are a market that is served by banks. Therefore these DFIs' programs continue to leave the SMMEs' market still underserved.

This study is based on these financing institutions' role they play in assisting SMMEs in the Free State to access finance. Both the development finance institutions and banks are referred to as financing institutions (FIs), as suppliers of business finance in this study. The rest of this chapter is organised as follows: section 2 deals with the research problem which will be followed by the aims and objectives of the research in section 3 of the chapter. Section 4 contains the methodology of the research and lastly the outlay of the study is covered in section 5.

1.2 Problem Statement

According to research results and various sources, (Beck et al. 2008; Rogerson, 2008; Mutezo, 2005; Mzimang, 2005), accessing credit finance is still a major problem for SMMEs although DFIs were established to finance SMMEs market that is not served by banks. The role DFIs play in SMME financing arena is a challenge. The manner in which DFIs approach SMME financing can do more harm than good for SMME development.

1.3 Research Objectives

The primary objective

To investigate whether DFIs are successful in filling the gaps in financial needs of SMMEs in the Free State that would not necessarily be assisted by the banks in terms of their access to credit finance.

The secondary objectives are as follows:

1. To examine the operation of DFIs and commercial banks with regard to programs, tools and methods in assisting SMMEs to access credit finance.
2. To explore the funding requirements in order to access credit finance from the FIs.
3. To find the problems that financing institutions encounter in assisting SMMEs to access finance.
4. To investigate to which extent development finance institutions are complementing or supplementing banks.

1.4. Research Methodology

To achieve these objectives, this research used both an applicable literature review and an empirical study.

1.4.1. Literature Review

The main aim of the literature review was to explain the concept of credit financing and its importance within the context of SMME development. The study also covered aspects, such as contribution of SMMEs in the economy and constraints that the SMME sector faces. Funding requirements have also been discovered from the review of literature. Different lending programs by different

financing institutions have formed part of the literature review. The literature review was made possible through the use of up-to-date relevant information retrieval from relevant scientific journals, books, reports, specific websites of financing institutions and working papers available for business finance.

1.4.2 Empirical Study

The empirical study consisted mainly of a qualitative research methodology. This methodology has its basis in the literature studies. It is defined by Nieuwenhuis et al (2007: 70) as the methodology that is concerned with understanding the process, the social and cultural contexts which underline various behaviour patterns. This qualitative approach is mostly concerned with exploring the "why" questions of research. The methodology typically studies people or systems by interacting with and observing the participants in the natural setting focusing on their meaning and interpretation (Holloway & Wheeler, 1996). This method has been found to be the most relevant for this research as it intended to answer the question "**why** access to credit finance is still a problem for SMMEs in the Free State?" addressed to the people responsible for issuing credit finance.

Unlike quantitative research that relies on numerical data to test the relationship between variables and a summary of quantitatively measured variables, qualitative emphasises on a "thick description" of specifics of the phenomenon (Babbie & Mouton, 2001: 272). For this reason, qualitative methods were used to obtain the thick description of specifics of "SMME financing" as the phenomenon of this research.

1.4.2.1 Sampling

Babbie and Mouton, (2001: 288) indicate that sampling in qualitative studies is always by means of purposive sampling. Purposive sampling according to Nieuwenhuis (2007: 79), means that participants are selected because of some defining characteristic that makes them the holders of the data needed for the

study. Moreover, sampling decisions are made for the explicit purpose of obtaining the richest information possible to answer research questions.

Based on this background, the participants selected for this study were the heads of investment committees of the DFIs in the Free State and the heads of small business units of the top four banks of South Africa to represent the banking industry. These are the only banks in the Free State that deal with the credit financing of businesses. The other banks such as African bank and Capitec bank do not issue business finance and were omitted in the study. Therefore, the selected research participants were found to be the most appropriate as they deal directly with the study phenomenon and hence are possible sources of the richest information to answer the research question. Table 1.2 gives an illustration of the sample of the study with what was aimed for and the actual sample. The Land Bank was, however, undergoing re-construction during the time of the study, therefore was unavailable and all the theory on the bank was deemed invalid.

Table 1.2 *Projected versus actual study sample*

Institution	Type	Status
FNB	Bank	Participated
Standard Bank	Bank	Participated
ABSA	Bank	Participated
Nedbank	Bank	Participated
Land Bank	Bank	*Not available*
Khula	DFI	Participated
FDC	DFI	Participated
NEF	DFI	*Declined*
SAMAF	DFI	Participated
IDC	DFI	Participated
UFY/NYDA	DFI	Participated

1.4.2.2 Data collection

Data was collected by means of face-to-face interviews and telephonic interviews using open-ended questions. According to Nieuwenhuis (2007: 87), an interview is a two-way conversation between the interviewer and interviewee. The former (researcher) asks the latter questions in order to learn about ideas, beliefs, views, opinions and behaviours of the study participants (interviewees). In qualitative research the aim of the interview is to see and understand the world through the eye of the interviewee. Nieuwenhuis (2007) further states that, if chosen correctly, interview participants can be the most valuable source of the rich information that the researcher will not be able to collect in any other way. Likewise, the participants of this study were interviewed in order to understand the world of SMMEs' credit financing. This method of data collection was found the most suitable to obtain rich descriptive data that will help the researcher to understand the study phenomenon. The conversations were tape recorded, notes were taken and probing was considered during the interviews to ensure that all the relevant information was collected.

1.4.2.3 Data Analysis

Data is analysed through the use of the content approach. Content analysis refers to a systematic observation and classification of communication through open-ended and/or semi structured interviews (van Buuren, 2008: 83). The recorded data was transcribed and analysed.

1.5 Ethical Considerations

Researchers are obliged to respect the rights, values and interests of the respondents. Therefore the relevant financing institutions were telephonically conducted to propose participation in the study. Upon consent to the proposal, the appointments for interviews were arranged with the targeted participants.

Before any interview could begin, the aim of the research and the length of the interview were explained to the participants. The purpose of the study was explained to the respondents and confidentiality was guaranteed. The research subjects were informed of the freedom to participate in the study as suggested by Babbie and Mouton (2001:420). The participants were asked to sign consent letters.

1.6. Outlay of Study

The following is then an outlay of the study:

1.6.1. Chapter one consists of the introduction and the problem statement of the study, including the research questions as well as the research objectives.

1.6.2. Chapter two provides a literature review on a brief account of the importance of the SMME sector and the concept of credit financing for SMMEs. The historical evolution and importance of credit financing for SMMEs is elicited in this chapter. The regulation and role of commercial banks in credit finance and their operation is also discussed in the chapter including specific lending programs banks have available for SMMEs. The chapter seals with the observation of financing gaps facing SMMEs

1.6.3. Chapter three gives an overview of the intervention by government in development finance. Different development financing institutions in South Africa is dealt with to investigate their roles in credit finance. The constraints of SMMEs in accessing finance also forms part of this chapter.

1.6.4. Chapter four consists of the research methods used in qualitative research.

1.6.5. Chapter five consists of an analysis and interpretation of the data.

1.6.6. Chapter six contains the summary of the study. Conclusions and recommendations based on the findings of the study are made.

1.7 Terminology

In order to make the reading of this document easy for the reader, the contexts in which different terminologies have been applied in the study are explained in the section below.

1.7.1 Credit financing/ debt financing: - acquisition of funds by borrowing

1.7.2 Entrepreneur: - someone who identifies the opportunity, develops and operates a small business.

1.7.3 Entrepreneurship: - is the emergence and growth of a new business

1.7.4 Financing gap: - Lack or limitations of funding from the financial sector for small businesses

1.7.5 Small, medium and micro enterprises (SMMEs)/ small businesses

The National Small Business Act 102 of 1996 defines **small businesses** as the separate and distinct business entities including co-operative enterprise managed by one or more owners in any sector or subsector of the economy. The small business employs between 1-250 people.

1.7.6 National Small Business Support Strategy defined in Notice N0. 213 of 1995 published Gazette No. 16317 of 28 March 1995 as:

> The national policy in respect of small business support as published by the Minister in the Gazette, and includes the policy as stated in the White Paper on National Strategy for Development and Promotion of Small Business in SA

1.7.7 In this study the following terms or words are used interchangeably:

1.7.7.1 SMMEs and small businesses.

1.7.7.2. Debt financing and credit finance

1.7.7.3 Financing institutions to mean both development finance institutions and banks

1.8 The rationale for the study

The following are the highlights of the importance of why the study is carried out.

- Despite various efforts to avail business finance, the problem of access to finance by SMMEs in SA still prevails;
- There is limited research on the field that is based on the SA perspective;
- Sustainable developmental support of SMMEs is the key driver of economic growth, employment and poverty alleviation;
- Availability of finance for small businesses helps reduce income inequality.

The results of the study may assist policy makers to identify where the actual finance gaps really lie in order to be able to address them.

McMillan & Schumacher, (2001: 74), indicates that the researcher becomes immersed in the situation and phenomena studied. This validates the researchers involvement in the study based on the experiences.

CHAPTER 2

2.0 SMMEs, Credit finance and the role of banks regarding credit finance

2.1 Introduction

This chapter contains a review of literature on credit financing for SMMEs in South Africa. The first section is a discussion on importance of SMMEs in the economy together with the challenges that they are faced with. This discussion is incorporated in this chapter in order to understand the rationale behind SMME promotion. The second section deals with the history of credit finance and importance of credit financing to SMMEs with the inclusion of microcredit finance which is very relevant for micro businesses. The integral part of the chapter in section three is on the role of commercial banks regarding credit finance as they are used as the elements of comparison in this study. Incorporated in this section are the financial products or programs that SA's major commercial banks have for SMMEs. The credit gaps in the financing arena are discussed in the last section of the chapter.

2.2 The contribution of SMMEs in the economy

Even though the importance of SMMEs has already been highlighted in chapter one, their deeper contribution to economic growth is worth noting from different angles. This is in order to validate the role of debt financing as one of the developmental strategies for SMMEs. The role of SMMEs towards the development of the economy is observed from the following angles: employment, economic growth, social responsibility and lastly innovation and efficiency.

2.2.1 Employment

Small businesses are considered as the backbone of virtually all economies in the world, especially in developing countries. This is because when compared to larger businesses, smaller businesses are more labour intensive than is the case with larger businesses, which are more capital intensive thus making the former agents of job creation (Christian, 2003: 3; Newberry, 2006: 1)). For example, in Association of South Asian Nations small businesses are accountable for the employment of 70%-90% of the domestic workforce.

In Africa, the same impact of SMMEs on employment is significant because small businesses account for 85% employment of the manufacturing sector in Ghana while in South Africa SMMEs employ approximately 70% of the private-sector employment (GEM, 2008: 12; Abor & Biekpe, 2005: 69). According to Stassa (2009), the unemployment rate in the last quarter of 2008 was 21, 9% (www.mg.co.za). The SA Presidency Planning Commission Ministers made an announcement that the government is still committed to its goal of halving unemployment and poverty in 2014 (SAPA: 2009). This is in consistence with what was earlier stated that the government of SA intends to bring down the unemployment rate by 14% by 2014 through committing about R44, 5 million to a four year development program to small businesses (Good News SA, 2008: 1). Perhaps achieving the goal can be possible given the huge contribution the SMME sector makes in the private sector employment. Due to the 2008/9 global recession, unemployment rate, however, rose to 24.5 % in the third quarter of 2009 from 23.6 in the second quarter (Stassa, 2009). This increase may affect the government's goal negatively if the job losses continue.

The line, however, needs to be drawn on how far the contribution of SMMEs towards economic development can be observed. Beck, Demirguc-Kunt & Levine (2005: 212) deviate from this general statement by pointing out that the share of employment by SMMEs is only greater in countries with higher education and a

more developed financial sector and not in countries with more exchange rate distortions. In South Africa SMMEs that are operated in the rural areas, for example have a limited ability to create jobs because their establishment is necessity driven (Dzani, 2007).

2.2.2 Economic growth

Small businesses' contribution towards economic growth is very remarkable. Oketa, (2009), for example, highlights that the percentage contribution of SMMEs to total value added GDP ranges from 60% in China, 57% in Germany, 55.3% in Japan and 50% in Korea. Moreover, Oketa (2009) shows that about 95% of firms in Australia are from the SMME sector and furthermore that in SA, 91% of formal entities are SMMEs with a contribution of about 57% to the GDP. Moreover, the small business sector has proven to be a growth sector in different countries. In Taiwan, for example, SMMEs have growth rate of 2.41% compared to large enterprises which only have 0.60% (Taiwan Economic Affairs, 2006: xii). Similarly in South Africa SMMEs are considered as the high growth businesses, which are likely to experience even more growth where equity investors promise capital investment, since investment growth is heavily based on return (Business Partners in Hannig & Joubert, 2003: 9). The White Paper on National Strategy for Development and Promotion of small business was introduced as a result of the fact that small businesses have made a great progress in the micro and small enterprises segments when compared to medium and large- sized enterprises (White Paper, 2006: 10).

2.2.3 Social responsibility

Because small businesses are considered less mobile than large businesses, they relate more to their communities in order to protect their reputation with their customers (Scozzi et. al, 2005: 3). Newberry (2006: 1), for instance mentions that from the European study conducted on small businesses, about 67.5% of them

reported to be practicing some external social responsibility projects, like supporting a local charity on regular basis. The main reason for this is reported as an effort to increase customer loyalty and better relationships with the community.

Some researchers believe that small businesses still practice the social responsibility principle but most of them are not aware of it (Lepoutre & Heene, 2006: 257; Murillo & Lozano, 2006: 229). Perhaps this migrates from the common usage of the term "corporate social responsibility" which is a language associated mostly with large firms (Murillo & Lozano, 2006: 228; Jenkins, 2006: 242). Therefore by creating jobs, small businesses help reduce unemployment, and also contribute to economic growth, all of which amounts to their responsiveness towards social responsibility.

2.2.4 Innovation and efficiency

Another factor that helps mark the importance of SMMEs is innovation. Newberry (2006:1), advocates that the inherent flexibility and risk-taking ability are the key drivers of innovation of a true entrepreneur. This is why small businesses are operated by entrepreneurs who nurture a business opportunity into a potentially high growth venture in a complex and unstable environment. These entrepreneurs at the same time conceptualise, organise and launch those businesses (Rwigema and Venter, (2004: 6). Cornwall (2009), further emphasises that when faced with challenges of the competitive market, SMMEs refine and redefine how to work and what they produce. This is SMMEs' strength as innovators in comparison to their large business counter-parts which, due to extra costs to incur, can innovate. Instead of innovating, large businesses would try to create something bigger and better. In achieving this comparative strength, SMMEs use six enablers:

- Personal passion;
- Customer connection;

- Agility and adaptation;
- Experimentation and improvisation;
- Resource limitation;
- Information sharing and collaboration.

Small businesses are natural innovators. Research findings indicate that SMMEs are innovators who use a mix of incremental market sustaining and more market radical changing innovation in their businesses. Moreover, these findings show that in small businesses innovation is used broadly across the small business sector and are not only limited to technological and high growth firms (Small Business Labs, 2009).

2.3 Constraints facing SMMEs

Despite the crucial role SMMEs play in the development of the country, their contribution may only be short lived given the impact of constraints with which they are faced. These challenges hinder SMMEs' growth and potential performance, which would otherwise have a significant impact on economic growth. These challenges include the regulatory environment and capital. According to a GEM SA report, (2006: 3) SMMEs in South Africa are faced with various factors of constraints, namely: finance, gender issues, business skills and financial illiteracy. Oketa (2009); Beck, Klapper & Mendoza (2008: 2) and Fan (2003: 17) confirm that financial constraints have a greater impact on small businesses than larger businesses. From all these academics, it can be concluded that finance is the most serious challenge.

2.3.1 Impact of regulatory environment on small businesses

Some of the challenges that hinder increased performance of SMMEs are regulations and bureaucratic practices around larger businesses in different countries. Large businesses make it difficult for small businesses to penetrate

their market by imposing barriers to entry. These factors influence entrepreneurs to operate illegally outside government's regulatory reach, which in turn compromise their access to human and financial resources. In countries where the environment is enabling, however, the operation of illegal businesses is low compared to environments with more regulatory constraints for small businesses. World Bank Group (2006), for example, reports that New Zealand has informal small businesses that account for only 12.7% of the gross national product (GNP), because the environment is enabling for small businesses.

In South Africa as well, informal small businesses account for only 8.8% of the GNP. The low figure may be an implication that most of the businesses are formal due to enabling environments. In contrast, Burkina Faso's informal businesses measure 38.4% on the GNP, which would otherwise make a positive contribution to the real GNP of the country, if the environment was not disabling. Further more business requirements are difficult to reach. In order to register a business in Burkina Faso one requires to have capital almost five times the individual's annual income. The registration fee of the business is 1.5 times income per capita. Property's registration fees require about 16% of its value (World Bank, 2005: 5), all of which is difficult for SMMEs to provide.

In addition to these, Wiboonchitikula (2001:12), is of the same opinion that small businesses are primarily constrained by insufficient capital followed by marketing and lastly by labour shortages which are the result of the increased real wage rate. There are many factors that hinder the growth of small businesses, like limited access to the market, limited information, business illiteracy, legal issues and demographical factors. Although various SMMEs' constraints have been identified, the next section, however, focuses only on access to finance, as it has been identified as the most important problem and a major need of SMMEs.

2.3.2 Access to finance: Is it the major challenge for SMME?

The problem of access to finance for small businesses is the impediment facing the developing countries. From the study that was done in Ghana in 1994, for example out of 133 medium/large scale enterprises access to finance was identified as the most significant constraint by 53% of the enterprises (Aryeetey, 1998: 2). Another example is Taiwan where about 40% of SMMEs reported that they were experiencing difficulties in securing funding (Taiwan White Paper, 2007: 67).

SMMES are disadvantaged in trying to obtain external funding if they do not have a track record or collateral (Beck & Frame, 2005: 1). In addition, access to finance is the most dominant factor that hinders growth of the SMMEs. Without enough working capital, the growth potential of small businesses becomes difficult to exploit. To achieve this potential, the entrepreneur needs to obtain extra finance from external sources. On condition that accessing external finance is an obstacle, the business remains at one stage of the business cycle forever, implying no growth. In support of this Beck & Demirguc-Kunt (2006: 2937), illustrate that small business financing obstacles have almost twice the effect on the annual growth than large firms' financing obstacles. Furthermore, obstacles of finance for small businesses exceed the negative effect of legal aspects and corruption by almost -2% as Fig. 2.1 highlights.

SMMEs' drawback in trying to attract external financing is difficult, particularly if they cannot find equity, because they do not have a track record or collateral. In Burkina Faso, for example, to get a loan from a bank requires large collateral (World Bank, 2005: 5). Asia Development Bank (2008), also reports that small businesses in most developing member countries are constrained in accessing finance, due to weaknesses of the businesses and lack of an understanding of micro finance institutions and small banks. In South Africa, Christianson (2003: 9), states that from the study of 30 participants, 27 of them indicated that their

main hurdle was their relation with their bank. The scholar further shows that the major banks of SA closed down their small business units due to transaction costs incurred when dealing with small businesses.

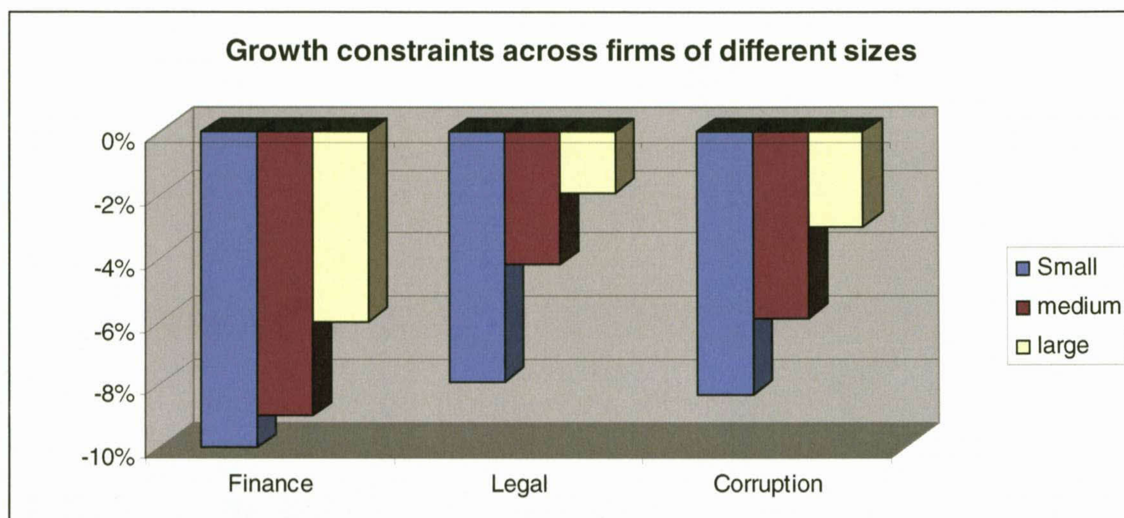


Fig.2.1 *The effects of financing obstacles on different sizes of firms*
Source: Beck et al. 2005c

Therefore if financing can have this big impact on the growth of SMMEs, it becomes eminent that: the historical evolution of credit financing, the importance and the challenges of credit finance that face SMMEs must be dealt with in this research. These aspects are discussed in the following sections.

2.4 History and Evolution of microcredit finance/ credit finance

Microcredit is defined as financial intermediation between micro savers and micro borrowers as it provides a wide range of financial services which include deposits, loans and insurance (UNCDF, 2003: 1). Microfinance is also an aspect of issuing small loans targeting the poor as it refers to banking the unbankable people by bringing credit and savings closer to the majority of people who do not have any relationship with any bank. Microfinance plays a crucial role as a tool to the rural poor in the fight against poverty by investing in their small businesses (www.cgap.org ; World Review, 2000: 1).

As microcredit financing includes all small loans offered to people mainly for operation of a small business, it is perceived as a steering tool in the business development support for emerging entrepreneurs. Looking at it from the suppliers' side, it is also considered as banking at the doorstep for the poor borrowers. Researchers such as Ahmed, (2005: 12) and Dsani & Guo, (2003: 2) agree that microfinance is an organised economic development strategy that offers several financial services aimed at assisting low income people to establish and grow their small and medium businesses.

Microcredit financing for small businesses received international attention from the 1980s, whereupon the World Bank issued numerous papers on the matter as well as setting standards of reporting from microcredit institutions (Evans, 1996: 1). In the United States of America microcredit financing was introduced in 1981, whereby the government issued a loan guarantee for small businesses. It has been since that time that various Finance Acts have extended the period of the scheme by making further funds available. In this system, the business proposition had to be looked at by an approved bank and considered viable, but it should not be within a bank's own support criteria. When the bank is convinced then the application would be passed on to the Department of Employment, using the approved format.

Once the proposal is approved by the Department, then the bank lends out money at the bank rate plus some amount and the department guarantees the bank 70% of its money in case the SMME does not pay. In return, the government charges a 2.5% insurance premium for the 70% the government has taken on risk. Borrowers would be expected to pledge all available assets as a security for the loan, but would however, not be exclude from the scheme if they did not have the assets. They would be encouraged to take the term loan which is split up between start-up capital and for growth capital, (Barrow, 1991: 208).

The same principle of financial support for the small businesses in Britain had been through banks, investment trust companies, pension funds, insurance companies, merchant banks and various other agencies. These institutions were functioning as sources of equity capital to small companies and firms (Mason, 1985: 144). The loans were categorised in terms of the periods for which money would be needed; short-term finance, medium term finance, long-term finance and permanent finance. The distinction to this type of financing was that the firm had to have a first class management structure, a sound business plan, above-average growth potential, which reflects the quality of management and its track record indicating favourable marketing opportunities. The implication therefore is that this strategy would exclude firms with a different structure and qualities; which means that the government would be their last resort.

According to World Review (2000: 2), microcredit and rural finance programs have, however, been in existence since the early 1970s with Grameen Bank founded in 1976. These programs were reported as the providers of microcredit. This was followed by the establishment and development of various microcredit activities and programs. Two decades later, in the 1990s, developing countries were able to access microcredit. In Argentina, for instance, a credit program to small businesses was implemented in 1993 (Paravisini, 2008: 2164).

While the use of microcredit in South Asia began in 1997, in South Africa the intervention by the government came into place in 1992. At this time the Minister of Trade and Industry of the Apartheid regime legalised micro finance by signing into law an exemption to the Usury Act that removed the price control on small loans. The act removed interest rate ceilings for loans under R6 000 with a repayment period of less than 36 months. This was followed by tremendous development in the commercial micro lending sector in the country, although this lending served more for consumer spending than for the operation of small businesses (Porteous & Hazelhurst, 2004: 77).

Microcredit was further developed in 1995 when the White Paper on the National Strategy for the Development and Promotion of Small business was introduced. The paper stated that it had been noted that black people in the past had made positive progress in the micro and small enterprise segments of the economy. This was more than in medium size and larger enterprises. The indication of constraints facing the small-business sector was, however, made clear in the paper. Access to finance was highlighted as one of the main obstacles which the development strategy must cover (White Paper 1995: 10).

The rapid growth of the micro finance industry provided the impetus for a second Exemption to the Usury Act in 1999. Revisions regarding the amount of small loans were increased from R6 000 to R10 000. To manage the sector, The Micro Finance Regulatory Council (MFRC) was established. This came along with new regulations for governing the way microloans would be administered and how repayments collected were added. (National Credit regulator: 2007).

2.5 Credit finance and SMMEs

Previous research suggests that if the SMME sector were to make a real contribution towards poverty alleviation and sustainable job creation in South Africa, a good deal of more support and finance would be required (Jekwa, Whitfield and Kelly. 2007: 63; Khandker, 2005: 1). Availability of funding helps small businesses to increase inputs for increased output and enable them to perform better amongst their competitors.

Credit finance helps an entrepreneur to maintain business ownership and control as opposed to large firm financing which potentially dilutes business ownership. Large firms outsource external finance through selling shares, for example through initial public offering (IPO). As the number of shareholders increases, the control of the company spreads across the shareholders, depending on the weight of the shares per investor. Berger & Udell (2003:301), believe that debt

finance is preferred by most investors above external equity due to the verification costs. The external debt-holder has to incur the cost of verifying the firms' cash-flow, only if the firm lags behind with the repayment or the latter becomes irregular. The external equity-holder may have to bear the verification cost on a regular basis. Full control of the business is, however, only short lived for the entrepreneur if there is enough collateral and security pledged against the debt or so long as the business is solvent. If the entrepreneur affords to provide collateral or security against the loan, the creditor does not have control over the business. Moreover, the scholars state that external debt finance is preferred above external equity due to verification costs incurred.

Small business lending does not only benefit SMMEs but it also acts as an instrument for profit making by banks (Beck & Demirguc-Kunt, 2008: 1). In Pakistan, for instance, a quarterly update on microfinance by Micro Watch in 2006 reported that about 39% of active savers included in banks were women entrepreneurs, which had not been the case in the past when women's place was in the kitchen (Niethammer, Saeed, Mohammed & Charifi, 2007: 3). Therefore, this one factor means that including SMMEs in their client base, banks increase their market share, which is a benefit to banks as well. Moreover, Tucker & Lean (2003: 51) imply that small businesses are agents of finance providers through generating returns from investment projects and loan portfolios of banks.

On taking advantage of opportunities availed by the external environment, businesses need to be financially sound to overcome challenges like competition. Hence access to finance is closely related to access to opportunities and markets as well as it is one of the factors inhibiting BEE (black empowerment program) (Drodkie, 2002: 21). The challenges faced by small businesses towards sustainable economic growth can, however, be addressed by creating a more favourable entrepreneurial climate and providing effective targeted support, including access to finance for each group of SMMEs.

Accessing credit finance is difficult because financial institutions, which are formal money lenders, as a rule only lend money to people in formal employment. The employment income becomes the security for such loans and the direct deductions from the wages and salaries are the recognised methods of repayment (Joubert & Nieuwenhuizen, 2002: 44). People outside formal employment are disadvantaged in obtaining credit finance. In Mexico, 90% of the respondents who had below median income (the unbankable) reported that access to finance is the most challenging aspect (Claessens, 2006: 219). Nonetheless, to show their commitment to poverty alleviation, the merge of international banks through their collective worldwide networks are projected to reach 2.5 to 3 million microfinance clients by 2010 (Coyle, Wehrell and MacDonald, 2006: 10). In addition, there are various sources of finance from which SMMEs can seek finance. These institutions include:

- Banks;
- venture capitalists;
- leasing/ renting companies;
- private investors;
- private financing companies;
- retail financial intermediaries and
- others (family, friends, community clubs).

Banks have been identified by many researchers as the main source of finance as figure 1.1 on page 3 indicates (Demyanyk, Ostergaarg, and Sorensen, 2007: 2763, Carey and Nini, 2007: 2971; Beck, Demirguc-Kunt, 2006: 2936; Expert Group Report, 2006: 6).

2.6 Commercial banks as sources of credit finance

Banks are efficient producers of valued products and are among the few truly international enterprises. Although they are now blamed for the current economic instability, American "big banks"' credit failure has had a significant impact on the whole world (economic recession) despite the fact that in 2009 the impact was

negative. Banks are also important regarding the conduct of monetary policy and hence they play a significant role in the development and growth of economies (Wall, 2004: 3). Therefore, banks are mostly used by businesses for external funding. Banks provide credit facilities such as mortgages, overdraft term loan and asset finance. More commonly used banks for debt financing in SA are ABSA, Standard Bank, First National Bank and Nedbank.

Demyanyk et al. (2007: 2763), indicate that banks play a central role in the allocation of capital in the economy and are the prime source of finance to small businesses. This is true for developing countries like South Africa because from the study that was conducted in Tshwane by Mutezo (2005: 75) the number of SMMEs that had approached banks for financial assistance ranged between 14.5% and 59.5% for different banks, whereas SMMEs that approached other sources who just below 9%.

The lack of an established financial reputation normally prevents small business from attain finance in the public market (Demyanyk et al, 2007: 2768). The evidence of this is to be in the study on SMMEs of Tshwane where less than 49% of SMMEs that participated in the study, succeeded to get credit finance from banks (Mutezo, 2005: 77). This implies that more than half (50%) of SMMEs failed to get financing from the banks. Nonetheless, banks' shareholders expect their businesses (banks) to generate income and increase their profits. Businesses are profit-driven and therefore banks as businesses cannot afford to expose their funds to risk by issuing credit to the market perceived as risky.

2.6.1. Regulation of banks

Commercial banks are among the most closely regulated of all the lending institutions. This means that the mix, quality and the yield of the loan portfolio of any bank is heavily influenced by the character and the depth of the regulation that it faces. The community Reinvestment Act (1977), for instance, requires that

all banks make "an affirmative effort" to meet the credit needs of individuals and businesses in their trade territories. This is to make certain that no areas of a local community are discriminated against in seeking access to bank credit. The Equal Credit Opportunity Act of 1974 stipulates that no individual can be denied credit on grounds of race, gender, religious affiliation, age, or receipt of public assistance (Peter & Hudgins, 2005: 527). Nonetheless banks are discouraged by their regulator to avoid lending to high risk loans (Wall, 2004: 7).

Conversely, banks become reluctant to grant small business loans because it is too costly. The transaction costs of a $5000 commercial loan are, for example similar to those of $500 000. The lending criteria, the client's market assumptions and financial projects all have to satisfy similar prudential standards (Beck, 2007: 8; Evans, 1996: 2); therefore costs of a small loan exceed the value of the loan itself. Nonetheless, Beck et al. (2008: 3) discovered that banks admit that the SMME segment is very profitable for them.

In South Africa, the regulation of credit is the responsibility of the National Credit Regulator (NCR). The NCR was established as the regulator under the National Credit Act 34 of 2005 (the Act) to regulate the SA credit industry. The act requires the regulator to promote the development of an accessible credit market which specifically addresses the needs of historically disadvantaged persons, low income persons and remote, isolated or low density population communities. The regulator is also tasked to register credit providers, credit bureaux, debt collectors and to foresee that all parties comply with the regulation (NCR, 2009).

Section 13 of the Act paragraph (c) (i), states that the regulator is responsible to monitor credit availability, price and market conditions, conducts and trends. Furthermore paragraph (c) (iii) requires the National Credit Regulator to monitor access to credit by small businesses or people from historically disadvantaged communities, remote, isolated and low density population (NCA, 2005). Commercial banks as authorised credit providers are therefore affected by this

act, implying some extent of indulgency in dealing with the previously marginalised communities. This body is supported by the Financial Services Charter where the financial institutions are committed to providing over R70 billion targeted for investment in support of sectors such as small and medium enterprises, low-income housing, resource-poor farmers and developmental infrastructure (Van Zyl et al. 2009: 87).

While banks are expected to be lenient in issuing credit, guarding against risk remains the banks' priority. The New Capital Accord (Basel II capital adequacy adopted by the world's banks with its three pillars: minimum capital requirements, a supervisory review process and effective use of market discipline) requires improved banking system stability to ensure all banks hold sufficient capital against credit risk. The Basel II expects banks to report the risks and capital adequacy to their central banks. It further provides a standardized basis for monitoring risk and capital adequacy by the banking regulator and by banks' counterparties like depositors and funders. The purpose for this is to enable banks to function and also to protect their stakeholders against loss (The Times, 2008).

Against this background, the SARB, through its bank supervision department, works closely with SA banks to ensure that four main objectives are achieved. Firstly, banks have adequate capital provided by shareholders. Secondly, banks apply efficient risk management procedures within their organizations. Thirdly, all stakeholders: the boards of directors, auditors and top management share in the responsibilities of the institutions. Lastly banks must cooperate with the SARB in the implementation and achievement of objectives of monetary policy (Van Zyl et al, 2008: 46).

2.6.2 Operations by banks on issuing credit

Banks are very careful with regard to how they deal with credit issuing so that the shareholders' money is not compromised. According to Wall (2004: 4), when issuing loans, banks evaluate the credibility of the borrower as the first step in granting the loan. Secondly, after they have granted the loan, banks monitor the borrower before the repayments are due. Lastly, they collect payments from the borrower.

In evaluating the borrower, banks guard against the risk of lending money to projects with negative net present values. The advocacy for credit risk assessment is grounded in the new capital requirements for banks (Basel II). Basel II reinforces the trend for banks to emphasise the need for thorough risk assessment of their clients (CEC, 2008: 7). Assessment for small businesses is even more important because they represent a higher risk than large firms (OECD, 2006: 5). Seemingly, the Basel II helps banks reduce risks as it sets risk-sensitive minimum capital requirements for the credit, market and operational risks that banks take. The National Treasury of SA favours Basel II as it is unlikely to affect the objectives of the financial charter and aims of Black Broad Based Economic Empowerment (BBBEE (Stovin, 2008).

When analysing credit assessment, banks verify the information provided by the loan applicant. They may through their staff, pay a physical visit to the business premises for assessments and verification of aspects, such as the physical address, actual business and business operation. Banks also verify the applicant's ability to pay back and lastly verify the soundness of the projections provided by the loan applicant (HSBC). Other issues banks consider in assessing a loan applicant include:

- Business plan;
- Business cash flow, profitability and existing commitments supplemented by account statements;

- Personal commitments;
- How previous finances have been handled;
- Information obtained from credit reference agencies;
- Ratings assigned by reputable rating agencies;
- Information from other creditors or lenders;
- Market reports;
- Collateral or security provided.

Banks make lending decisions to the SMMEs based on the soundness of the business plans, the value of the SMMEs' fixed assets to serve as collateral or security and the guarantor or guarantee fund. Mutezo (2005: 79), for example, shows that from a study held on 200 Tshwane entrepreneurs, 31% of the study participants were rejected by banks on account of collateral, while poor business plans accounted for 18% of rejected loans. Nonetheless, Wattanapruttipaisan (2003:16), advises that the machinery and equipment purchased under application is still considered as partial security with land and buildings most often used by banks.

Commercial banks use different tools and methods in processing of loan application such as credit assessments. Credit assessment usually involves some basic methodology of evaluating business and household cash flows (Jekwa, Whitfield & Kelly, 2007: 62; Enterprise Toronto, 2008). In order to assess whether a potential borrower will default, the lenders use credit scoring. For the purpose of this study, only loan pricing, credit scoring and credit assessment will be used as examples of tools banks use in processing business loans.

2.6.2.1 Loan pricing

Loan pricing is the interest rate charged on the loan plus any associated fees required as part of the financing package (Taylor & Sansone, 2007: 174). Glantz

& Mun (2008: 206), point out that although loans initially were priced based on prime rate as the benchmark, the loans are currently priced depending on the market forces. These market forces include competition, economic factors, political and legal forces.

Banks use funds that are generated from member savings and deposits to make loans. For this reason, banks need to price the loans to cover the costs of those funds and hence receive expected returns from these investments. To achieve this, loan rates are charged based on the interest rate paid on the savings (Njuguna, 2008; Bledsoe, 2007: 1; Beck, Siegel & Beares, 2001: 163). This implies that the higher the interest rates paid to the depositors, the higher the interest rate charged on the loan. Beck et al. (2001: 163), furthermore indicate that the interest rate is the product of the principal rate, (the amount of the loan excluding interest), and the time (the term money will be used) and frequency (number of payments).

Although banks are at liberty of setting their own interest rates, countries' monetary authorities are responsible for setting interest ceilings through usury laws. In Europe, a country like Belgium regulates its own usury rates for the instalment credit according to the loan amount and reimbursement period. In German the usury law also forbids banks from charging more than double the average interest rate or even to exceed the average rate by 12 percentage points. In Italy the usury law becomes functional if the interest rate exceeds the average annual effective global rate.

In South Africa, financial institutions are regulated under the Banks' Act and by the NCR on the pricing of the loans. Nonetheless, these financial institutions are liberated to price their own loans as long as they are within the framework of the prescribed maximum rates shown in table 2.1. Based on the capital requirements of the Basel II, banks are expected to make the loans available from the total capital minus regulatory reserve requirements (Paravisini, 2008: 2178). To avoid

manipulation of customers, MFIs are given the framework of loan pricing as shown in the table below. The South African Reserve Bank (SARB), sets the repo rate on which banks borrow from it (SARB) and in turn banks use this rate as the benchmark in their lending rates (Mboweni, 2007).

Table 2.2 *Maximum prescribed Interest Rates.*

Sub-sector	*Maximum Prescribed Interest Rate*
Mortgage agreements	[(RR x 2.2) + 5%] per year
Credit facilities	[(RR x 2.2) +10%] per year
Unsecured credit transactions	[(RR x 2.2) + 20%] per year
Developmental Credit Agreements For the development of small businesses	[(RR x 2.2) + 20%] per year
for low income housing (unsecured)	[(RR x 2.2) + 20%] per year
Short term credit transactions	5% per month
Other credit agreements	[(RR X 2.2) + 10%] per year
Incidental agreements	2% per month

Source: The National Credit Regulation, 2006

Some researchers like Xie (2008: 4) and CEC (2006: 7), found that not only savings or deposits determine the value of the interest rate, but also the merging of banks and the concentration of the market also have an influence on the value of the interest rates. They discovered that the lower the concentration of the market, the lower the interest rates. This therefore implies that competition is another factor that determines loan pricing in the financial markets, which in turn improves access to finance by lowering the cost of the capital.

Regardless of how different researchers define loan pricing, Hannagan (2004: 1), examines it from a risk management perspective. He shows that loan pricing gives an institution the ability to ensure coverage for the inherent costs of credit

risk associated with different risk grades of loans. This suggests that risk-adjusted loan pricing leads to improved risk management which is highly recommended by Basel II, as supported by Bledsoe, (2007: 1) who highlights that without a good pricing model it would be difficult to know the return. There are different methods that banks use in pricing loans. The next section will deal with methods or models that banks use in pricing loans.

2.6.2.1.1 Types of pricing methods/ models

Pricing of loans do differ from different sources of finance for reasons such as the sources of finance and the relevance of customer relationships with the bank (Repullo & Suarez, 2004: 3). In order for SMMEs in the lookout for debt financing, it is vital to understand what loan pricing to expect from the loans they may request from banks. Validation for this section is based on the previous research whereby a lot of results state that the high cost of bank loans prevent them (small businesses) from accessing debt finance, which ultimately impedes to their growth.

The following section observes the different factors that influence loan pricing. It is imperative to understand these factors in order to justify the rationale behind the prices of loans which are perceived by loan applicants as being high. Loan prices are based on costs, risk, product relationship and competition.

(a) Cost based loan pricing model

This simple model, according to Diette (2000: 1) and Njuguna (2008), is based on the assumption that the interest rate of any loan is a function of four components which are:

- The funding cost incurred by the bank to raise funds from the depositors through the money market facility;

- Operating costs of servicing the loan including appropriate repayment processing, bank's wages, salaries and other expenses, such as monitoring, statements and collections;
- Risk premium for compensation of bank's degree of commitment inherent in the loan request; and
- Profit margin provided by each individual loan made by the bank from its capital. Loans are priced based on all revenues associated with all revenues including the interest income and any fee-based income. All these revenues are spread over the life of the loan with the consideration of the amortisation.

Njuguna (2008: 6) further states that members invest their money in order that there must be a return on the investment. This return is also calculated in the loan price.

(b) Risk-based pricing model

Risk based pricing is the loan pricing strategy that is made in parallel to the expected loan risk. The riskiness of the loan is based on the credit risk of the borrower's ability to pay back, which predicts loan acceptance or rejection. The riskiness of the applicant determines the price of the loan should the application be accepted (King, 2007: 1). Should the bank perceive that the SMME has a high probability to default; the loan issued gets priced at a higher rate than for the firm with low probability to default. The risk adjusted rate is meant to compensate the lender for the possibility of default.

(c) Relationship-based pricing model

The prolonged relationship between the client and the bank plays a role in the availability of funds. This is because from the track record, banks are able to analyse the loan applicant. This ability gives the client a comparative advantage

over the other clients and hence minimises the risk factor of the loan applicant, implying a lower interest rate.

(d) Competition-based pricing model

Competition as a loan pricing function depends on the position of the bank in the market with regard to whether the bank is a price leader or price taker. Even though in the highly concentrated market the price leader sets the price, because the business loan market is highly competitive, the lowest price competitor usually drives down loan prices in the market (Basu & Rolfes, 1996: 128).

Farm Credit Act (FCA) exam manual, (2000) suggests that continued observation of competitors pricing of their loans is a good business practice, which is helpful in any bank's loan-pricing system. The essence of this is that the extent to which the competitive financial market operates varies between various types of lenders. These lenders have different rates across different loan products that are updated throughout the year (www.fca.gov). This theory highlights that if the market is not appropriately and timely monitored, pricing below market may prevail. The below market pricing may mean pricing deficiencies and unsafe and unsound practices for the bank.

(e) Asset-based pricing

Asset-based pricing is used to determine the price of the loan with incorporation of the liquidity of the asset pledged. The more liquid the asset is, the less the price of the loan, because the asset can be easily converted into cash should the default arise.

2.6.2.2 Credit scoring

Credit scoring is another tool used by banks to evaluate loans. This is the process of assigning a single quantitative measure or score to a potential borrower. Credit score is used to determine the future performance of the loan and to reflect a relative chance of default (Wall, 2004: 5; Frame et al. 2004: 37; Frame, Srinivasan & Woosley, 2001: 815; Feldman, 1997: 1). According to Estes (2006: 1), the use of credit scoring was long developed in 1958 by Bill Fair and Roger Isaac and was initially used to derive mathematical probability of a borrower to pay back the debt on time. The two founded the company called Fair Isaac Corporation and developed this credit scoring model. This process is predicted by five factors:

- Borrower's payment history;
- The level of outstanding debt;
- The length of credit history contained at the credit bureau;
- The number of credit inquiries on the report; and
- Types of credit present.

In order to accommodate small businesses in the lending market, Fair Isaac developed business credit scoring in 1995. Banks are still using the credit scoring model to make sound business lending decisions, where the higher the score the more favourable the decision will be for the business.

Frame et al. (2004: 37), highlight that credit scoring is an important loan evaluating tool. Firstly, because it helps financial services to determine the credit risk associated with a borrower. Secondly, it ensures the maximum profit and security from their loan portfolios. Credit scoring in addition to the above helps the lender to underwrite and monitor loans without actually meeting borrowers. Institutions that use credit scoring have a competitive advantage over others in small business lending. For example, Harrison (2009) cites Drechsel on reflecting that his company's ability to credit score its clients' customers on an individual basis, has made the company more competitive as the function is in high

demand (www.bnet.com). Lastly, the use of credit scoring can help banks lower underwriting costs and also improve accuracy of credit evaluation. Given the law of supply, the lower credit costs increase supply and hence lower prices for credit. On the other hand, the authors argue that banks that use traditional underwriting methods may increase costs leading to increased pressure on credit prices.

Similarly, Berger and Frame (2005: 7) discover from the study that the use of credit scoring in small business (SBCS) in the U.S. reduces costs which increase availability of credit from banks. The results further reveal that the reduction of costs increases credit availability when banks use small business credit scoring rather than the reduction in information opacity. Interestingly, the study shows that SBCS helps banks to have low-risk small business credits. This implies low loan price for SMMEs, an element of risk-based loan pricing.

2.6.2.3 Credit Assessment

Although credit scoring seems to be a perfect tool in determining the amount of the loan for which the business qualifies, it also helps to determine the payment period and the rate charged. Nonetheless, other researchers criticise this tool. The criticism is on the model of credit scoring because the model does not guarantee that the borrower will indeed pay back the loan. The researchers, therefore, propose credit assessment as the best instrument in the loan application process. Credit assessment involves some basic methodology of evaluating business and household cash flows (Jekwa, Whitfield & Kelly, 2007: 62; Enterprise Toronto, 2008).

2.6.3 Commercial banks of SA

Given these instruments and methods that the banks use in processing loans, the next section discusses the top four banks of SA that are engaged in small

business lending. The purpose of the discussion is to look at different programs and products offered by each of these banks in order to identify the role and financing gaps in the small business sector. These banks are: ABSA, FNB, Nedbank and Standard Bank. These banks dominate the banking industry in the country. According to Karani & Gantsho (2005: 211), SA's top banks (ABSA, FNB, Standard Bank and Nedbank) make 80% of the financial market and are said to be highly profitable in comparison with banks from other African countries. If SA big four make up 80% of the financial market it shows that the SA's financial market is highly concentrated.

The next section is based on the role of these SA's top banks on SMME financing.

2.6.3.1 ABSA

ABSA considers itself as one of the leading banks in the financing of SMMEs in SA. It claims that ABSA's New Enterprise Banking forms part of the ABSA Business Toolbox. This toolbox features all products and services that ABSA has to offer for starting, managing, expanding and protecting small businesses. The New Enterprise Banking assists entrepreneurs to access technical assistance through support programs. It also offers financial support where deemed necessary through credit guarantee schemes for people with insufficient security or collateral in order to qualify for business loans (ABSA, 2009).

The technical support programs that ABSA provide to small businesses comprise of:

- **Start-up Basic** which assists entrepreneurs on issues of starting a business, FAQs and business plan and online business skills program;
- **Considering a Business** booklet which is a booklet that highlights important issues around considering a business including warning signs to adhere in making decisions;

- **The Business Plan** that entrepreneurs create with ABSA's help for promotion and securing venture capital;
- **Your Business and Your Bank** that entails the bank's initiatives to help entrepreneurs understand the importance of having good relationships with their bank;
- **Principle of Finance** that addresses all aspects of financial administration and small business management;
- **Tax Guide** that helps an entrepreneur to master the tax return process efficiently;
- **Legal Issues Guide** is aimed at less informed business owner to be at the right side of the law; and
- **Cash Flow Program** is intended to assist SMMEs to effectively manage their cash flow.

In addition to these programs, ABSA has distinguished support programs for SMMEs: Mentorship, Credit Guarantee Scheme and After-Care programs.

(a) Mentorship Program

ABSA also offers a mentorship program as part of its initial relationship contract with small business entrepreneurs. This mentoring service is intended to provide the guidance and skill transfer to the entrepreneurs throughout the different stages of business growth. The program also assists small business owners in completing business plans and sourcing required information. Moreover, the mentoring services aid entrepreneurs in the business finance application from the bank. ABSA aims at creating a supportive and a developing environment to small businesses.

(b) Credit Guarantee Scheme

According to ABSA (2009), in assisting SMMEs to access finance, it provides finance to the deserving entrepreneur with the help of the Khula Guarantee

Scheme. In achieving this, the entrepreneur is expected to provide a viable business plan and loan application done with the assistance of the mentoring services. The completed documents are the New Enterprise Banker for initial assessment of the proposal after which documents are referred to ABSA's Credit department for approval. If the proposal is approved, it is then passed onto the bank's New Enterprise Banking department at ABSA's head office. This unit then makes a presentation to Khula Enterprise Limited on behalf of the entrepreneur for a credit guarantee. Should Khula approve the application, it provides the bank with the necessary security for the entrepreneur to qualify for the business loan. ABSA still expects the business owner to provide 10% of his or her own capital contribution to the business. Khula charges 3% plus value added tax per annum for the guarantee (ABSA, 2009). In this way, ABSA manages to assist SMMEs that would not necessarily access finance due to lack of collateral. Terblanche (2005: 1), denotes that the use of the Khula credit scheme is the biggest opportunity of getting a business loan approved.

(c) Aftercare program

Upon funding, ABSA appoints a New Business Banker or a mentor to do monthly visits to the business. The purpose of the visits is to monitor the progress of the business against the plan and to provide guidance where necessary (ABSA, 2009). This helps the small business to keep on track and the possibility of success is very high.

2.6.3.2 First National Bank (FNB)

The opportunity to venture into the small business market is also supported by the chief economist of Rand Merchant Bank (RMB), an FNB group member who indicated that SA's macro-economic environment in 2006 was increasingly favouring emerging entrepreneurs. According to the head of Solutions for New Business at FNB, the bank is aware of the difficulties associated with starting a

new business and the risk of failure. Nevertheless, FNB aims at nurturing and advancing small businesses in SA. This is the challenge the bank has set itself in finding ways to support small businesses to succeed. It is intending to achieve this aim by offering business related resources, services and products (Really Simple Syndication, 2006).

FNB had all along been focusing on small businesses not just start-ups through its business unit. Fortunately, the bank's executives realized that the start-up market was not being served. The main reasons behind this include insufficient collateral, high rates of business failures and lack of skills. To address the problem, the bank decided to launch a unit aiming specifically at start-ups that had been in operation for not more than two years. The unit was meant in addition to lending, to incorporate mentorship, business plan writing, legal assistance and the ability to draw cash flow projections which were deemed the basic needs for start-ups. Furthermore, with the help of research FNB discovered that entrepreneurs needed access to information, education and networking to meet likeminded people and potential entrepreneurial clients. These beyond-lending needs of start-up businesses were outside FNB's core business. Therefore, the bank identified some stakeholders to partner with (FNB's comprehensive Small Business Package, 2007). These strategic partners include Enterprise Support, Shelf Company, Khula, Umsobomvu Youth Fund and Enablis Fund as table 2.2 demonstrates.

Table 2.2 *FNB strategic partnerships in small business support*

Strategic Partner	Support
Shelf Company Warehouse	Company registration
Enterprise Support	Online business plan, cash projections, mentorship
Khula	Credit guarantee scheme
Umsobomvu Youth Fund/NYDA	Progress Youth Fund
Enablis Fund	Start-up finance

2.6.3.3 Nedbank

Nedbank Small Business Service helps small businesses with a banking and solution service. According to Nedbank, small business is any enterprise that has an annual turnover of between R150 000 and R7, 5 million. The bank aims to cater for the needs of small businesses from start-ups, franchising, professionals and established businesses. In achieving this developmental aim for small businesses, the bank commits itself to offer: firstly, specialized and competitively priced products and services to meet the specific needs of small businesses; secondly, it offers financing solutions structured for individual circumstances and needs. Thirdly, the bank provides value added services, such as mentorship and free business seminars. Lastly, Nedbank claims that it is committed to service efficiency and excellence (www.nedbank.co.za).

Nedbank claims that regardless of the financial need of the business, it (Nedbank) has the solution. This financial need can be in the form of: the capital to finance a business venture, the working capital for existing business expansion or the asset finance. The asset finance for Nedbank means acquiring vehicles, plant and machinery, including property. Nedbank also has an agreement with Khula to assist small businesses that lack adequate collateral to qualify for loans. Khula therefore provides credit guarantee schemes for these applicants.

2.6.3.4 Standard Bank of South Africa (SBSA)

Standard Bank offers loans like a business revolving credit loan plan for small businesses. These loans' repayments are made in equal monthly installments. On repayments the bank expects that only the interest on the amount used is payable. Furthermore, on condition that the borrower has paid 25% of the loan the same amount can be withdrawn again up to the original limit (Standard bank, 2009). This means that the SMME that has this facility with SBSA is able to

access finance at this time if necessary. Furthermore, SBSA, points-out that the loan can be linked electronically to the business account implying that funds can be accessed electronically. Moreover, the business owner can redraw funds without having to reapply with easy cash flow planning, because of the fixed monthly payments. Fixed monthly payments suggest that the business owner's cash flow is constant.

According to Standard Bank, if one needs business finance, one is required to provide:

1. A **business plan** that entails details such as the nature of the business, the business product, the market environment and the management skills; and
2. **Financial information** which incorporates:
   - Personal statement of assets and liabilities for all partners, members and directors;
   - Cash flow forecast;
   - Projected income and expenditure;
   - Amount and source of business owners' contribution or stake in the business;
   - How will the business use the finance? For example, capital expenditure or working capital; and
   - Sales and purchase budgets.

On the condition that the small business owner requires finance to purchase an **existing business,** the entrepreneur needs to provide the bank with:

- Copy of deed of sale or draft of deed; and
- Draft or signed lease agreement for premises.

In addition, the bank goes further to assess the small business on the details of the offered collateral and credit checks of the business and partners issued by the credit bureaus. In the case where the business has been banking with other banks, Standard Bank requires the:

- Financial statements of the business;

- Three months bank statements;
- A letter from the existing bank; and
- Details of collateral held by existing bankers.

All these are required by Standard Bank in order to access any of the following types of the products: Business Term loan, Medium Term loan, Business Mortgage and Guarantees.

(a) Business Term loan

Business term loans are short-term loans that are paid over a short period. These loans become longer term loans, because they can be renewed over and over. According to the American Bankers' Association, term loans have a maturity of one to three years used by small businesses for working capital. These loans can also be used to purchase assets or equipment used in the daily business operations, such as computer equipment used within one to three years. (www.bizfinance.about.com). Working capital is the money needed for daily operating of small businesses.

Standard Bank provides these types of loans because business term loans are a relatively simply way of securing funds. Standard Bank, however, provides business term loans for a period of up to eight years. Term loans may be used to purchase fixed assets, like property, equipment, refurbishments and alterations and acquiring a new business. While the minimum loan amount is R50 000, the maximum limit is dependent on what the applicant can afford to pay in equal installments. For this reason, there is no fixed repayment period. Periods differ for individuals, because they are determined by monthly repayments that incorporate capital and interest. Any additional deposits made above the agreed monthly repayments are, however, available for withdrawal subject to a minimum of R10 000 and in multiples of R1 000 (Standard Bank, 2009). This type of loan can assist the SMME to quickly reduce the loan, but at same time can be able to access funds should there be a need.

(b) Medium Term Loans

A medium Term loan is suitable for capital expenses that is payable in monthly installments over two to seven years. The amount of the loan depends on the value of the assets to be bought and collateral a client has. Standard Bank assists the entrepreneur by agreeing upon the repayment plan that suits the business and the cash flow. The interest charged is linked to prime. The bank furthermore claims that it will not call for repayments earlier than the terms agreed upon as long as the terms and conditions of the loan are met (Standard Bank, 2007).

(c) Business Mortgage

Business mortgage is meant to assist SMMEs purchase, extend or improve a residential property where a portion of the property is used for business purposes. SMMEs catered for here are such as Bed and Breakfasts (B & Bs) or guesthouses, Attorneys, Doctors and Accountants. One can borrow an amount between R100 000 and R10 million which can be repaid over a period of twenty years. The loan applicant can obtain the loan up to 80% of the property's assessed value. This can also be linked to one's Access bond facility, implying that the residential business property is financed as a home loan. Qualification for this loan is based on the properties zoned for business purposes with Consent Use from the local municipality. The consent use indicates that the greater portion of the property is for residential use.

(d) Guarantees

From Standard Bank's perspective, a guarantee or banker's guarantee is a written undertaking in which the bank agrees to make stipulated payments on behalf of the loan recipient. This is in the case where the client fails to fulfill or carry out the specified terms of the contract. Guarantees may also be issued for

the purchase of fixed property and against cash cover. The bank, however, takes the liability to pay the sum of money, but does not take responsibility for the completion of the contract. The party, to which the guarantee is issued, is entitled to specify the wording of the document. The bank, on the other hand, can draft the wording of the document on request of the client. This type of assistance helps the client firstly to avoid paying in advance or lodge cash cover to secure a purchase or contract. If the cash cover is lodged with the SBSA under pledge, the client is paid interest on the investment. Secondly, it helps the client to bid for contracts which call for guarantees and to buy fixed property which requires a guarantee (Standard Bank, 2009).

(e) Khula Guarantee Scheme

Khula guarantee scheme (detailed in chapter 3) is used to assist small businesses that do not have assets to put up as collateral for a bank loan. Khula indemnifies to the bank should the business fail to pay the loan. The indemnity value ranges between 50% and 90% of the bank loan. The maximum loan that can be approved under this scheme is R3 million. In order for a business to qualify for a Khula supported loan, the business should contribute at least 10% of the required amount. This contribution can be in the form of either cash or equipment that will be used in the business (Standard Bank, 2009).

Upon discussing different products programs by different banks to small businesses, the next section confers attention to the gaps in the credit finance market.

2.7 Gaps facing SMMEs in the credit financing arena

The institutional regulation of the financial industry is responsible for the way the banks work. Christianson (2003: 9), states that a large volume of research, including the National Treasury, agrees that financial markets are over-regulated.

The regulation which is based on guarding against risk and reckless lending by banks restricts banks from comprehensively serving risky markets, such as the SMME market. This challenge of regulation, impacts heavier on SMMEs than large businesses. Beck, (2007: 5) reports that access to finance is easier for large firms than for small firms. From his study carried out on 71 developing countries, 30% of large businesses use bank finance and only 12 % of small firms use bank credit. Moreover, a number of researchers, Dayal et al. (2008: 3), Beck (2007: 227), Claessens (2006), OECD (2006:130), Mensah (2004: 2) and Hashi (2001: 227) also agree that accessing finance from banks is difficult for SMMEs due to various reasons observed both from the supply side and demand side:

- Lack of acceptable collateral;
- High risk sector in terms of lending (with regard to failure rate);
- poor credit worthiness;
- High costs of credit;
- High costs of small loans;
- Short payment period;
- Poor saving and credit management culture;
- Poor entrepreneurship and inadequate skills;
- Information asymmetry and lack of track record;
- Lack of trust between entrepreneurs and investors;
- Limited margins for banks on small loan amounts; and
- Conservative nature of financial markets.

The conservative nature of financial markets is supported by the Basel II capital adequacy pillar three, based on credit risk management. Credit risk management is then the driving force behind banks' way of operation (Godbillon-Camus & Godlewski, 2005). In order to be responsive to the capital adequacy framework, banks use methods that help them minimise risk. From these methods or systems, various factors can result in limiting access to finance for SMMEs.

Factors, such as the use of credit assessment systems may fail start-ups as they may have limited or no credit history to prove them worthy and hence SMMEs are risky (Naim, 2008: 1; O'Brien, 2008: 4). Moreover, Godbillon-Camus & Godlewski (2005: 1), show that SMMEs are considered as the most opaque, because of lack of public information.

On the other hand, Wanjohi (2010) argues that credit finance is a challenge to SMMEs in Kenya because long term finance is not available. Lack of long term for SMMEs forces them to rely on high cost short term finance from banks. These high costs include: the cost of credit, high bank charges and fees. Due to these high costs, SMMEs are not able to make profits and hence cannot be competitive (www.buzzle.com).

Christianson (2003:10), however, mentions that the study participants believe that banks do not understand SMMEs market, because the interviewees complained that banks expected 'unreasonable' collateral. The participants further complained that short term finance was unavailable even with the support of guarantees from other financial institutions. In eight cases the interviewees mentioned that they had been granted overdraft facilities by banks. Two interviewees stated that although they could not get loans, they were granted unrequested overdraft facilities of R100 000 which they never used. Besides, the interviewees believe that their business plans were not a problem because they used the same business plan at other institutions, like IDC and got assisted.

2.8 Factors behind finance gaps

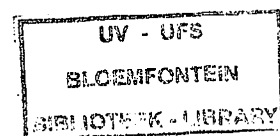
The financial gaps that have been identified above are dependent on distinctive factors that make access to finance difficult. These factors include: gender and age, educational or skills shortage, age, size of the bank and the size of the business as discussed in the next section.

2.8.1 Gender and age

Access to finance is often difficult for start-up SMMEs. Research shows that it becomes even more difficult for female owned businesses (FOBs) to access credit finance in comparison to their counterparts, male owned businesses (MOBs) (Kim, 2006: 370). Neithammer et al. (2007:6), for example show that in Pakistan 91% of large loans were borrowed to men with average sized loans issued to women at 8000 rupees, compared to 19 000 rupees to men. The authors, however, suggest that the reason behind this discrepancy rests with limited services by financial institutions to meet the needs of women entrepreneurs. Moreover, evidence suggests that in Pakistan, as is the case in most developing countries, women do not own land or business premises and often do not meet minimum lending requirements. Land and business premises can be used by banks as security against loans.

Women entrepreneurs are faced with challenges in seeking start up finance, credit schemes and investment capital. The main criticism for women's inability to access finance in Pakistan is based on the social norm in the country where it is unacceptable for women to interact with male bank professionals. Research shows that women face discrimination from bankers. For this reason they are shy to approach banks and because they lack collateral and viable business plans (Roomi, 2005: 7). This challenge of discrimination against women by bankers faces women entrepreneurs in SA as well. Nieman & Nieuwenhuizen (2009: 39), for example, cites Adhikary et al. (1999), in showing that women in SA lack finance for start-up and that the financial institutions readily criticize their business plans without offering directions and guidance.

In addition, proponents of this theory such as Rau (2006: 8) and Nwoye (2007: 172), further agree that women have limited access to finance due to their high levels of illiteracy and their inability to develop viable business plans. In South Africa, Ntsika Enterprise Promotion Agency in the last decade had indicated in its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workshops that women were faced with a lack of start-up finance. The basis for this was behind financial institutions' criticism against business plans by women without giving directions and guidance (Adhikary et al. 1999: 30). There is evidence that women still make as successful entrepreneurs as men despite their challenges with regard to sources of finance and support systems (Nieman & Nieuwenhuizen, 2009: 39).

Nevertheless, some researches show that there is no significant difference between availability of finance from banks and the gender of the credit finance applicant. Watson (2006: 9), for example, states that the mean score for loan approval by banks for male applicants is 3.84 and 3.83 for female loan applicants. The figures are generally the same, although the research sample for females was significantly smaller than for the male sample: n=13 (female) and n=52 (male). In support of this, another research by Vos et al. (2007: 2664), argue that there is no relationship between the owner of the firm's gender and the loan activity both in the UK and USA.

Age is another factor that has an influence on the availability of credit to the entrepreneur. In countries, such as South Africa's law of persons stipulates that a person under the age of 18 has contractual capacity limited to the support of a parent or legal guardian. This restriction means that anyone wishing to secure debt finance from the bank is disadvantaged if no guardian is willing to co-sign their surety. The implication is that young entrepreneurs have difficulty to access business finance directly from financial markets.

2.8.2 Educational/ skills shortage factors

The level of education of the loan applicant plays a crucial role in the decision making process. The level of education and business skill determines the ability of business management and hence business success. Unfortunately, due to limited business skills, emerging entrepreneurs do not keep proper records of the

business. Berger & Frame (2005: 1), maintain that information deficiency is the result of unavailable of audited financial statements by SMMEs. These scholars suggest that the audited financial statements yield credible financial information.

2.8.3 Size of the bank

Another element that has an impact on the availability of finance is the size of the bank. Some academics, for example, believe that larger more diversified banks, in particular interstate banks, have more advantage of risk sharing than small and less diversified banks, which make larger banks more accessible to small businesses (Demyanyk, Ostergaard and Sorensen, 2007: 2763; Jayaratne & Wolken, 1999: 429). Moreover the empirical study by Frame, Srinivasan and Woosley (2001: 814) further indicates that large banks tend to charge lower rates to small businesses and also less often than not require collateral and yet this can harm them as their overall costly relationship loan's volume is reduced through price and quantity rationing. In support of this, the Asian Development Bank (2008) states that small banks are accountable for the lack of access to finance to small businesses.

Inversely, Godbillon-Camus and Godlewski, (2005: 5) discovered that small businesses opt for small banks as sources of external finance. This is in order to reduce credit rationing, given small banks' super capacity around bank-borrower long term relationships. Again, while large banks are more accessible to SMMEs in developed countries, it may not necessarily be the case in developing countries. In Nigeria, for instance, the opposite has proved to be true. From the study that was done on the static and dynamic effect of bank merger and acquisition on small business lending, the results showed that there was a negative relationship between merged banks and their lending to small business. The results show that for every 1% increase in the market share, the lending for small business fell by 6,694.76 naira (Nigerian currency). On contrary, for unmerged banks an additional unit of naira in the bank gross total asset, loans to

small businesses increased by 47000.00 naira. In addition, for every one unit increase in the ratio of equity to gross total asset, small business lending increased by 300,457.20 naira. (Emine & Okafor, 2008: 150).

The principle of behavioural finance holds that diversification minimises portfolio risk (Mpofu et al. 2008: 247). In this study risk is associated with credit. The larger the number of deposits, the more business lending increases, regardless of the actual size of the banks. Therefore, in bank credit the more diverse the bank becomes in deposit terms, the more accessible it becomes for small business financing.

2.8.4 Size of the business

The size of the business also influences the accessibility to credit finance. Small businesses struggle more to get finance than large businesses. According to Msimang (2005: 28), banks have left some gaps in the development finance because mostly start-up SMMEs are left out. CDE (2004: 53) argues that making loans to micro enterprise is enormously costly for the bank compared to the actual size of the loan. Nonetheless, CDE appreciates that making loans to small businesses and medium enterprises can still be profitable if more caution is taken with those SMME. The prudence that needs to be made here is with regard to an acceptable credit history, sufficient collateral and access to credit.

2.9 Conclusion

Various financing gaps facing SMMEs imply that acquiring finance from banks is with limited success. Nevertheless, the quality and the yield of the loan portfolio of any bank are heavily influenced by the regulation it faces. While the regulation and risk management principles may be responsible for all the criticism behind banks way of operation, banks still carry the blame of not being willing to assist SMMEs especially new entrants. Nonetheless, it needs to be understood that

banks like any business have to minimise and manage their risk and mostly they need to be profitable. Although financing gaps still prevails in SA, banks are increasingly considering and attending to the needs of SMMEs. They achieve this through introducing some innovative financing schemes and programs to assist their entrepreneurial clients.

If this is as far as the banks can go from a private sector point of view, then government must take its own role from the public sector's point of view in the SMMEs financing arena. To be effective in this the government must be able to target the gaps identified in this chapter. In the next chapter, therefore, the SA government's intervention regarding development finance for SMMEs will be discussed.

CHAPTER 3

3.0 Government Intervention: Operations by development financing institutions in SMMEs financing

3.1 Introduction

In addressing poverty and unemployment reduction, the SMME sector had been noted as being crucial to give attention to the development of this sector. Inability for SMMEs to outsource business finance from commercial banks due to the identified gaps and factors responsible for these gaps creates the platform for the government to intervene. Vanhanen (2007:10), states that more public funding is needed to boost and develop the SMME sector. Vanhanen further discovered that overcoming the challenges of the seed capital could help to create economies of scale and attract investors. The government intervention efficiency will be realised if it addresses these gaps in assisting SMMEs to exploit their full potential.

To be efficient the SA government needs to intervene by addressing these gaps as they were identified in chapter two. Therefore this chapter observes the role played by the government of SA in providing developmental finance through its subsidiaries and development finance institutions (DFIs). Their distinctive operations will be elicited in order to understand their roles in SMMEs' development and also to observe which gaps they aim to fill. These government development financing institutions that are available for SMMEs in the Free State are: Khula, FDC, IDC, SAMAF, NEF and NYDA/ UYF.

The following sections therefore discuss each of these institutions in detail and the products offered by each of them. The Land Bank is, however, not part of the discussion, because the bank has been disbanded and is under reconstruction

when the current study is carried out. Therefore all the information that was available is void. Only Khula Enterprise Limited, FDC, IDC, NEF, NYDA and SAMAF are dealt with in the following sections.

3.2 Khula Enterprise Limited

According to DTI (2005), Khula Enterprise Limited is a limited liability company with DTI as a major shareholder. Its mandate is to facilitate loan and equity capital to small, medium and micro enterprises. Khula (2007), states that as a wholesale finance institution, it is dedicated to the development and sustainability of small business enterprises in South Africa. It further claims that as a complementary financial institution, its main objective is to bridge the funding gap in the SMME market that is not catered for by the commercial banks. Therefore the role played by Khula in the SMME credit financing arena is to provide a credit guarantee where the loan applicant cannot provide collateral to a bank or any other partnering financial institution. This role by Khula is to remain for the unforeseeable future for as long as collateral remains the requirement of banks. This statement is confirmed by the Minister of DTI in his call for broader economic participation that Khula will remain the provider of financial support to the under-serviced market (Bua News, 2009). This ministerial call implies that to date, Khula is still entrusted to service the under-served SMME credit market.

Khula achieves its objective through a network of channels to supply much needed funding to small businesses. The network channels of Khula include retail financial institutions, South Africa's leading commercial banks (Standard bank, ABSA, Nedbank and FNB), specialist fund and joint ventures where Khula is a participant (Khula, 2007). In all its networks Khula provides a guarantee to partnering financial institutions serving the SMME market. When Khula started the guarantee scheme operation, the bank and Khula risk sharing ratio was 40: 60 which banks felt that risks were still high. Therefore banks proposed the new

arrangement: 20: 80, implying that the banks are exposed to a lesser risk of 20% than the initial 40% (Nigrini & Schoombee, 2002: 743).

3.2.1 Use of credit guarantee schemes

The guarantee scheme is an indemnity that is used to secure the bank loan for the SMME with no collateral (Khula, 2007). In addition to this definition by Khula, Oh et al. (2009: 335) indicate that the purpose of the guarantee scheme is to provide financial support to small businesses that lack sufficient investment from private financial institutions due to market failures and lack of collateral. The scholars further show that guarantee schemes help to increase accessibility to private finance and to enhance the competitiveness of the SMMEs. Most importantly, the scholars state that guarantee helps reduce the risks of lending to SMMEs.

In chapter 2, it was noted that the main driving force for the low success rate of the supply of finance to small businesses by banks was associated with the risk factor of lending to SMME sector. Guarantees are therefore used to share the risk between the bank and the guarantee institution in an agreed ratio. In this way bank's risk and operation costs are lower while at the same time its returns are increased (Nigrini & Schoombee, 2002: 734). In the process banks are encouraged to participate more in SMMEs lending than otherwise. To minimise their risk banks expect the borrower to provide collateral in the form of a fixed asset or machinery which in most cases SMMEs in developing countries, including SA do not have. While in South Africa the risk is shared between the bank and the government through its agency, Khula, in Japan, on the other hand, the government covers 100% of the loan and the bank does not incur any risk (Nilcox &Yasund, 2008: 7).

Therefore, lack of collateral is one of the stumbling blocks that disqualify borrowers from obtaining finance from the bank. Guarantee schemes help

alleviate the collateral problem through which governments participate in the SMME financing challenge. In different countries, governments have made an effort to step in support of SMMEs through guarantee schemes. In Ghana, for example, the guarantee scheme was introduced in 2001 (Mensah, 2004: 4). In Japan, the use of guarantee schemes was established in 1937 with its public status backed by Japanese central government conferred in 1953 through the Credit Guarantee Corporation Law (Nilcox & Yasund, 2008: 7). In South Africa, the use of the credit guarantee came with establishment of DFIs in 1996.

Khula offers a range of financial resources and information to the public. Khula's operations on financial services are either through loans or credit guarantees. These products or programs offered by Khula, as illustrated in figure 3.1, are: Loans for Retail Finance Intermediaries, Emerging Entrepreneur Scheme, Equity Fund, Individual Guarantee Scheme, The Empowerment Scheme, The Portfolio Guarantee Scheme and the Land Reform Empowerment Facility.

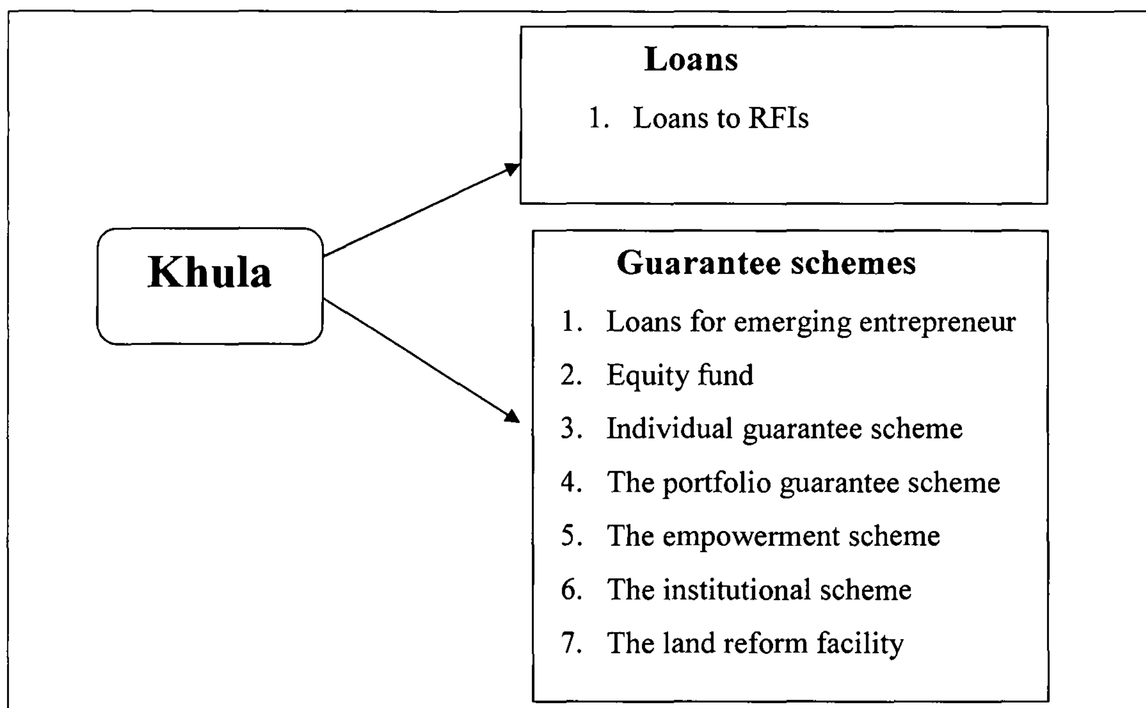

Figure 3.1 Khula's lending model

Each of these Khula's products will be discussed in the next sections.

(a) Loans for Retail Finance Intermediaries (RFIs)

Retail finance Intermediaries' loans are used to provide business loans to RFIs for on-lending to SMMEs. RFI are non-bank independent institutions Khula lends money to on a wholesale basis. Their objectives are to provide:

- A funding to SMMEs that would otherwise not be able to access finance from commercial banks;
- Khula with a vehicle of facilitating access to finance to previously non-bankable SMMEs operating in rural areas; and
- Financing solutions to SMMEs operating in niche markets where traditional financial services would otherwise not be available.

Khula's loans are used to assist both less experienced RFIs and experienced RFIs. Loans for less experienced RFIs range from R1 million to R10 million. Similarly loan amounts for experienced RFIs range from R5 million to R100 million.

In order to access these loans, both experienced and less experienced RFIs must meet Khula's development and institutional criteria. Khula expects less experienced RFIs to be able to demonstrate credible plans for operations, management and credit policy. A less experienced RFI has to give a clear indication of operating sustainability within 60 months or five years. Similarly, for experienced RFIs, Khula expects that RFIs must be able to self-fund the envisaged program for at least the first two months of implementation. The RFIs must provide the three year projections that indicate operational sustainability. In addition, the projections must show at least five year financial sustainability (Khula, 2007).

(b) Loans for Emerging Entrepreneur Scheme

The purpose of this type of loans is to increase access to finance for SMMEs through banks. These loans are intended for individually owned SMMEs with assets less than R12 million before financing. This scheme is intended to assist and enable entrepreneurs to access funding from their bankers in order to establish, expand or for acquisition of a new or existing business. The maximum indemnity is 60- 70 % of the loan with a maximum facility of R75 000. SMMEs must, however, meet bank lending criteria.

(c) Equity Fund

Equity fund is used to finance joint ventures, expansions to existing businesses, recapitalisation of companies and also for buying out existing shareholders. Criteria for accessibility is SMMEs that have net asset value of not less than R500 000. Applicants of this finance must be able to demonstrate that they are viable in the medium term to long term. They also need to demonstrate that the investors can anticipate an adequate rate of return.

(d) Individual Guarantee Scheme

Like loans for emerging entrepreneurs, the individual guarantee scheme is intended to increase access to finance for SMMEs through banks. Khula uses this type of finance to assist SMMEs that require bank finance, but do not have collateral or security. In applying, the entrepreneur approaches the participating bank of own choice with a business plan. The entrepreneur needs to inform the bank if he or she does not have enough collateral or security. The bank then, approaches Khula for an indemnity on behalf of the entrepreneur.

This guarantee scheme is to be used by SMMEs for the establishment of businesses. SMMEs can also use this option for financing expansion or acquisition of existing businesses. An individual must

- Be able to repay the bank facility;
- Prove to have entrepreneurship skills and experience directly related to the business; and
- Provide own financial contribution towards start-up or expansion of the business.

The guarantee covers 80% of the loan and the maximum facility is R1 million for up to five years. The bank is responsible for collection of instalments for the duration of the loan.

(e) The Portfolio Guarantee Scheme

Khula uses the portfolio guarantee scheme to provide a comprehensive guarantee to a financier. This is done to enable the financier to avail funding to a similar class of SMMEs. There is no specific limit to this guarantee of the amount of this scheme; the cover depends on the risk of the applicant. The maximum term of the scheme is, however, five years covering between 50% and 80% of the total loan (Khula, 2007).

(f) The Empowerment Scheme

The empowerment scheme is another indemnity used to increase access to bank finance for small businesses. This is provided for SMMEs that do not have collateral required by commercial banks. The bank approaches Khula for a guarantee scheme on condition that the entrepreneur qualifies for a bank loan but lacks collateral. The maximum amount on this scheme is R5 million which covers 60% of the loan amount for a period of five years.

(g) The Institutional Guarantee Scheme

This scheme's objective is to provide a guarantee to a financial institution that services a lending institution. This lending institution in turn provides finance to small businesses. The guarantee limit is dependent on the risk associated with the lending institution. The time limit of the cover is five years.

(h) Land Reform Empowerment Facility

In an effort to assist agriculture and eco-tourism projects, Khula provides wholesale loans to commercial banks at concessionary terms. Banks lend out to eligible projects demonstrating an empowerment impact. This facility is in terms of mortgage and equity-share to a ceiling of R600 000 for the participating beneficiary and R400 000 per partner for equity-share projects.

According to Khula's Handbook, the support programs available for small businesses are credit guarantee schemes and nonfinancial support services. An entrepreneur is assisted with the drawing up of a business plan. Khula then facilitates access to finance for people who wish to start a small business to medium–sized business and who do not have collateral to secure a bank loan. The maximum Khula can guarantee is 80% of the loan. After assisting their client with a guarantee scheme, a mentor is appointed to offer aftercare service to improve the business that has been assisted. The business owner must, however, contribute at least 10% of the loan and must have a clean financial record.

Khula seems to address the lack of collateral gap which banks consider as one of the requirements of issuing business loans.

3.3 South African Micro Apex Fund (SAMAF)

SAMAF is another development finance company that has been established by the government. It was launched by the DTI in 2006 to build a vibrant microfinance industry in SA. The reason for this was to contribute to economic growth and poverty alleviation. Therefore it is mandated to address poverty and unemployment through provision of affordable finance access to financial services, institutional and client capacity building and savings mobilisation (DTI, 2005: 19). The South African Yearbook (2006/2007: 178) further indicates that SAMAF was established to provide affordable and sustainable access to finance for the poor South Africans.

This fund works through partnership with other organisations to carry out its mandate of reaching even the people from previously disadvantaged communities. Partnering with other organisations helps SAMAF in its outreach program that aims to target and have an impact on all local levels. Therefore it states that its choice of partners is crucial and ongoing. The types of organisational partners include but are not limited to the registered NGOs and local entrepreneurial agencies which are selected using standard criteria. The organisational partner selection guidelines incorporate:

- organisation;
- organiser;
- management;
- governance;
- human resources;
- working area;
- field activities;
- past performance; and
- management information and accounting systems

The fund offers three main products as demonstrated in figure 3.2 being: Micro Credit Loan Fund, Institutional Capacity Building and Savings Mobilisation which are discussed in the next sections.

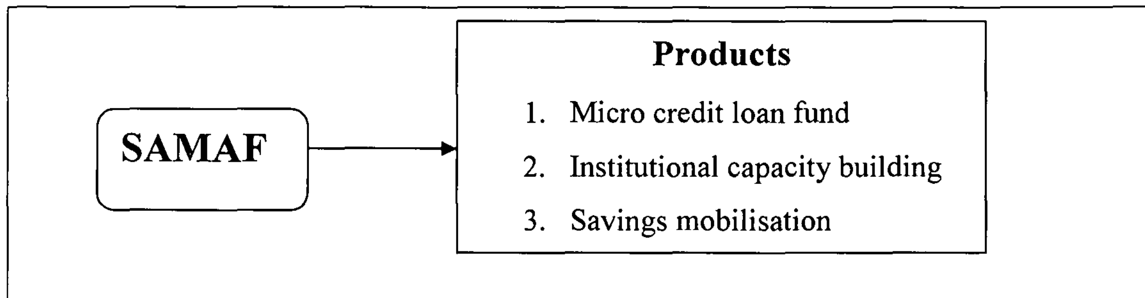

Figure 3.2 SAMAF funding model

(a) Micro Credit Loan Fund (MCLF)

MCLF program provides finance for loans of up to R10 000 to households. This is also offered to micro entrepreneurs who depend on their micro enterprises for their livelihood. Under this fund there are two products:

- Micro credit for micro enterprise development; and
- Poverty alleviation for clients whose households' income is less than R1 500.

This indicates that should the entrepreneur own a small business, he is eligible to borrow up to R10 000 towards the development of the business. Likewise, the household with income not exceeding R1 500 per month also qualifies for a loan of up to R 10 000 from MCLF.

(b) Institutional Capacity Building

This program provides funds in order to empower and strengthen the performance of the co-operative. The program entails management training and workshops the co-operative personnel. The program also drives to ensure the co-operative's long term sustainability, (DTI, 2005).

(d) Savings Mobilisation

The purpose of this program is to promote and encourage the creation of financial co-operatives. The program also incorporates other indigenous savings establishments, such as stockvels and burial societies for the accumulation of locally owned and invested wealth (DTI, 2005: 19). In a community there are, for example, groups of people saving together in stockvels or burial societies, these groups can create their own co-operative bank where money can be saved and accessed easily as the members know each other.

3.4 Industrial Development Corporation (IDC)

IDC is self financing DFI which was established in 1940 as a state-owned development finance institution. IDC is primarily aiming at contributing to sustainable economic growth in Africa. The institution also promotes the economic empowerment prosperity of all South Africans. In promoting economic propensity, IDC promotes entrepreneurs by the building of competitive industries and enterprises based on sound business principles (IDC, 2006).

Nieman & Nieuwenhuizen, (2009: 204) highlight the following core strategies of IDC:

- Maintaining financial independence;
- Providing risk capital to widest range of industrial projects;
- Serving areas not yet addressed by the market;
- Empowering new entrants of entrepreneurship market and medium- sized manufacturing businesses;
- Developing and investing in diverse human capital; and
- Promoting global involvement in partnerships rooted in and for the benefit of SA and the rest of Africa.

IDC aligns itself with the goals of the "Shared and Accelerated Growth Initiative of South Africa" (ASGISA). IDC provides financing that stimulates job creation, investment activities and economic growth. IDC, for example, reports a remarkable job creation of 6.65 jobs for every R1 million invested in SMMEs' financing and only 2.74 jobs created per R1 million invested in other sectors (IDC Report, 2008). This evidence shows that by investing in SMMEs, IDC is more fruitful. It may be argued that more jobs are created from investment in SMMEs, because IDC claims that this small business sector constitutes the majority of the institution's clients. In 2004, for example, 73% of IDC's approved loans were for SMMEs, implying therefore that only 27% of loans were invested elsewhere. IDC considers SMME sector as crucial element of a developing country, hence the justification for more investment in the sector.

IDC (2008), states that because it fully supports government's Black Economic Empowerment (BEE), in considering funding applications, the assessment for each project covers the project's ability to meet these BEE requirements:

- Job creation;
- Urban renewal;
- Rural development;
- The empowerment of women;
- Poverty alleviation;
- Skills development;
- Education; and
- Access to finance for wealth creation.

For its involvement with BEE, IDC won four awards in 2007 at the Business Map Business Report BEE Awards.

IDC's main program as discussed below is transformation and entrepreneurship scheme which provides different funding schemes.

(a) Transformation and entrepreneurship scheme

This is a financing scheme aimed at entrepreneurs from previously disadvantaged groups in SA: women, people with disabilities, worker and community groupings. IDC's funding model as shown in figure 3.3 targets at these groups of people. This institution has been established to assist these people with access to finance to develop or grow their businesses. IDC considers this scheme to be a catalyst for the development of business opportunities by providing capital for start-up, expansion and acquisition of businesses. It is expected to run for a period of seven years from 2008 (IDC, 2008). The scheme consists of the following five forms funds:

- Women's entrepreneurial fund to the value of R400 million;
- Equity contribution valued at R150 million;
- People with disability fund of R50 million; and
- Development Fund for workers to the value of R250 million.

From the above programs the minority gaps are addressed. Since the element of collateral can be high for this group from banks, therefore IDC is positioned and established to target the group.

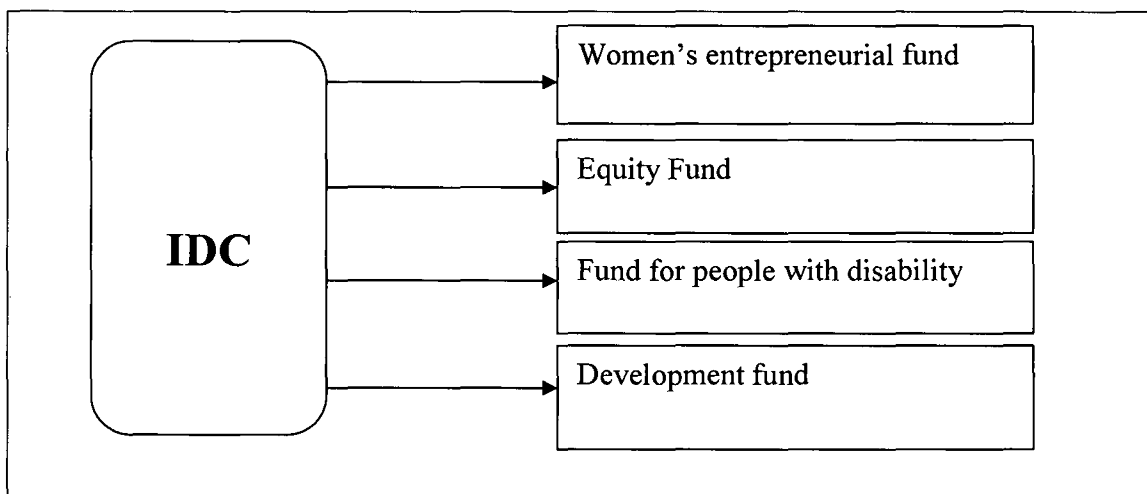

Figure 3.3 *IDC's funding model*

3.5 National Empowerment Fund (NEF)

This is a government set-up agency that was established to provide capital for black economic empowerment transactions. It was established in 1998 by the National Empowerment Fund Act No. 105 of 1998. As another agency of the DTI established to redress the post 1994 inequalities, it is mandated to:

- Promote a better universal understanding of equity ownership through promoting a competitive and efficient economy capable of generating employment opportunities;
- Provide historically disadvantaged people (HDPs) with opportunities to acquire shares in restructured state-owned assets and private enterprises;
- Encourage the culture of saving and investment among HDPs and foster entrepreneurship; and
- Achieve its goals of sustainable empowerment and transformation by developing business ventures pioneered and run by HDPs (DTI, 2005: 33).

Because NEF supports the BBEEE Strategy and related scorecards, it funds HDPs that want to start their own businesses, existing ones that aim to expand and HDP wishing to acquire shares in existing white-owned enterprises (DTI, 2005: 33). NEF states that it does not function as a bank and cannot compete with other DFIs, so its stands up to:

- Ensuring consistency of application of various charter scorecards across industries;
- Facilitating transformation in targeted areas and sectors in the economy;
- Facilitating additional funding from other by leveraging HDPs funding; and
- Offering rural and community development support programs that to assist communities to acquire shares in projects that generate income for social up-liftment.

Products offered by NEF in support of SMMEs include: Entrepreneurial Support and Rural and Community Support as shown in figure 3.3.

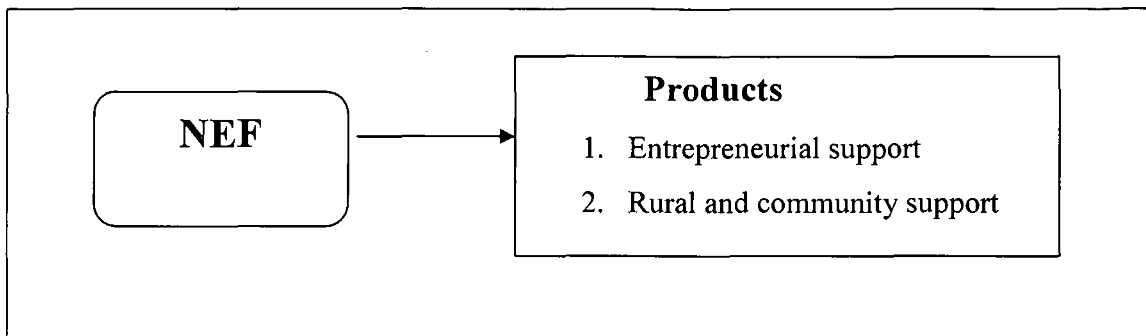

Figure 3.4 *NEF funding model*

(a) Entrepreneurial Support

Entrepreneurial support offers three types of funding programs for SMMEs depending on the amount the business requires and the stage of the business cycle the business is in. These programs include generator, accelerator and transformer as table 3.1 below demonstrates.

Table 3.1 *types of Entrepreneurial support loans*

Product	Amount	Purpose
Generator	R250 000 – R1 million	For start-up and early stage business
Accelerator	R1 million to R3 million	For business expansion
Transformer	R3million to R10 million	For transforming Businesses into BEE entities

(b) Rural and community support

The rural and community development projects facilitate community involvement projects that promote social and economic upliftment. The program supports the BBBEE Act, therefore aims to increase the extent to which the workers, co-operatives and other collective enterprises own and manage businesses. This product enables communities to acquire shares in income generating projects in historically marginalised economic areas.

Priority is given to or will be given to the legally operating enterprises. Moreover, in order for the fund to be effective, NEF expects the HDP to be assumed to be really risky. The HDPs must, however, demonstrate a contribution to the enterprise either financially or otherwise. Potential for survival, prosperity and sustainability earns more consideration by NEF (DTI, 2005).

3.6 Free State Development Corporation (FDC)

The Free State Development Corporation is a statutory organisation established in terms of the Free State Development Corporation Amendment Act 4 of 2006. It is mandated to establish and develop sustainable SMMEs in the Free State by providing both financial and non-financial services (FDC, 2007).

FDC aims at achieving the provincial growth and developing the strategic goal of promoting sustainable economic development. Although it issues finance to only qualifying entrepreneurs, does not however give distinction to "the qualifying". FDC maintains that its activities for the period 2007/2008 targeted on supporting the SMMEs owned wholly or partially by women, youth and people with disabilities. FDC in its 2007-2014 corporate plan aims to reduce the current unemployment in the Free State which is recorded to be 38.5% to 20% by 2014 (FDC, 2007).

FDC is determined to at address finance gaps brought by gender and age factors by targeting to serve these markets. It also assists businesses that lack collateral by taking equity if there is an implication of potential for growth and profitability in the business. FDC claims that it offers business subsidies for tailored services such as rent rates for emerging entrepreneurs. The businesses that FDC aims to assist include manufacturing, franchising, retail, mineral beneficiation, tourism and agro-processing. This institution provides three types of the loans for start-up capital, expansion capital and bridging capital to small business in the Free State that are exemplified in following figure 3.2

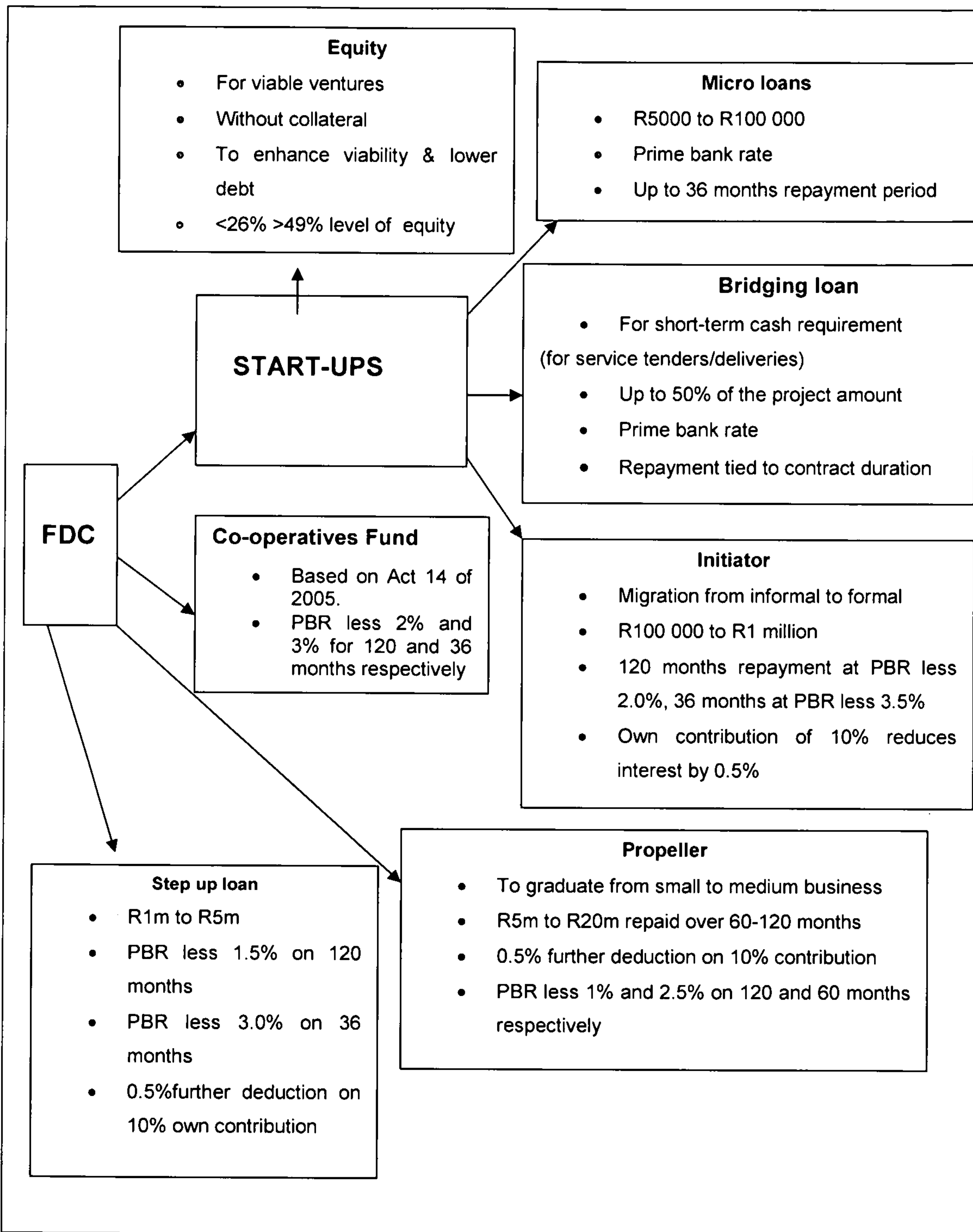

Figure 3.5 *FDC lending model*

There are micro loans with the minimum value of R5000 and maximum of R20000. The interest rate on these loans is linked to the prime bank rate less 3.5% with the repayment period of up to 36 months (FDC, 2007).

3.7 Umsobomvu Youth Fund (UYF)/ National Development Youth Agency (NYDA)

The challenges facing young people, such as unemployment and underemployment are the problems facing the world. According to the World Youth Report (WYR), (2005) Western Asia, followed by North Africa and sub-Saharan Africa have the largest number of young people who live below the poverty line. The report notes that over 200 million youth live below one dollar per day and about 515 million young people live below two dollars per day. The WYR (2005), shows that the problems have worsened since the recent global recession which has affected the developing countries even more seriously than developed countries.

The report further indicates that due to the economic slow-down, the influx of youth into the employment markets has brought with it acute problems in some countries. This report is backed by the International Labour Organisation that states that more than 100 million new jobs would have to be created in the next twenty years. This job creation is to be created to provide suitable employment for the growing numbers of youth including girls, young women and people living with disabilities in the economically active populations of the developing countries. The United Nations Report (2005) also recommends that with funds designated to promote youth employment, governments should designate resources for programs supporting the efforts of young women and youth with disabilities (UN Report, 2005).

In response to calls such as the above UN's report, The South African government then launched Umsobomvu Youth Fund (UYF). Umsobomvu Youth

Fund is the fund that was established in 2001 to address the needs of the South African youth (18-35 years old) and women who are seeking self-employment opportunities or a business ownership. Umsobomvu launched its new name National Youth Development Agency (NYDA) on the 16th June, 2009. This name came as result of a combination of two arms of youth bodies: Umsobomvu Youth Fund and Youth Commission of SA. According to Ramatlabana (2009), the North West Premier, the provincial government will continue to economically empower the young people by providing opportunities for the youth. The premier added that the provincial government will continue to ensure that it supports youth-owned small businesses and to make sure that youth benefit from government contracts by being represented in their procurement services.

NYDA has various programs that are aimed at facilitating access to finance for the young people of South Africa. The financing programs offered by UYF/NYDA are: Enterprise Finance (micro loans), Masisizane Women Enterprise Fund and Youth Progressive Fund, which are demonstrated in figure 3..

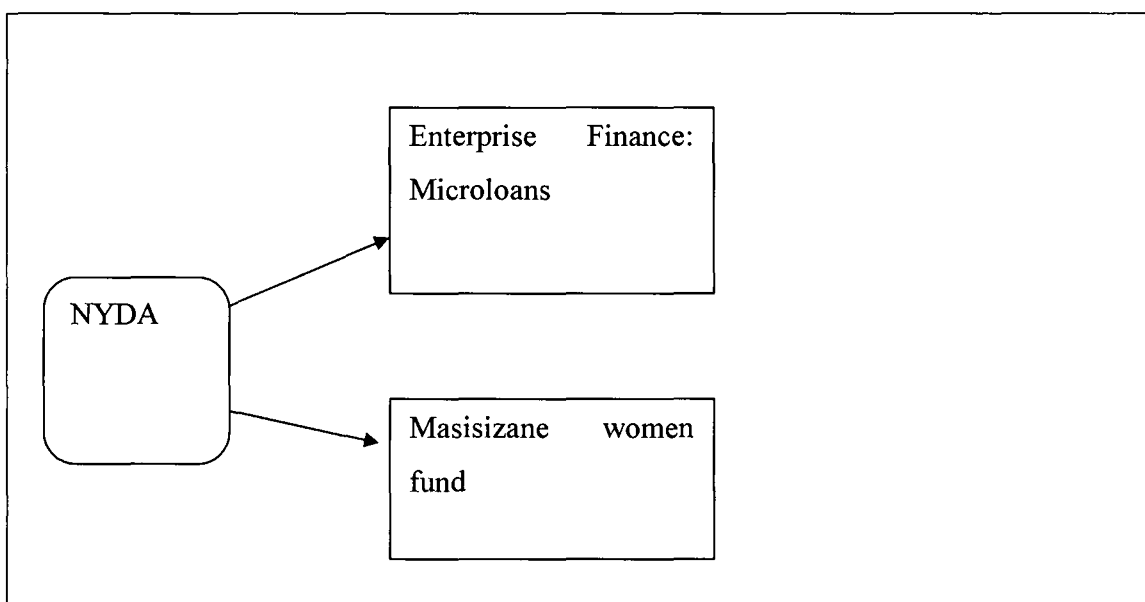

Figure 3.6 *UYF/NYDA funding model*

(a) Enterprise Finance: Micro loans

The aim of providing micro loans is to promote entrepreneurship among young people by providing financing for start-up businesses or for growing existing businesses. This type of financing is aimed at the black South African youth who want to be or are in businesses. The loan is structured according to the amount of finance required, affordability indicators and type of required finance, such as working capital, asset finance or contract-based finance (UYF, 2009).

(b) Masisizane Women Fund

The Masisizane Women Fund is a joint fund between UYF and Old Mutual Fund to the value of R200 million. The purpose of this fund is to advance women-owned enterprises. The role played by the sponsors of the fund is in such a way that UYF's enterprise team manages the fund with the complement from UYF's Business Development Services and Mentorship Programs. Old Mutual on the other hand provides free financial education to the entrepreneurs.

3.8 Conclusion

The current chapter was based on how the government of South Africa in the Free State intervened in filling the financial gap left by banks in the SMME market. This intervention was made possible through highlighting the different roles of the DFIs in the development financing of SMMEs. The chapter also highlighted the different products that each of the DFIs offer in support of SMMEs. Only the government financing institutions that are available for SMMEs/SMMEs in the Free State have been dealt with. In the next chapter the methodology that was employed in this study is discussed.

CHAPTER 4

4.0 Research Design and Methodology

4.1 Introduction

In chapter 1, it was indicated that this study is based on qualitative methods. The study is working on the phenomenon of credit financing for SMMEs in the Free State Province. The understanding and interpretation of those dealing with the phenomenon in their everyday lives form the basis for the study. While quantitative studies aim at classifying features, counting and constructing statistical models to explain what is studied, qualitative studies aim to analyse complete detailed description of the content. Qualitative research is therefore better based on content analysis than in numerical tables and statistics (Miles & Huberman, 1994: 40). In has been highlighted in section 1.4.2: 9 that qualitative research has basis on the literature studies. This research also has the foundation in the literature in order to review and to examine the phenomenon.

This study is based on the phenomenon of "credit financing of SMMEs". Creswell (1998: 51) as cited by Fouche (2005: 270), describes phenomenological study as the study that describes the meaning of the experience the topic or concept has for various individuals. He further explains that the researcher eventually reduces the experiences to a central meaning and the product of the research is the description of the essence of the experiences being studied. This is achieved by analysing the conversation and interaction that the researcher has with the subjects. Moreover, the scholarship indicates that the researchers using this interpretive inquiry identify multiple of individuals (participants) who deal with the particular phenomenon. Mainly this design utilises interviews as methods of data collection. Therefore an interpretive approach was found to be the most applicable methodology to use in the current study.

This chapter outlines the structure of the empirical study. It provides a description of the participants, an explanation of the measurement instruments, an explanation of the method used to collect data and the approach used to analyse the data. A purposive sample was drawn from the population of Investment Managers of the DFIs and Heads of Small Business Units of the four banks in the Free State (cf 1.4.2.1:6) who are engaged in the development of businesses, who therefore have direct contact with loan request from SMMEs. McMillan & Schumacher (2001: 74), indicate that the researcher becomes immersed in the situation and phenomena studied. This validates the researcher's involvement in the study based on the experiences.

The aim of this chapter is to describe the methods by which the study was conducted. It gives the details of qualitative methods as they apply to the study. It also provides a description of the participants (sample) and an explanation of the measurement instruments. The chapter also gives a description of the methods used to collect data based on their validity and reliability and the approach used to analyse the data.

4.2 The Role of the Literature Review

The literature review was done in chapter two and three respectively. The purpose of literature or theoretical study is to review and discuss the most relevant and appropriate theories, definitions and models of a phenomenon under inquiry. The literature review forms the theoretical framework for the empirical study (Mouton, 2009: 92). Similarly, in the current study the aim is to explain the meaning of the concept of credit financing within the context of SMME development and support systems.

According to Kumar (2005: 30), the literature review has four most important functions; it helps to:

- Bring clarity and focus to the research problem;

- Improve research methodology;
- Broaden knowledge base of the research area; and
- Contextualise the findings.

Based on these, the literature review has firstly helped the researcher to understand the relationship between the research problem and the body of knowledge in the area of SMME credit financing. Secondly, it has helped to identify from other researchers the methods and procedures used in investigating similar research questions to the one investigated here, those that have worked well and those where problems were encountered. Upon knowledge of these pitfalls the researcher was in a position to select the method that was capable of providing valid answers to the research question. In addition the researcher is confident in defending the use of the methodology used in this study (**validity**).

Thirdly, the literature review has broadened the knowledge base of the researcher to be able to identify the gaps and how the current findings will fit into the existing body of knowledge. Lastly, upon fitting into the existing knowledge, literature also helps in comparing current answers with what others have found in order to identify how the study contributes to the knowledge. Continued referral to the literature review helped in distinguishing the current study from others without compromising the importance of placing the findings in context of what is already known in the field.

4.3 Empirical Study

The empirical study consists mainly of qualitative research methodology. These methods include sampling methods, data collection techniques and methods of analysis. This approach (qualitative) differs from the quantitative approach because it focuses on the process and not the outcome of the behaviour. The participants' perspective is emphasised. Most importantly qualitative research aims to understand social action in terms of its specific context (idiographic motive) rather than attempting to generalise some theoretical population (Babbie

& Mouton, 2001: 270). These scholars further distinguish qualitative from quantitative research by indicating that the interest of the idiographic strategy of qualitative study is to understand the particular and specific event or case within its own context. Inversely, the nomothetic strategy of quantitative study aims at generalising the regularities of laws of human behaviour from the larger population. Therefore, because this research is not quantitative, it does not generalise the regularities of human behaviour from a larger sample. Instead, it is aimed at understanding the case of credit financing within its own context.

The research problem was approached from an interpretive perspective. According to Henning, van Rensburg & Smit (2009:21), interpretive research paradigm emphasises on experience and interpretation. Interpretive research is fundamentally based on the meaning and understanding of members' definition of situations. Therefore qualitative methodology was chosen for a number of reasons: respondents' perspectives and experiences are emphasised, it takes into account respondents' interpretation and it allows for flexibility. The limitations of this method, however are that the method is very subjective in nature and one cannot generalise the basis of the method. This method was used in order to gain an insight and understanding of the programs and operations of the financing institutions towards assisting small businesses.

4.3.1 Validity and Reliability

Validity is defined as the extent to which the instrument measures what it is intended to measure and describe (www.oadd.org). In-depth interviews are used as the instruments of inquiry in this study and the interview guide measured the problem of access to finance from the perspective of finance providers. The instrument did measure what it was meant to measure. Reliability is defined as the reproducibility of the measure. This means that if the study were to be done again the same results would still be found. The method was found to be the only

way to reach the results found and no other way would be more appropriate (Lincoln & Guba, 1985: 259).

4.3.2 Sampling

The sampling method that was used in this study is purposive sampling. This sampling method means that participants are selected because of some defining characteristics that make them the holders of the data needed for the study (Nieuwenhuis, 2007: 79). Congruent to the objectives of the study, the study used purposive sampling because the subjects here possess some specific attributes and have the expertise insights with regard to SMME financing. Purposive sampling is non-probability sampling which refers to the collection of information from persons that possess some distinct knowledge with regard to the study phenomenon. Sampling in the qualitative/ interpretive approach always use purposeful sampling. This type of sampling increases transferability of the study and maximises the range of information that can be obtained about the object of the study (Babbie and Mouton, 2001: 400).

This sampling was considered the best method for sampling, because according to Patton (1990: 169) it is about selection of information-rich cases for the study. Therefore the study subjects were chosen because they are dealing with the financing of small businesses and hence are likely to be the most knowledgeable and also informative about the phenomenon that the researcher was investigating. This method of sampling increases transferability of the study while it also maximises the range of information which can be obtained about the object of study.

The study is qualitative and exploratory in nature and therefore is limited only to research participants that are believed to be most relevant to the study, implying that the size of the sample is allowed to be small (Payze, 2004). In qualitative research, the content of the information is more important than the size of the

sample. Denzin & Lincoln, (2000) indicate that since qualitative research is not focused on statistical significance, there is no requirement that samples should be of a significant scale to achieve this. Therefore the sample size needed to be kept reasonably small in order to do justice to the rich evidence provided by qualitative studies and to make the best use of resources available for intensive research (Ritchie &Lewis, 2003). Because the size is of no major importance in qualitative research, the targeted sample was 12. The actual sample size of the interviewees was, however, 9 as table 1.1 highlights: 5 Senior Managers of the development finance institutions in the Free State and 4 Senior Managers of commercial banks, who are engaged in the financing of small businesses and who therefore, have direct contact with loan application requests from SMMEs. The other subjects that had been invited to participate decided not to.

4.4 Data collection

Personal and telephonic interviews with the study subjects were used to obtain information. Interviewing is done through interaction of the interviewer and the participants. Babbie (2004: 263), indicates that interviews attain higher response rates than do other methods like mail surveys. Due to logistical constraints, such as costs, telephonic interviews were used to conduct interviews that would have implicated more costs on using face-to-face interviews. He further shows that the presence of the researcher decreases the "don't know" and "no answers" by probing for answers. The presence of the researcher helped to clarify questions unclear to respondents while the latter were allowed to ask questions as well. The researcher, however, needs to be the medium of neutrality through which questions and answers are transmitted. For this reason, the different researchers should be able to obtain exactly the same response from the same participant (**reliability**). The presence of the researcher therefore plays a critical role in the qualitative interviews. This is also backed by Babbie and Mouton (2001: 270), by arguing that the researcher is the main instrument in the research process.

The study used open-ended questions. The interview guide was used as it would not be very easy to approach research without some agenda and game-plan in mind (Denscombe, 2007: 189). Before the interviews could begin, the motivation for the research was explained to the participant and the primary task was defined. Each participant was interviewed from his own setting to allow for a relaxed environment. Interviews were allowed to take at least 40 minutes yet others went beyond the targeted time to at least one hour depending on the elaboration of different interviewees. The interviews were tape recorded so as to make sure that no information from respondents was missed. The tape recordings were also used to afford the researcher an opportunity to listen attentively to the discussion rather than just note taking. The field notes were also taken to highlight the most critical points, to help the researcher remember and explore the process of the interview and also to help to facilitate the analysis. Field and More (1994: 72-82), also recommended the following the points:

- Using a quiet place;
- Setting adequate time to complete the notes;
- Sequencing events in order of occurrence; and
- Letting events and conversation flow from mind onto paper.

With regard to the current study, the interviews were held at the premises of the respondents at the quiet settings. Because the interviews were tape recorded, highlighting important points required minimal time. The events were sequenced in order of occurrence: introductions, briefing study participants about the intention of the study and interviews being recorded, signing of consent letters, proceeding with interviews and at the end of the interviews thanking the respondents.

4.5 Data Analysis

The purpose of this section is to demonstrate how the data analysis plan corresponds to the research questions. The content analysis was used as the

analysis tool of the study. Content analysis refers to a systematic observation and classification of human communication through open ended and unstructured interviews (van Buuren, 2008: 83). Babbie (2004: 318), goes further to indicate that content analysis is a methodology in social sciences for studying the content of recorded human communication and a coding operation. Coding in essence is the process of transforming raw data into a standardised form.

Content analysis was used in this study to analyse recorded transcripts of interviews with study participants. Data in this study was transcribed, coded, categorised and matched to the themes were pre-determined. Therefore the analysis of data in this study is limited to the context in which the messages were presented in the interviews. According to Denscombe (2007: 292), the process of data interpretation involves four tasks:

- Code the data;
- Categorise these codes;
- Identify themes and relationships among codes and categories; and
- Develop concepts and arrive at some generalised statements.

Noting the above issues, in the current study the researcher used the pre-determined themes developed from the literature and research questions. Data was transcribed verbatim from the open-ended interviews with the research participants. The transcriptions were coded and grouped into the categories and were matched to the themes which were developed from the research questions.

4.6 Conclusion

This chapter was based on the methodology of this study. The chapter discussed the sources of gathering information: literature review and empirical study. The choice of the appropriate methods of inquiry was done with the assistance of the theory and examples of other researchers who used similar approaches. The chapter also gives a detailed account of how the data was collected and how it

was analysed. The next chapter therefore presents the results of the study as obtained through the methodology discussed in this chapter.

CHAPTER 5

5.0 Data Presentation and Analysis

5.1 Introduction

Beck (2008:2), shows that credit financing of SMMEs has been a burning issue which needed attention by policy-makers and researchers alike, because of the importance of the sector in the world. The current chapter unfolds in two sections. The first section presents the findings of the study which focused on the credit financing of SMMEs from both the perspectives of the development finance institutions and commercial banks in the Free State. The second section is based on the discussion of the chapter in relation to the theoretical chapters. The analysis is based on the responses of the study participants.

5.2 Data presentation

This section deals with the presentation and findings of the results by the respondents that participated in the study as illustrated in figure 5.1. The banking industry was represented by only the four major banks in the Free State, because the other banks such as Capitec and African Bank are credit banks but they do not offer commercial loans. The Land Bank indicated that it was still under reconstruction and therefore could not participate in the study. From the DFIs, only government finance institutions operating in the Free State represented the DFIs, as they were established to implement the developmental strategy Act 102 of 1996 on which the study is based. Therefore Business Partners and Enablis, although they issue business finance, could not be part of the study. The two are non-governmental development financing institutions. Moreover, the latter was only launched in the Free State in October 2009, when the study was almost being finalised.

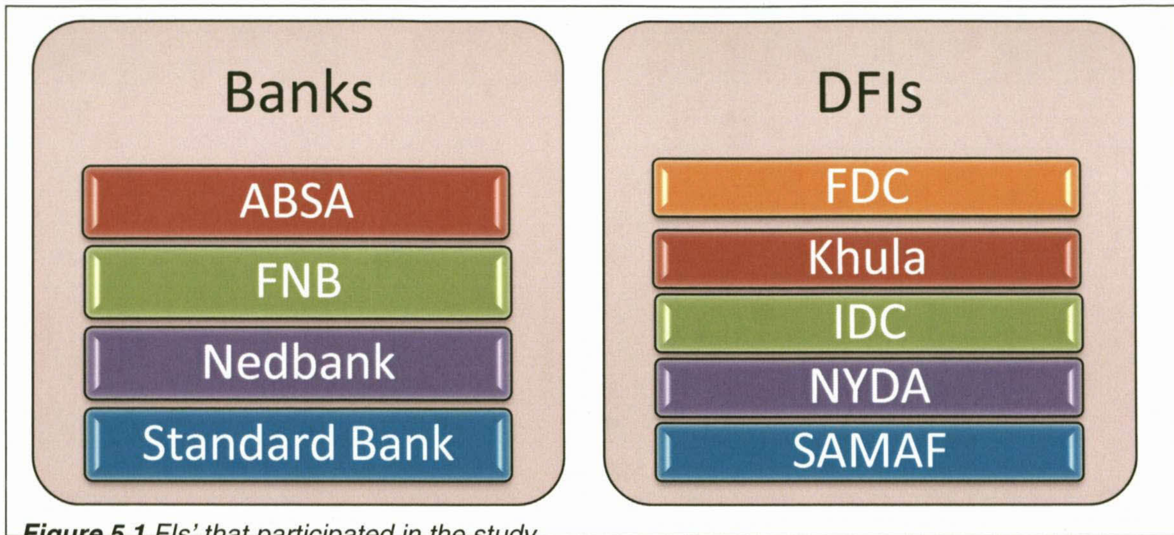

Figure 5.1 *FIs' that participated in the study*

5.2.1 Main themes

Because the research study is of qualitative nature, the priori coding was used in the analysis of data. Priori coding was used whereby the researcher used the predetermined codes combined from both the interview guide and the literature review. The themes that were predetermined were:

Figure 5.2 *The themes of the study*

The themes in figure 5.2 present the model of how the DFIs implemented the developmental strategy Act of 1996. **Specific programs** were at the top of the theme hierarchy to investigate whether the programs do exist from the DFIs to address SMMEs' financial needs. To check if the DFIs programs addressed the relevant market that was stipulated in the Act (previously marginalised community/ population) the second theme was the "**target market**". The third theme was "**lending criteria and tools**" as the instruments the DFIs used in their financial programs to ensure that they served only the target market. Lending criteria was followed by **pricing of the loans** to supplement the lending criteria. The second last theme was **challenges** the DFIs encounter in providing the programs and lastly their suggested **solutions** towards the challenges was the last theme. To measure the success of the developmental strategy implementation (to fill the gap left by banks), the analysis was made by comparing and contrasting DFIs' operations against those of banks'.

5.2.1.1 Special Programs for SMMEs

Seven institutions from nine FIs showed that they had special programs for SMMEs; the other two did not directly have SMMEs as their target market. These programs were both financial and non-financial as shown in the figure 5.3

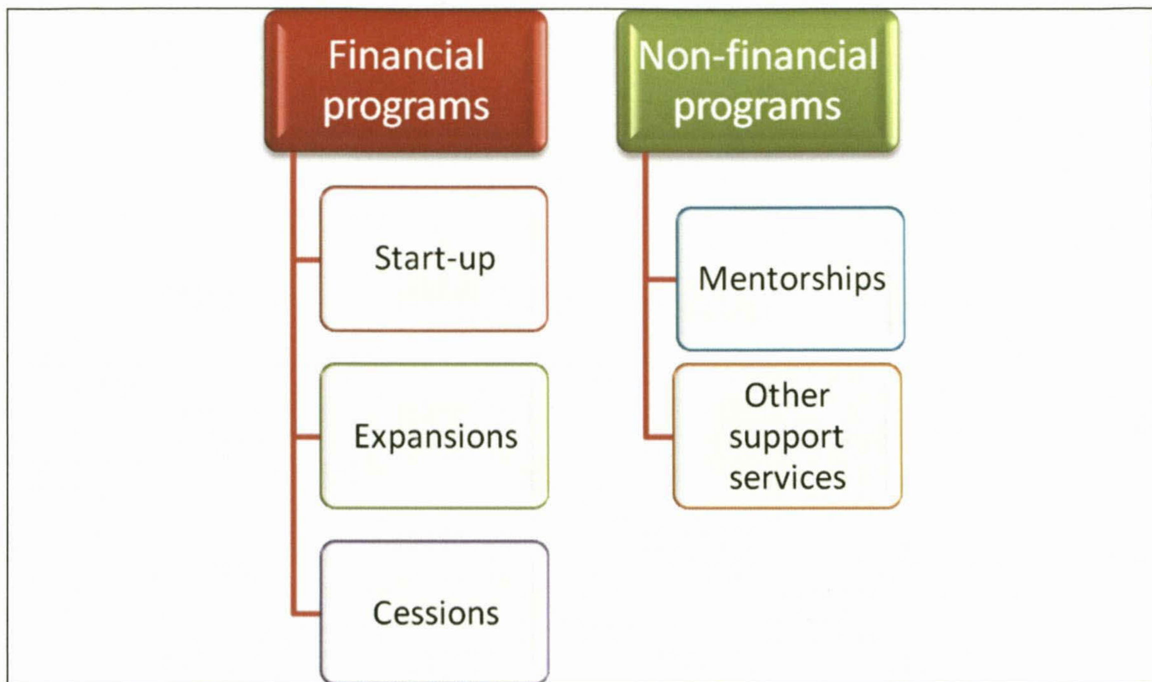

Figure 5.3 *Specific programs for SMMEs by financing institutions in the Free State*

(a) Financial Programs

In order to check if the financing institutions did have the programs that were aimed at assisting small businesses to access credit finance, it was discovered that both banks and development finance institutions did have lending programs specifically targeting small businesses (table 5.1). Only one bank (FNB) out of four banks (25%), however, indicated that they did not have separate **products for SMMEs**. The respondent indicated that SMMEs are served and assessed like any business seeking finance at FNB. "*...there is no specialised product for SMMEs at this stage at FNB"*. Furthermore, FNB indicated that general funding was available for business finance applicants and all were assessed on the same grounds including applicants from the small business sector. This implied that (3 out of 4) 75% of the banks had specific financial programs aimed at assisting SMMEs to access finance.

Table 5.1 *market share of SMME lending between banks and DFIs in the Free State*

Product	**No. of Banks**	**%**	**No. of DFIs**	**%**
SMME direct funding	3	**75**	3	**60**
No direct SMME funding	1	**25**	2	**40**
Total	4	**100**	5	**100**

From the DFIs' perspective, 60% of the DFIs funded SMMEs directly; only FDC, NYDA and IDC did have direct lending programs to SMMEs, although IDC focused on SMMEs leaving out the micro component of the SMME. IDC only lent to SMMEs, not **micro** businesses, due to the minimum amount of the money they were set to lend out which was more than what micro businesses required (R1000 – R 100 000): "*We only offer loans and equity from R1 million not less due to costs we incur in processing small loans....*"

The other two or 40% of the DFIs did not directly fund SMMEs (1/5 or 20% of DFIs). Khula did not offer direct finance to small businesses it supported SMMEs through the help of other institutions, such as banks and mentors: "*we are not selling our products to the end-user, we wholesale it through the banks by way of crediting them by demnifying the loan*". On the other hand SAMAF (1/5 or 20% of DFIs) also did not lend directly to SMMEs, but rather offered wholesale finance to co-operatives who in turn supplied finance to small businesses. Even though SAMAF did not have many clients in the Free State, as there weren't many co-operatives in the province SAMAF, had a very profitable client in the Eastern Free State, Makwane Financial Services Co-operative.

Nonetheless lending programs aimed at financing small businesses were categorised according to the different stages of the businesses:

- **start-ups** for introductory stages of the business cycle (0-2 years)
- **expansion** of existing businesses (including franchise finance, equity and buy-out finance) for growth stage of the business cycle (>2 years)

- **sessions** at either early or growth stage of the business cycle

The following figure illustrates the institutions that offered these financial programs for SMMEs.

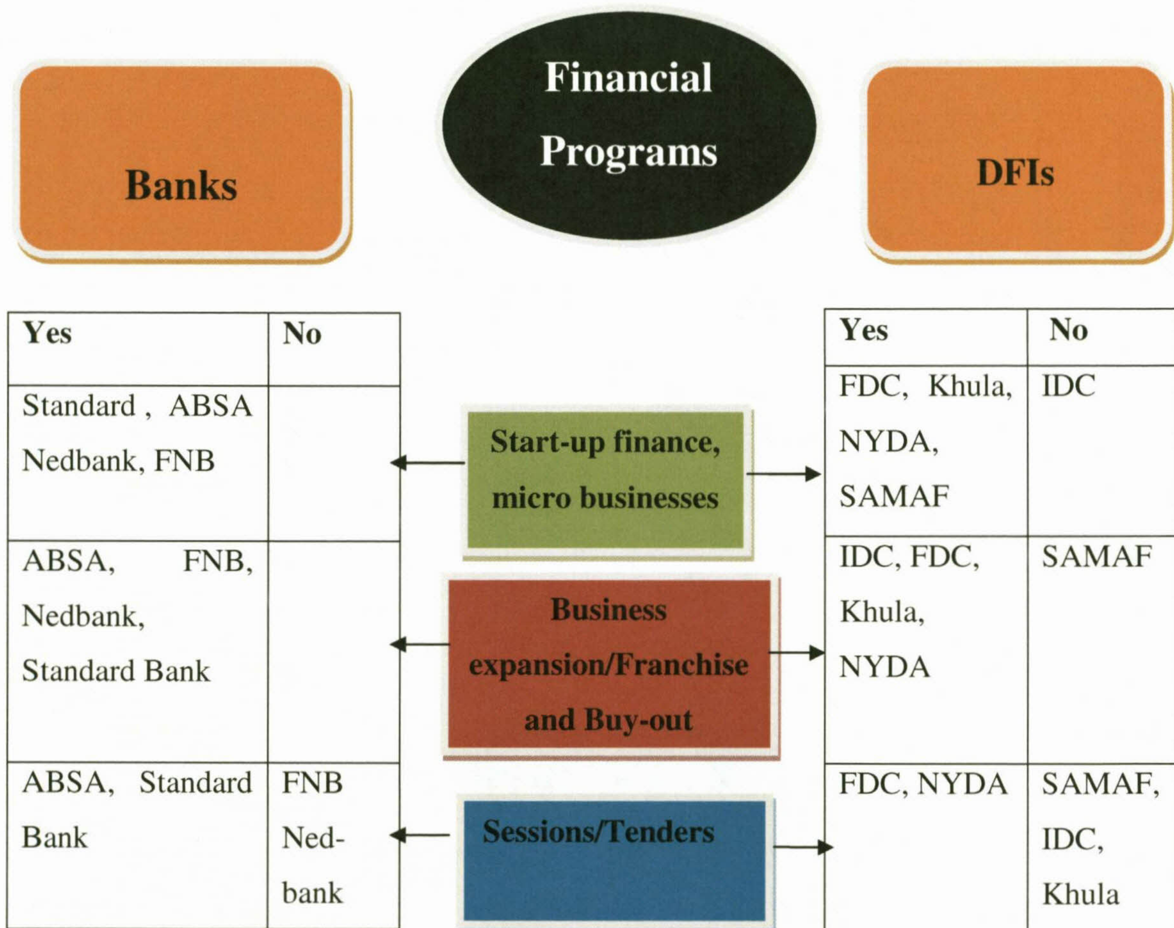

Figure 5.4 *Financial products offered by financing institutions in the Free State*

(i) Start-up finance

Start-up finance was aimed at the businesses that were entirely new or had less than one year of existence or were in the earliest stages of the business cycle. Due to the high risk profile of start-ups, banks were less willing to finance this

market as it became unprofitable for banks to invest in SMMEs given the costs attached to the market. This was in line with the theory (see paragraph 2.8.4: 54) where it had been noted that banks consider start-up market as a risky market to invest in. Standard Bank, however, indicated that for short term financial need, an overdraft facility was available to assist to finance stock and working capital depending on the need of an individual without providing any security. Alternatively, the entrepreneur could apply for a business revolving credit plan or a medium term loan depending on the asset being financed and of the collateral an entrepreneur had. In general, banks had no tailor-made start-up packages.

Otherwise the entrepreneur could get a personal loan from a bank to kick start the business where upon growth, the bank could be able to assist, for example Nedbank claimed: "*...the pre-small business banking loan where a client borrows a R100 000 minimum from Nedbank Small Business Services and the client is entitled to 2 years of free banking with Nedbank*". The bank's normal lending criteria, however still applied.

The development finance institutions on the other hand did offer finance for start-ups that would necessarily not be able to get financing from banks. FDC, for example, said: "*Our funding is different; it caters for people that are* ***unbankable*** *...*" Banks considered people who did not have a regular income, who did not have a bank account indicating the cash flow as unbankable. Khula on the other hand assisted the SMMEs that lacked collateral to access start-up finance from banks. The entrepreneur approached the bank for finance and if after the assessment by the bank it appeared that the client met all the lending requirements but lacked collateral or security, then Khula offered to fill that gap by providing the **credit guarantee scheme.** The credit guarantee scheme (see paragraph 3.2.1: 57) was an indemnity against the loan should the recipient of the loan fail to pay back the loan. Khula usually pledged to pay 80% of the loan amount.

(ii) Business expansion finance

Both banks and DFIs provided finance for business expansion. In this section all lending products aiming at existing businesses were incorporated (expansion, franchising, equity and buy-out).

- Business expansion is defined as growth in the business product or service offering (www.businessdictionary.com).
- A franchise is a form of business in which a firm with a successful product or service and a reputable trade mark (the franchisor) enters into a continuing contractual relationship with other business (franchisee) operating under franchisor's trade name and usually with the franchisor's guidance in exchange for a fee (www.investorwords.com).
- Business buyout is defined as buying of an existing business (Nieman, 2008: 153)

Figure 5.4 shows that all the four banks indicated that they considered the growth potential from the business plan and cash flow of the existing business. ABSA, for example, indicated that it financed even the informal micro businesses: "*we have micro-enterprise finance for informal businesses where individual runs for example from home and street vendors selling apples, fruits and vegetables. We also have vendor finance where we support production finance apart from traditional lending...*" Moreover Standard Bank claimed that they did not discriminate against anyone who met their lending criteria: *"we assist anyone that has the viable business plan and because we are a very big establishment with our very big asset base, capital mobility, we are very secured ......we assist each and everyone .... If your business plan is viable and you meet qualifying criteria, we assist".* FNB and Nedbank did not make any comment other than that they fund any business including franchises, expansion and business buyout that met their lending requirements. The lending requirements were the following:

- Business plan;

- Owner's contribution;
- Collateral or security;
- Business financial statements and projected cash flow;
- Owner's credit history;
- Owner's identity; and
- Business and owner's residential address.

From the DFIs' side, figure 5.4 further shows that four (80%) of the DFIs reported that they financed business expansions and 20% (SAMAF) did not fund business expansion. NYDA on the one hand indicated that they did have a franchise fund for people who wanted to purchase a franchise. IDC on the other hand stated that while they had done away with micro-lending they had wholesale facilities: "*We do, however, finance franchises and agriculture ... we now provide wholesale finance to certain institutions who in turn lend to smaller businesses*". IDC gave the example of a Hotdog cafè where about 10 hotdog cafes were addressed under one umbrella.

(iii) Cessions/ tender finance

Cessions or tender finance are the type of finance where the financing institutions assist small businesses to be able to provide a service to the government. Upon receiving a business deal or a tender from government an entrepreneur approaches a financing institution to pledge for financial support to enable an entrepreneur to complete the project. Two of the four banks (50%), Standard Bank and ABSA, and two of the five DFIs (40%), FDC and NYDA were institutions that had indicated that they had this particular program for small business in the Free State. ABSA claimed: "*....we support government contracts for the suppliers... the government will actually provide us with the leads to the suppliers and we would finance the suppliers*". The other 50% of the banks (FNB and Nedbank) did not comment about the cessions. 20% of the DFIs (SAMAF)

did not provide this type of funding. 40% of the DFIs (IDC and Khula) did not mention if they did offer cession/ tender finance.

(b) Other programs/services

This research discovered that financing institutions did not only offer financial support to small businesses. Beyond lending, these institutions also provided other programs such as business support services and mentorships for the SMMEs. Support services were services other than financial services that were offered for the development of SMMEs by financial institutions. Support services included:

- training
- mentorships
- websites development
- marketing material

These non-financial services were not offered by all the financing institutions as reflected in both tables 5.2 and 5.3.

***Table 5.2** Non financial programs offered to SMMEs by banks in the Free State*

Non Financial programs	**Banks (Yes)**	**%**	**Banks (No)**	**%**	**Total %**
Mentorships	Nedbank, ABSA, Standard	**75**	FNB	**25**	100
Training	Nedbank	**25**	Standard Bank, ABSA,	**75**	100
Relationship management	Standard Bank, FNB	**50**	Nedbank, ABSA,	**50**	100
Business registration	Nedbank	**50**	ABSA, Standard Bank	**75**	100

Three banks (ABSA, Nedbank and Standard Bank) out of four banks (75%) had said that they offered support services to small businesses as table 5.2 illustrates. To ensure that their clients did not fail, financing institutions offered them mentorship programs.

From the banks' perspective Standard Bank revealed that upon investing in small business (less than 3 years), they (Standard Bank) assign a mentor. The mentor gave the bank a quarterly report on the management statements and that specific account was assigned to a relationship manager who was the banker. The relationship manager in turn paid spontaneous quarterly site visits to the business. This was in order to compare what the relationship manager found the report of the mentor and to check if the mentor did his duties: "*...you have to verify the content of the report that you get from the mentor and also ask employees for it, ... if they do not know that person then how can they say they have been there? ... because these mentors, they also get paid yet they do not necessarily go to the businesses... by the time ...the SMME has a problem, it is really late...*"

For the businesses that had been in existence for more than three years, the relationship manager only got the report from the entrepreneur/ manager since the business was well established and could work on its own. Moreover the relationship manager paid site visits once a year because of the volume of SMMEs per one relationship manager (350: 1) which may not be possible on a quarterly basis. Nonetheless the mentorship for this market was only considered if the business was expanding.

Table 5.3 Non-financial programs offered to SMMEs by DFIs in the Free State

Non-financial Programs	Yes	%	No	%	Total %
Mentorship	Khula, NYDA, SAMAF	60	FDC,IDC	40	100
Training	SAMAF, NYDA, IDC	60	FDC, Khula	40	100
Marketing and website development	NYDA	20	FDC, Khula, IDC, SAMAF	80%	100

Table 5.3 shows that four of the five DFIs (80%) had indicated that they provided support services to their clients. IDC had indicated that: *"we facilitate external learning and development by arranging applicable course for potential clients and even for non-potential clients"*. NYDA also had shown that they had realised that their clients did not only require financial support and therefore they (NYDA) provide these other support mechanisms to their clients (young people aged 18-35), such as website development and legal advice: *"if a young person comes and say I am having a business and I need a website for my business, we get a consultant who is going to assist you and organise a website for you….If you are looking for a legal advice, we get you a lawyer…bill boards, business cards…"*. NYDA insisted that their mandate was to help their clients in every way to make sure that their businesses grow. SAMAF also had demonstrated that they provided capacity building for the co-operative and they offer basic financial management training to the co-operative manager.

Khula mentioned that they did pre-loan and post-loan mentoring for SMMEs depending on the individual needs: *"we specialise in mentorships … we are providing advice to a client as far as what products can be suitable for their needs and we also make sure that if they have an idea, we refer them to the right agencies or financial institutions. But if there is a gap… we have got mentors, accredited mentors that operate for Khula … accredited with the Institute of Business Advices…"* Khula further pointed out that on contracting a mentor they

(Khula) made sure that their client and the mentor signed the terms of reference and service level agreement to the satisfaction of the client. One (FDC) of the five DFIs (20%) indicated that they referred the clients to SEDA (Small Enterprise Development Agency) which was a non-financial DTI's institution for any developmental need other than finance.

5.2.1. 2 Target Market

Figure 5.5 shows that banks financed any business that met the bank lending criteria (figure 5.11). Nedbank claimed that it had a black market (targeting african people) strategy where they served mainly the black entrepreneurs. "*We have dedicated what we call business development managers that operate in the townships and the whole CBD area focusing currently on accounts for black business owners".* Other banks however did not mention if they have any specific market except that any business that met their lending requirements.

Figure 5.5 *Banks target market*

The DFIs on the other hand had their differentiated target markets within the SMME sector. These markets that were served by DFIs would not be served by the banks because they did not meet the bank's lending criteria. This was because each institution had its own specific mandate pertaining to their

exclusive products. This section is therefore based on those markets together with the loan limits as had been explained by different DFIs. The section also highlights some specific exclusion to the DFIs' target market illustrated in figures 5.5, 5.6, 5.7, 5.8 and 5.9 respectively.

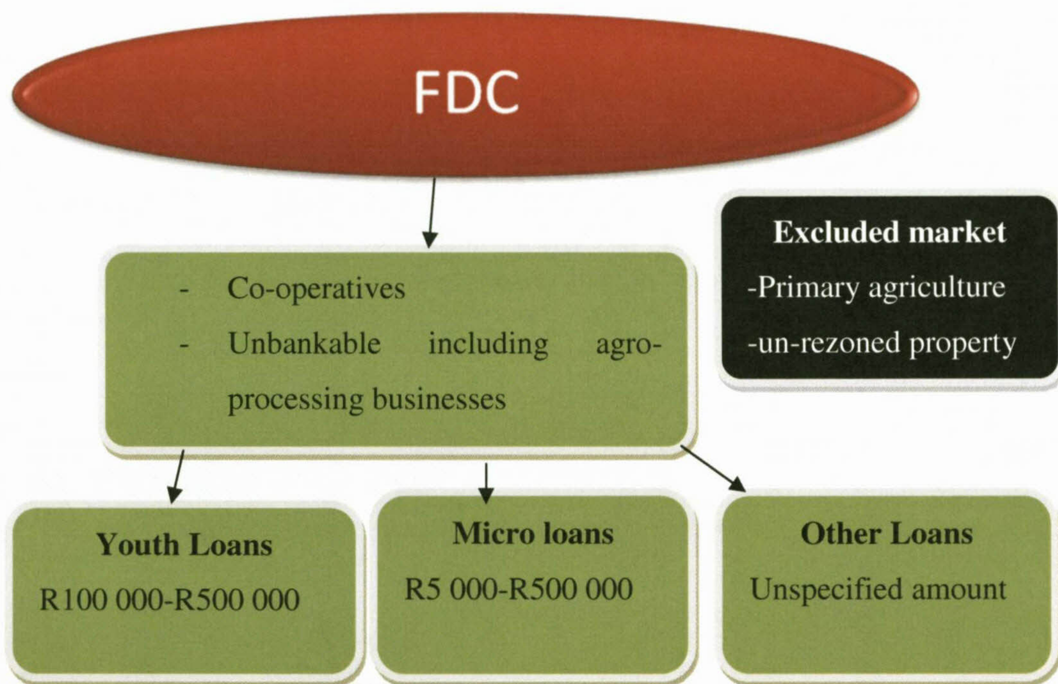

Figure 5.6 *FDC target market*

From figure 5.6, the observation was that FDC serviced all co-operatives and all businesses that were considered **unbankable** (people with no regular flow of income, no bank account) by banks, but excluded primary agriculture from their market because this market was served by Land Bank. FDC also excluded the un-rezoned property (the land that has not been zoned by the land affairs as a business land). FDC had loans for all the business types including micro loans for businesses that required loans from R5 000 to R500 000 who might be at the introductory stages of the businesses. This institution also had a partnership with NYDA where they had the memorandum of understanding being the cost-sharing in serving young people "*...we have an MOU with NYDA to cost sharing where each institution have committed R4.5 million to make R9 million towards providing finance for youth".*

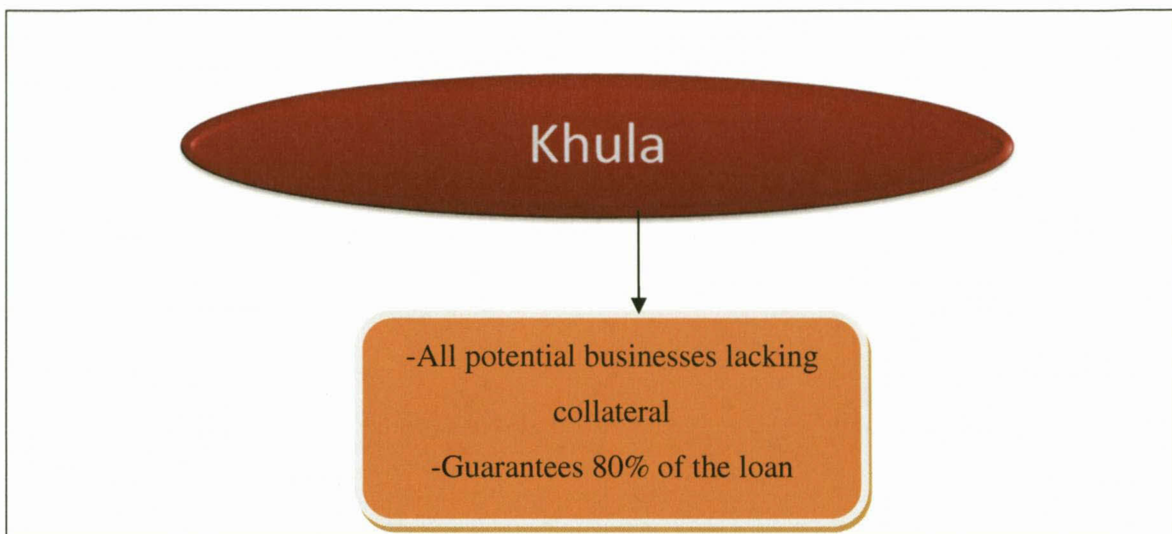

Figure 5.7 *Khula's target market*

From figure 5.7, the researcher discovered that all businesses seeking finance but did not have collateral; Khula was available to fill the collateral gap. Khula, however, offered only 80% of the required loan amount. The entrepreneur was then liable to pay the other 20% to provide 100% security against the loan. The 20% could be in a form of an asset or cash. Khula believed that there should be some level of commitment by the client to make own contribution as well. Nonetheless, this was a big challenge for a good business opportunity that could not afford the 20% contribution.

Table 5.8 represents IDC's target market which included all the small businesses that needed finance from a minimum of R1 million. IDC had decided to make R1million their minimum loan amount because it said it costed IDC about R250 000 to approve a facility "*...at one stage we costed our process and we said, look it's costing us about R250, 000 just to approve a facility. So just to break even on that, we must at least provide larger amounts than R250, 000. So a few years ago we decided on a minimum of R1 million. So, yes that we can at least cover our costs, our efforts to grant that facility...*" The businesses funded by IDC were franchises, agro-processing, mining, tourism, professional practices such as medical practices and lastly industries in metal, wood and textile. IDC unfortunately did not finance primary

agriculture, retailing, wholesaling and property development sectors because these markets were serviced by commercial banks and Land Bank.

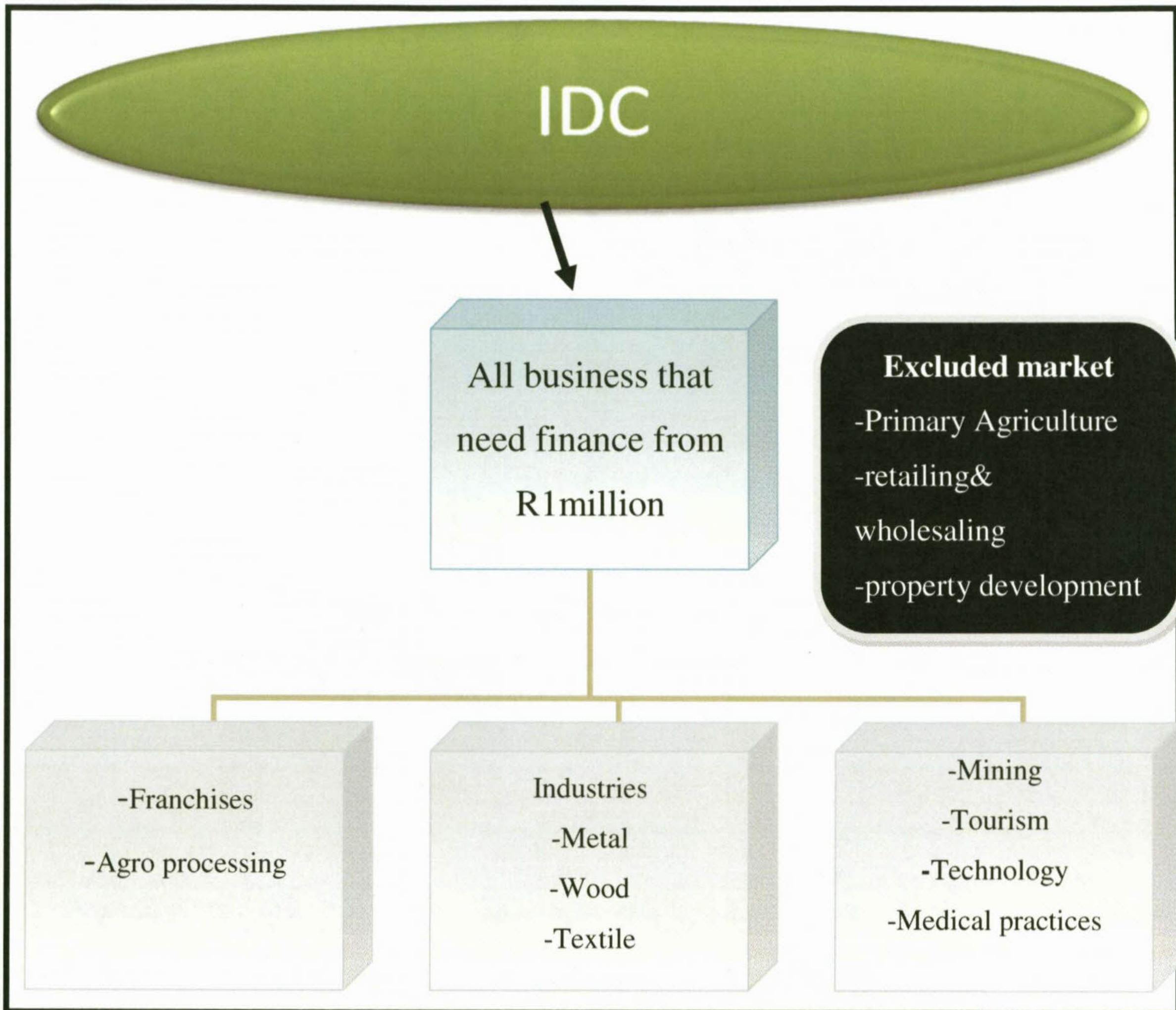

Figure 5.8 *IDC target market*

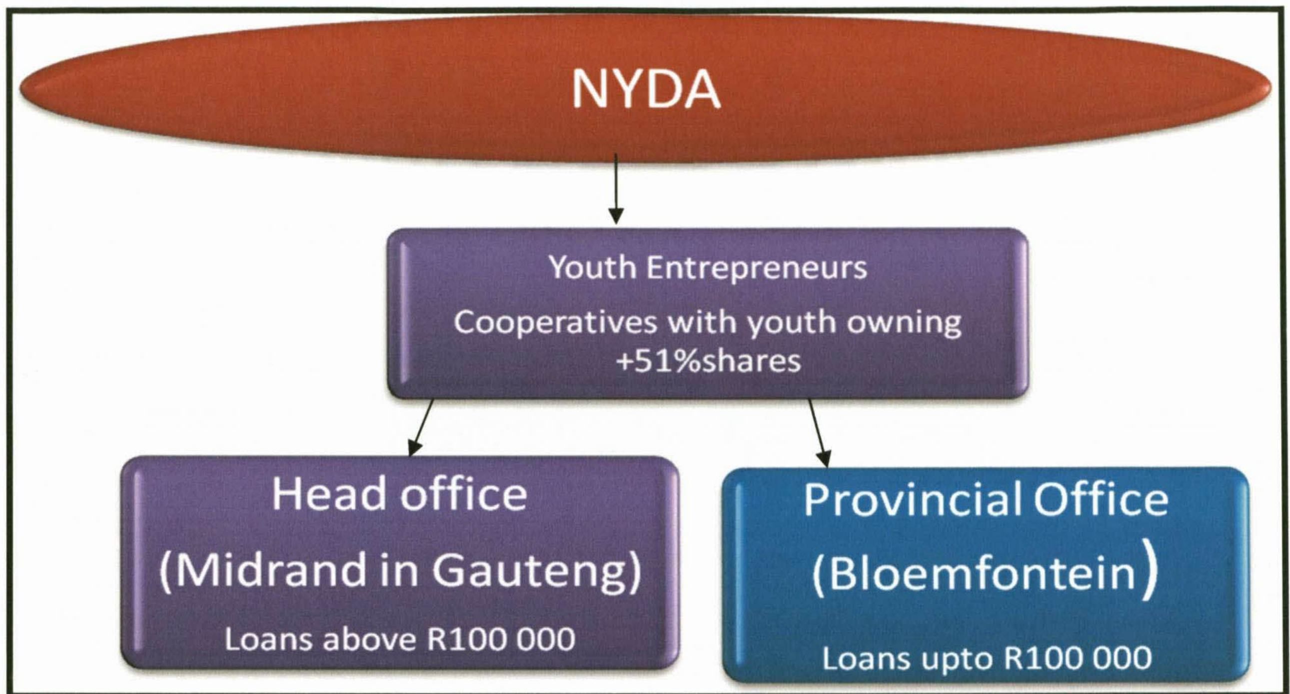

Figure 5.9 *NYDA's target market*

Target market for NYDA was young (18-35 years) entrepreneurs and co-operatives that had young people owning the minimum of 51% shares to enable skill transfer to the youth of SA. NYDA, as can be seen from figure 5.9 offered loans up to R100 000 from the provincial office in Bloemfontein and loans exceeding R100 000 were handled at the institution's head offices in Midrand. Young entrepreneurs made their applications at the provincial offices for assessment. When all the requirements had been met, the applications were submitted to head office for finalisation. This implied that the provincial office did not decide on whether the application was successful or not. All the decisions rested with head office.

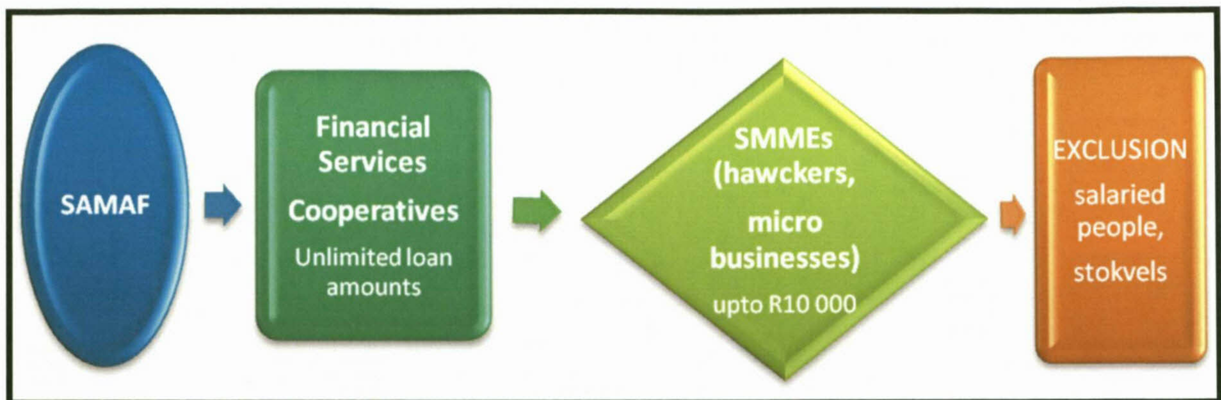

Figure 5.10 *SAMAF's target market*

Figure 5.10 illustrates the target market for SAMAF. This institution offered loans to financial services co-operatives. The financial services co-operative was made of groups of people (small businesses) who saved together. The members of the co-operative developed a constitution that governed the co-operative and the name was also decided upon by the members and was registered as such at the Registrar of Companies. The members saved with the co-operative and the co-operative in turn managed the bank account on behalf of its members. For any service the members approached the co-operative which in turn accepted deposit and issued loans to members. SAMAF did not have specific loan limits it, however, had financed their only client in the Free State, (Makwane Financial Services Corporative) with R1, 3 million. (Makwane Financial Services Cooperation was the only cooperation in the Free State after the other one in Thaba-Nchu ceased to exist). The co-operative in turn issued up to R10 000 to the SMMEs who saved with it (the co-operative). SMMEs could only access finance from SAMAF through the co-operative.

5.2.1.3 Lending requirements

The results suggested that all four banks operate similar with regard to lending requirements. There were requirements that were exclusive to individual banks. Figure 5.11 highlights lending criteria by banks. Three banks (75%), FNB, Nedbank and ABSA had stated that they had business templates. FNB and

Nedbank say that the templates were available online while ABSA indicated that they had a business plan booklet that highlighted key issues to be included in the business plans. Standard bank mentioned that they did not have any particular business plan template for the clients but the business plan should highlight the SWOT analysis. Seventy-five percent (75%) of the banks had business plan templates and only 25% accepted any business plan. 75% (3 out of 4) of the banks required only 10% of owner's contribution of the loan amount while only 25% (1 out of 4 banks) required a 20% owner's contribution.

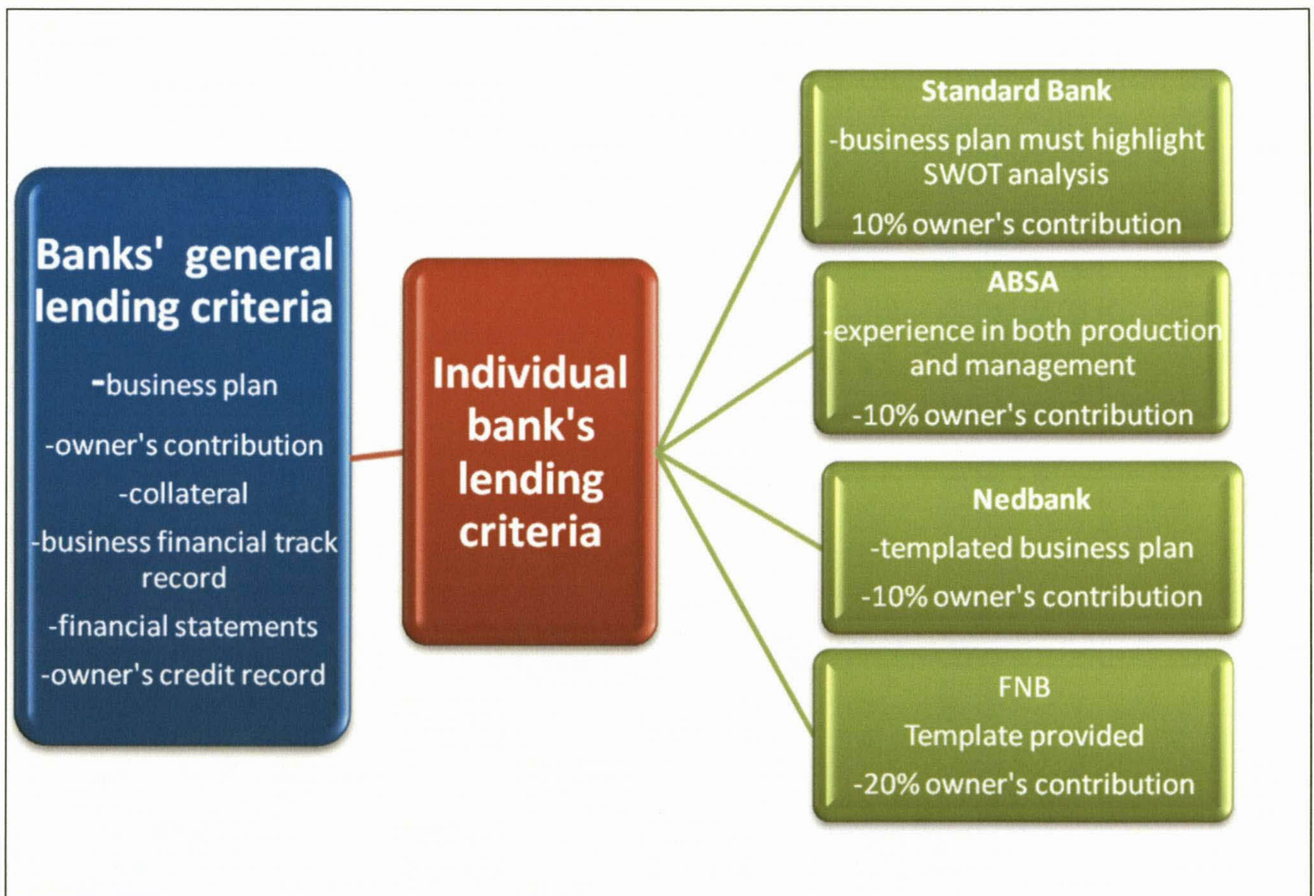

Figure 5.11 *banks' lending criteria*

While the above play the central role for all the banks there were other issues that were considered by individual banks, for example ABSA stated: "*I think experience in the business is very important...we see high failure rates*

...because of lack of skills and lack of experience in both the production and management of the business".

Similarly for the DFIs the business plan and credit assessments including financial viability seemed to be the core requirements for most of them (80% or 4 of 5 DFIs). The exception as can be seen from figure 5.12, was SAMAF, which required the co-operative's constitution instead of the business plan. NYDA also preferred a constitution for **group lending:** **"***young people group themselves 5-10 each with their different individual businesses...give their group a constitution and a name to own the account at bank or post office...they apply for individual loans and they sign the security for each other in the group... the group will be a sort of security...".* NYDA further requested a saving of at least 10% of the requested amount (up to R10 000) from the group to encourage them to develop a culture of saving. As for the other loans NYDA used assets that the client put on the table or it (NYDA) took equity in the business for loans between R100 000 up to R5 million. Signing of surety was one of the requirements of NYDA while assets bought catered for collateral or NYDA took equity in the business " *... collateral to us does not determine business success, the capacity of the entrepreneur and cash flow are the key issues... and for other types of businesses like tuck-shops, we do not require business plans ".*

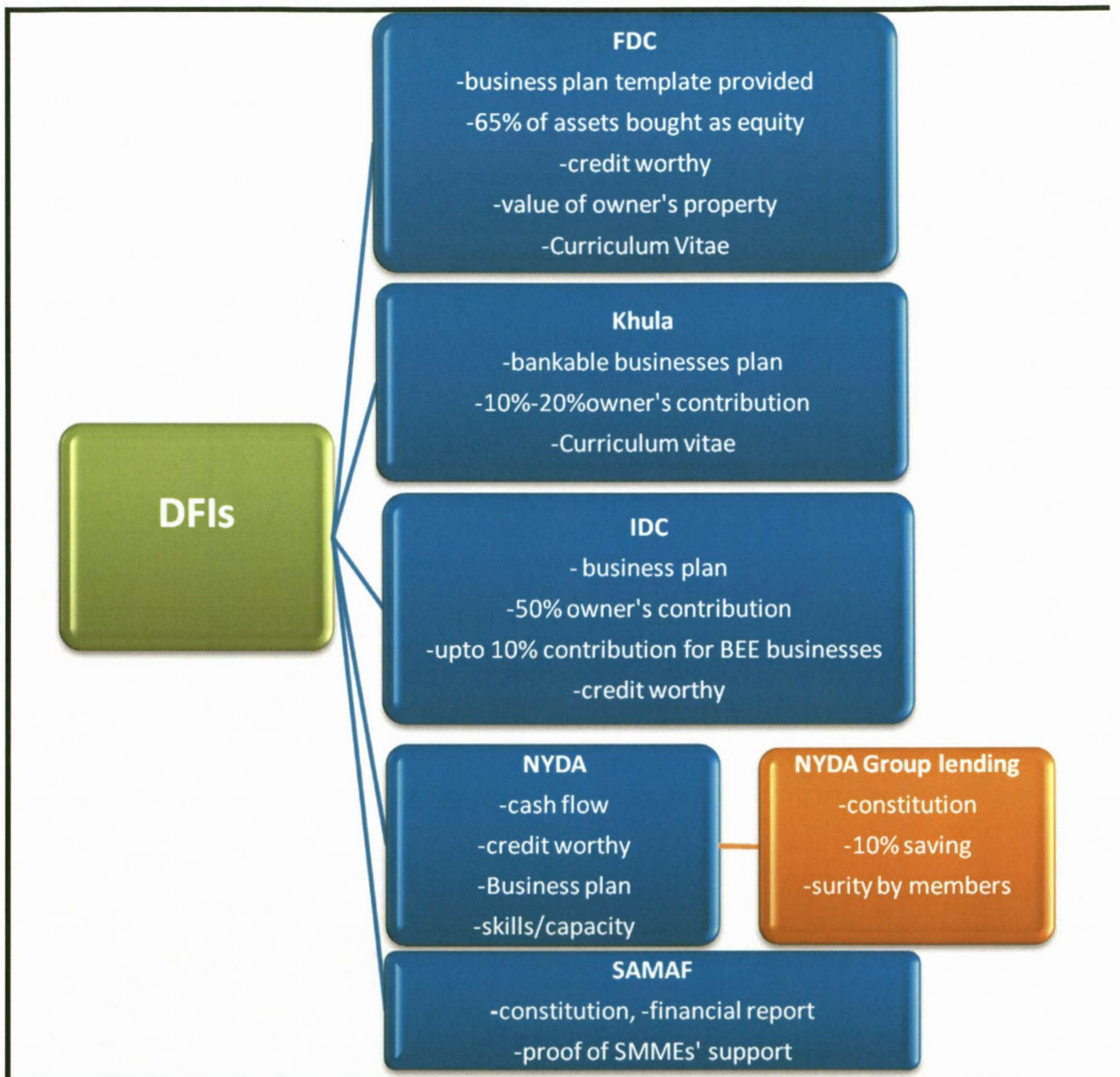

Figure 5.12 *DFIs' lending criteria*

Two of the five DFIs (40%) Khula and FDC considered the curriculum vitae of the applicant as one of the requirements. In the case of FDC it depended on what the client used as collateral. In the case where the loan applicant did not have the collateral FDC claimed 65% equity from the total assets purchased with the loan "*...we do not require collateral... may be 65% would be from the assets that*

we buy from the client and then we take our collateral back. But let's say if you are buying stock and do not have collateral...then we use evaluators, service providers to go and evaluate your house..." IDC's exclusive requirement was the owner's contribution of about 50%, which was less for a black client depending on the sector the business was in. IDC stipulated that in the case of BEE business, where existing business partnered with black people for skill transfer and capacity building, IDC was willing to take an increased risk to the maximum risk exposure of 50%-60% or even 90% at times. This implied that the business would only have to pay between 50% and 10% owner's contribution towards IDC loan if the business was a BEE business.

Otherwise 60% of the DFIs: Khula, FDC and NYDA indicated that the other requirements, such as credit checks were done by the banks with which they (DFIs) partnered in their lending programs as shown in the section 5.2.1.5. In distinction, (20% of the DFIs) IDC claimed that it handled all the credit checks through their credit committee at their head offices especially for loans above R10 million. The other 20% of the DFIs, SAMAF did not do credit checks at all.
It seems like IDC handles all their credit analysis and scoring as did banks, because it does not partner with any banks. SAMAF did not do any credit assessments because SAMAF lent to financial intermediaries and not directly to the SMMEs.

5.2.1.4 Loan Pricing

Table 5.4 illustrates the tools banks used in determining their loan prices. On handling loan applications, all four banks mentioned that they did credit assessment, credit scoring, credit risk checks (which they mentioned they did with the help of credit bureaus), and credit scoring, all of which helped them decide the rate to which they priced their loan for a specific applicant. From the DFIs' side, of all the five DFIs, only IDC mentioned that they went through all the tools that have been mentioned by banks in their loan pricing. FDC, NYDA, and

Khula did use credit assessments as did IDC, for example, NYDA reported "... *in South Africa, you cannot issue a loan without doing credit assessment... that's the act...*" Only SAMAF did not mention if it did credit assessments.

Table 5.4 *Instruments/Tools used by banks and DFIs in loan pricing*

Instruments	**Banks**		**DFIs**	
	Yes	**No**	**Yes**	**No**
Credit assessment	All 4 banks 100%	0%	80% (FDC,IDC,NYDA, Khula)	20% (SAMAF)
Credit scoring	All 4 banks	0%	20% (IDC)	80% (FDC, NYDA, SAMAF, Khula)
Credit risk consideration	All 4 banks	0%	20% (IDC)	80% (FDC,NYDA,SAMAF, Khula)

On the one hand, all the banks (100%) had stated that they mainly priced their loans based on the risk profile of the individual loan applicant. All bank loans were linked to the **prime rate** and the **financial riskiness** of the individual client. Prime rate is the interest rate which banks charge to the credit worthy clients (www.investpedia.com). The risk either increased or decreased the interest rate charged on the loan. This depended on whether the bank perceived the client risky or not from the credit screening and scores.

Financial **risk** is defined as the probability of experiencing a negative financial implication or financial loss (Mpofu et al. 2009: 7). For example FNB said "... *we do financial assessments and the interest rate is linked to the financial risk of the client* ..." Similarly Standard Bank had mentioned that "...*our loans are prime linked ...the risk premium for start-ups is high and normally the interest rates will be higher*". In addition, Standard Bank pointed out that they reviewed their

interest rates annually. Standard Bank also reviewed business performances of their individual clients to see if the risk premium had increased or decreased and charged accordingly. Depending on the type of the business industry, repayments were determined accordingly but the interest was serviced monthly from the day the loan was awarded "*...if you will be getting your income quarterly, we expect you to reduce your loan quarterly with as x-amount. However, you have to service the interest monthly from day 1*". Nedbank went further to show that their pricing was very much risk based. Nonetheless, Nedbank stated that for small business overdraft facility and asset finance, the interest rates charged were higher "*... if small business is looking for an overdraft, that will usually come in at prime plus X% ... on asset based finance also prime plus...*" The interpretation of these results was that the risk factor of the SMME determined the price charged for the loan issued.

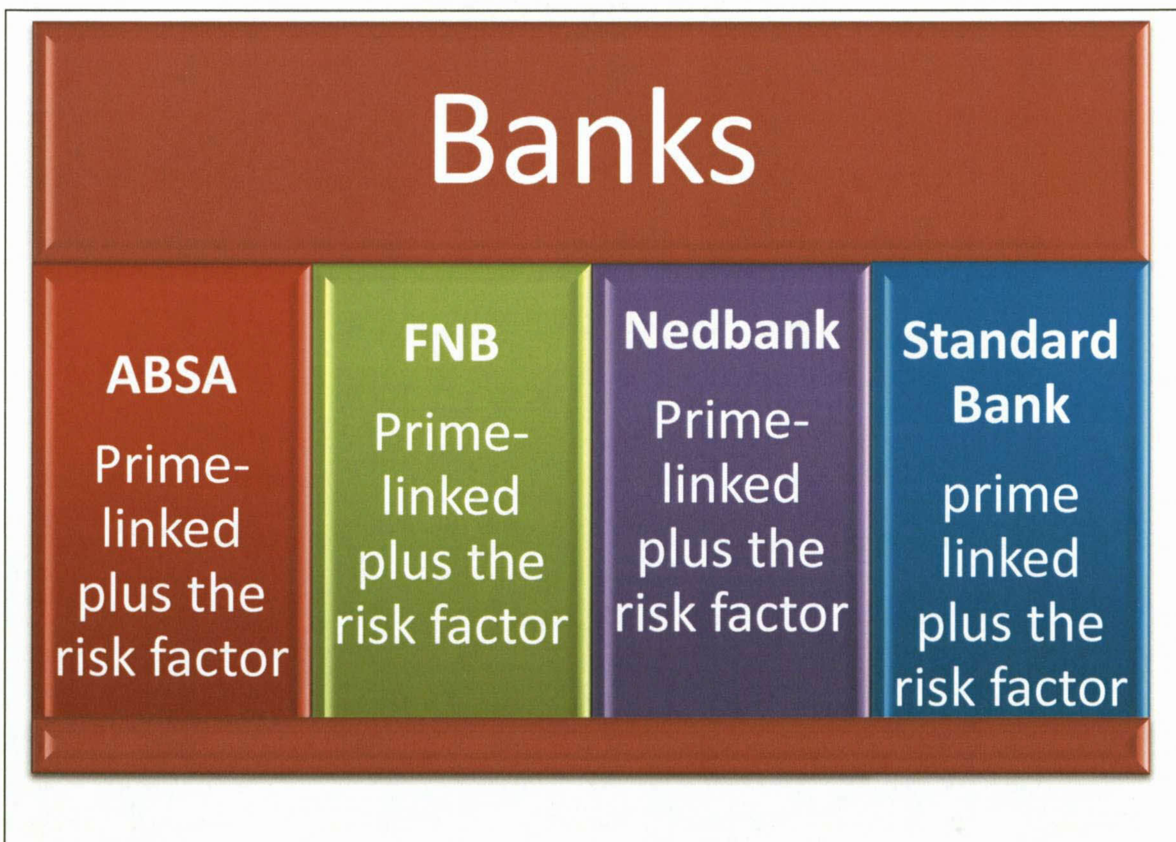

Figure 5.13 *Loan pricing by banks*

While banks stood on risk-based pricing for their loans, different DFIs on the other hand had different ways of determining their pricing.

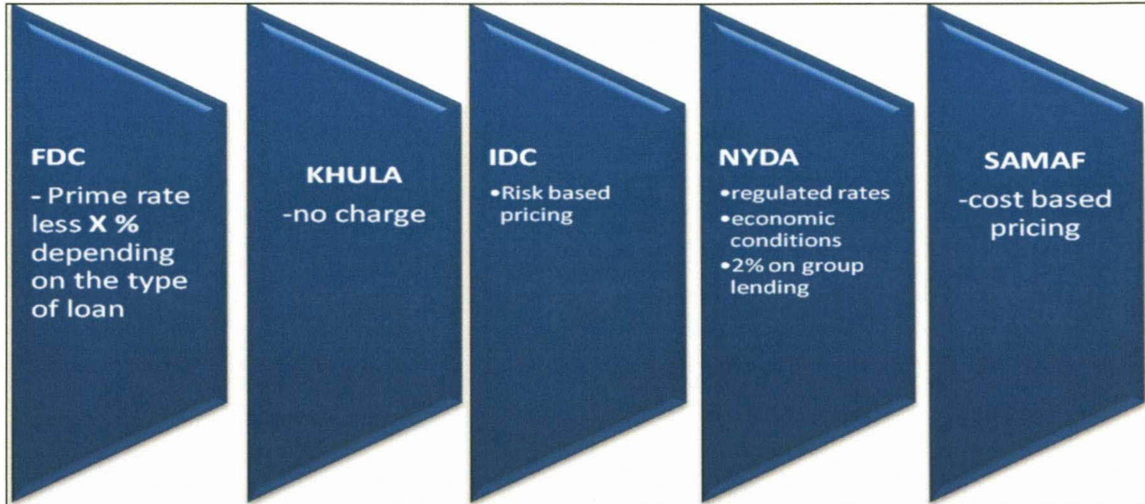

Figure 5.14 *Loan pricing by DFIs*

- IDC reported that they did risk-based pricing. In addition IDC considered also at the level of empowerment (where skills were transferred to previously disadvantaged community/ population) and economic merit of the business as illustrated by the owner's projections. Seemingly, IDC's pricing model was determined by the business risk as do banks and level of empowerment within the business (BEE).
- SAMAF indicated that their pricing model was based on the costs at +/- 4.5% and expected the co-operatives to charge the SMMEs at least 10% to 15% just cover their own costs and a make a bit of profit. The indication of the results was that SAMAF's pricing just covered financial costs incurred and expected the co-operatives not to be too strict in their pricing.
- Khula mentioned that it did not charge SMMEs anything. Implying therefore, that the client was only charged the rate determined by the bank for the loan issued.
- NYDA's pricing model incorporated risk-based pricing, the regulation (prime less x), economic growth, credit checks "...*we take it in line with*

regulations, NCA regulations, these regulations that guide ... we just take general economic growth... when the recession started, we dropped the interest rates by 2%... we drop it when we see young people are struggling to...for loans above R10 000 we charge 1.42% a month, so if you pay that loan in three months somewhere, you pay... 4 point Something %". The results might mean that NYDA's pricing depended more on the regulation and market forces.

FDC

Micro loans	Bridging loans	Cooperative Fund	Initiator	Step-up loan	Propeller	Equity
- Prime rate less 3.5% for 36 months	- Prime rate	-Prime rate less 2%	Prime rate less 2%	Prime rate less than 1.5%	Prime rate less 2.5%	Non-interest bearing

Figure 5.15 *FDC loan pricing model*

FDC had different pricing structures for different types of loans (Figure 5.15) but basically their interest rates were prime based less (between 2% and 3.5%). In addition, FDC stated that for loans where FDC took equity, that portion of equity was non-interest bearing. From the above table, it seemed that FDC's lending was based on prime rate even though the prices might not exceed prime rate.

5.2.1.5 Partnerships

In their efforts to assist SMMEs some DFIs had developed some strategic partnerships with other institutions to mobilise their lending programs. The

decision- making on who to lend to and pricing was one of the crucial issues in the partnerships. The table below illustrates the partnerships with which the DFIs in the Free State were engaged in SMMEs financing.

Table 5.5 *DFIs' strategic partnership in SMMEs financing*

DFI	Strategic Partner	Product	Contribution	Final Decision maker
FDC	ABSA	Joint Fund	-ABSA pays 100% loan -FDC initiates loan application for unbankable clients	ABSA
FDC	NYDA	Provincial Youth Fund	50/50 of R4.5 million to make R9 million	FDC
NYDA	FNB	Progress Fund	Up to R10 million	FNB
Khula	All the four banks	Credit Guarantee schemes	Unspecified	Banks
IDC	None	None	None	None
SAMAF	None	None	None	None

Table 5.5 illustrated the strategic partnerships that the DFIs in the Free State had with other FIs in their SMME lending programs. FDC had partnerships with ABSA and NYDA. In its partnership with ABSA, FDC handled all the clients that the

bank considered unbankable (see 5.2.1.2) where FDC would use its lending criteria, including 65% equity where collateral was not available, to assist the client. Upon approval, FDC passed all the documents to ABSA to make its own assessments and final decision as 100% of the loan amount was provided by the bank not FDC. FDC also had strategic partnership with the NYDA where the two institutions contributed 50% (R4, 5 million) of the Youth Fund (R9 million) towards assisting their youth clients. The fund was managed by FDC; NYDA only referred applicants that approached them to FDC. Khula had strategic partnerships with all the four major banks in the Free State.

Therefore, the results showed that three of the DFIs (Khula, FDC and NYDA) had in lending partnerships with other FIs. Further that in these partnerships, only one partner made the final decision concerning the issuing of credit.

5.2.1.6 Challenges

The financing institutions had indicated that they were faced with some problems in their attempts to assist small business to access finance. It was therefore crucial to highlight these problems that these financing institutions believed to be the stumbling blocks towards SMMEs funding. The problems were:

- Separate lending criterion by lending partners;
- Session/ tender-related problems;
- Misuse of credit guarantee schemes;
- Centralised business units;
- Irrelevant products / services;
- High loan prices;
- Credibility of clients;
- Unethical behaviour of bankers and DFIs personnel;
- Limited budget;
- Poor marketing; and

- Legislation.

Each of the problems will now be discussed in more details in the next sections in no specific order.

(a) Different lending criteria for lending partners

Some DFIs complained that parties in the lending partnerships (table 5.5) at times had different opinions on the decision on who qualified for the loan. FDC, for example confirms "... *we have our reason as FDC why we said the business is viable ...They* (ABSA) *will have their own reasons why they say it's not viable. At the end...the client does not know it's ABSA that approves the loan ... it's our reputation that is at stake. Sometimes they will approve the loan ...tender finance and it has to be processed speedily. So if they take time, they take longer to do that...the client will end up losing a tender...*" this might have been the implication of separate lending criteria that applicants were exposed to at different financing institutions within the lending partnerships.

While this issue of conflicting interest did not affect the DFIs that were not in any lending partnerships, banks also did not consider it as a challenge as well.

(b) Sessions/ Tenders related problems

Only FIs that lent directly to SMMEs (banks, FDC, NYDA and IDC) were able to provide sessions or tender finance to SMMEs. Other FIs like Khula, SAMAF did not provide sessions. There was a problem that FIs that provided sessions encounter: Standard Bank complained about the clients who applied for finance to support the session from one bank and used the other bank to receive the tender finance and also about the irregularities within government departments "... *last year we had ...about 25 applications approved and nobody could acknowledge the session, as a result we could not pay out that money...*" ABSA

indicated that they were at pilot stage with this program and therefore had no problems concerning the sessions to report. FNB and Nedbank did not make any comment on this. The reason behind this sessions' problem might have been that the SMMEs were not well trained on issues such as relationship building and the benefits thereof.

While the session did not work very well with the Standard Bank, FDC indicated that the program worked very well for them although at times the government department paid the tender money directly to the client instead of paying through FDC as the financier. FDC in turn needed first to deduct its money and give the client the balance and then it became a challenge for unreliable clients. The results demonstrated that sessions did not work well for DFIs if money was paid directly to SMMEs.

(c) Misuse of Credit Guarantee Schemes

Khula was the only DFI that provide credit guarantee scheme from the DFIs side and hence the only DFI that had a problem. Khula pointed out that it did not have the influence over the loans, banks still made the final decision, but should the loan fail they (Khula) had to pay back "*... should the client defaults ....banks will recall that security of Khula...black SMMEs are still not being able to access this...I am sitting with a portfolio of **100% whites**. So you see...*" Khula further claimed that the interest rate charged to the clients remains the same regardless of the availability of the indemnity which should reduce the risk profile for it is more liquid "*... do not charge more than prime because we give you a guarantee that is soft money. So the security is more liquid that what you could... but banks want to charge prime plus...*"

ABSA, from the banks' side, believed that it was difficult to make profit with credit schemes *"...it is very difficult to make any profit on there...the quality of applicants. So if we grant loans and they can't pay then it's a big issue. Also you*

are restricted in terms of pricing..." ABSA was concerned that the process of credit guarantee was not a smooth path "*...the credit guarantees are normally good in principle but there is a lot of conditions around when the guarantee will actually pay out...*" This challenge might have been caused by the fact that the two institutions in the partnership did not decide jointly on the issue of a credit scheme. Other banks, Standard Bank, FNB and Nedbank did not raise a concern about Khula's credit guarantee scheme.

(d) Centralised business units of financial institutions

The centralisation of business units or departments within the institutions made their processes lengthy. An IDC respondent, for example blamed the centralisation of the institution for the delay of the processes. The respondent claimed that it was due to the requirements of the corporate governance "*...every approval is done at the head office: which makes the process a bit longer, more cumbersome...*" FDC also mentioned that the final decision rested with the investment committee of the FDC which was based in Bloemfontein, implying therefore that even if SMMEs submitted their applications at the District office, the decision had to be made from the Provincial office.

Similar concern was raised by Standard Bank that the provincial office only made the recommendations to the head office which made the final decisions with regard to Khula deals "*...It takes up to three months to be finalised... we have only centralised office in Johannesburg...we are not allowed to make decisions and memorandum of understanding with Khula is centralised....the local office, ... send us the applications, but with recommendation and put recommendations on that financial decisions assessed. Even so it will still go through the centralised office to say that the local Free State Khula ...they have granted the 80% collateral but then they will still talk to them and do the paperwork in Johannesburg, then they will come to us*".

FNB also indicated that because their credit head office was in Bloemfontein it became easy for the process to be dealt with. *"...our credit head office sits in Bloemfontein, so it's much easier. Should they decline an application and you feel very strong about the application, you go directly to the credit head office and discuss it with the portfolio manager..."*

From DFIs' side, it was only FDC and IDC that indicated the concern on centralisation of their businesses. Other DFIs, Khula, SAMAF and NYDA did not mention if this issue affected them. Nedbank and ABSA, however, did not indicate if centralisation of business units of their institutions had any impact on their operations. Seemingly, centralisation of business units of DFIs prolongs and prevents subjective decisions that could benefit SMMEs.

(e) Irrelevant products for Free State

Some DFIs offered products that were not relevant to Free State SMMEs. IDC, for example stated that the types of products they had, did not address the needs of the businesses in the Free State. The respondent indicated that the business focus in the Free State was more on primary agriculture. Agriculture was excluded from IDC's target market parameters which had a small impact on their funding "*...the Free State has not been a very good province for IDC...Free State is not known for many industries... From the R10 billion approvals IDC made last year, we only got 0.2%...so it's very small; we haven't been that successful...*" IDC claimed to be working on other approaches to make their programs more accessible for SMMEs.

Another challenges with regard to irrelevancy of products or service provided by the DFIs had been highlighted by SAMAF *"...we only focused on co-operative "... the fact is that we don't have even the co-operatives... only one in QwaQwa... we used to have one in Thaba-Nchu but it doesn't exist anymore... so the impact is very minimal"*. This problem of product irrelevancy was not highlighted by FDC,

NYDA and Khula. Banks as well did not mention if they encountered any problems with regard to irrelevant products.

DFIs might have been providing irrelevant products for Free State because the products/ programs were designed from their head offices. Head offices designed products based on the general needs of the country as a whole without considering individual provinces. DFI's products, for example were more relevant for an industrialised province such as Gauteng which might have a lot of influence on the designing of IDC's programs because the head office was in Gauteng.

(f) High bank loan prices

The respondents from the banks acknowledged that their loan fees were too high that the cost of the entire loan cost became higher than the value of the loan for SMMEs. This might have been due to imperfect competition in the credit markets of SA, where SA's four top banks were said to be dominating the financial market. Because if this was not the case, theory indicated that competition always helps bring down the prices, which was not the case with SA loans. Moreover, it may be because of information asymmetry on SMMEs that banks charged them higher prices to cover original costs and unexpected losses.

(g) Credibility of clients

The respondent from Standard bank had mentioned that while they (banks) were blamed for not willing to help, the unreliability of clients had cost people's jobs *"...there is a whole lot of people that lost their jobs because they put the neck on the line for an SMME client. Whereas the contrary perception that we are not willing to help, the thing is that SMMEs tend to be very unreliable"*. The other three banks made no comment on this. While SAMAF and IDC made no statement concerning credibility of clients, FDC and NYDA had indicated that this

challenge of non-payment affect them. FDC have indicated that non-payment was a challenge it faced because their cash flow was affected negatively "...*I think the biggest challenge is non-repayment ... because it affects FDC cash flow".* Khula reported that they were actually established for this purpose, therefore it was not a challenge, however, before they paid for non-paying client they make certain that it was indeed the case "...*we investigate if the bank had not been reckless in lending according to the National Credit Regulator...*" The indication of non-payment might have been that people believed the loan was government's money. Therefore they might have believed that they were entitled to funds and decided not have to pay back.

It might have been that communication channels with clients were not designed in such a way that they enabled SMMEs to communicate with their bankers on the progress of their businesses.

(h) Unethical behaviour of bankers and DFIs personnel

There was continued unethical behaviour practiced by some bankers who misused the guarantee scheme system of the government. One respondent from the bank states, " ... *I think banks are just making money out of this whole thing...sometimes they grant loans to guys that they* know *for a fact that this guy will not survive. But because at the end of the day they get their money because they know there is a Khula guarantee in place."* The other three banks did not mention this as problem.

One respondent from the DFIs mentioned that there was perception that people business plans were stolen from clients by some employees. The respondent stated that this perception might discourage SMMEs to approach the DFIs. The respondent reported that they did not assist brick construction due to high failure in that industry. NYDA reported that at times, although some employees may have been trained, they did not have clients' service as a skill. The respondent

indicated that instead of referring the client to the other person, the employee let the client leave the institution not served. This challenge was mentioned by only two DFIs while the other three did not say anything with regard to the problem.

(i) Limited Budget

DFIs got their funding from government, but the budget allocated to small business funding was never enough to cater for all their clients' financial needs. A respondent from FDC said that one of their biggest challenges was the limited budget *"...we have a limited budget, so if we exhaust the budget, then we cannot continue to fund".* The other DFIs did not discuss this as their challenge. Banks on the other hand stated that budget was never a problem to them. The respondent from Standard Bank indicated that they as banks never failed to finance a business on account of the limited budget.

(j) Poor Marketing

Proper marketing was one area that the financing institutions seemed to fall behind with. IDC had indicated that entrepreneurs seemed not to know what IDC was offering which was a reflection of poor marketing from their side *"I think IDC tends to be a little at a distance... I think we create that impression sometimes – very professional, difficult to talk to... We need to come closer to the potential client."* FIs also placed pamphlets about their programs in their branches which limited the spread of the information particularly for communities such as rural communities where the institutions did not reach. The respondent from IDC was concerned that they advertised in the wrong media *"... sometimes people in the townships do not even read the press that we are printing our adverts in."* IDC further admitted that the physical location of their offices might be another indication of poor marketing as many entrepreneurs may not necessarily notice the offices let alone those residing in other regions of the Free State, outside Bloemfontein.

NYDA claimed that people in the Free State knew about their programs as they had been in existence for some time although the institution was still known by majority with the former name- Umsobomvu Youth Fund, but this did not create problems as it was just the name that was changed. They had flyers at their offices displaying the new name and that their offices were in Bloemfontein. SAMAF also indicated that people did not know the SAMAF fund, because the office was still approached by individual SMMEs rather than co-operatives for funding. The respondent mentions that there was a limited knowledge about SAMAF. FDC mentioned that it had offices across all the five Districts of the Free State and satellite offices in some local municipalities, such as Botshabelo in the Mangaung local municipality and was hoping to establish more offices in other local municipalities. Khula had its offices in Bloemfontein but the respondent mentioned that they did regular outreach programs around Free State. The results were indications of poor marketing by DFIs.

Banks made no comment on the issue of marketing as a problem towards SMME financing. It could be concluded that banks had long been established and therefore SMMEs were well aware of their programs.

(k) Legislation and policies

Legislation plays an important role in financial services but may disadvantage parties in the lending contract. FIs operated through the framework of their regulation and institutional policies. One respondent from banks indicated that legislation was responsible for the way they (banks) behaved towards the issuing of credit which, he acknowledged that he was disadvantaging SMMEs *"...banks have their shareholders that they've got to satisfy. So they can't just do reckless lending...NCA has made it a lot tougher for people to access finance for small businesses".* Another respondent from the DFIs confirmed that while NCR was protecting both the client and the institution, it might have been very difficult for entrepreneurs that did not qualify according to the NCR regulation to access

funding. FDC stated that it was their policy that they handed over non-payments accounts to their legal departments which made people reluctant to approach them in case anything go as unplanned. All the respondents, both banks and DFIs have indicated that they operated within the parameters of their institutional policies which set who and how to finance. While DFIs stipulated that they were given the mandate by government, banks acknowledged that beyond the industry and institutional policies, NCR regulates their operations. It was observed that legislation might have been too rigid towards SMME lending.

5.2.1.7 Solutions/ Way Forward

When asked to make recommendations on the way forward concerning assisting SMMEs in the Free State to access finance, participants acknowledged the importance of the small business sector in the economy. A respondent from FNB, for example reported "*...I believe that if we can assist the SMMEs, our profits will grow because if they do good, we will do good*". Therefore the respondent recommended that it was profitable for banks to assist small businesses.

The participants have recommended that the SMME sector needed more support from all the stakeholders involved, both government and private sector. A respondent from banks, for example, suggested that banks need to be more lenient in terms of pricing SMMEs "*...the pricing plays a big factor because the pricing on money lend, pricing on the service fees, on cash deposit fees, all of these are factors that cost the small businesses at the end of the day...*" The other one from the very same banks' side has recommended that government should monitor the programs very closely "*...I think start off with government, it must intervene. I think that is my main thing...*"

The other recommendation had been that the consultants/ advisors that provided business plans to SMMEs should include the clients in the whole process of the business plans. This was because as in most cases the entrepreneur hardly

knew the contents "... *somebody else drew up the business plan but the owner still doesn't understand it...*"

Efforts to communicate with the consumers/ market were poor. For example, *"We need to advertise in such a way that target market is reached".* One respondent claimed that the marketing of the programs needed to reach their target market.

5.4 Conclusion

This chapter was based on the presentation and interpretation of the findings of the empirical study by the interpretation of the researcher. Data was transcribed verbatim from the open-ended interviews with the research participants. The transcriptions were coded and grouped into the categories. The categories were matched to the seven themes which were predetermined and formed the basis of the chapter. The themes have been discussed in details to give meaning with regard to what they mean to this research relative to the theoretical chapters. Based on the findings, the next chapter discusses the findings in relation to the objectives of the research. A summary and overview of the research including the recommendations and conclusions are also presented in the next chapter.

CHAPTER 6

6.0 Synthesis of findings, Conclusions and Recommendations

6.1 Introduction

In the context of small business development, it was evident that credit financing is a burning issue that needed attention in the developing countries such as SA. While the problem might still prevail in the developed countries, in the developing countries it was even worse. Both GEM (2006: 5 and OECD, 2006) suggested that small businesses in the developing countries were faced with challenges of securing finance from financing institutions such as banks especially at the earliest stage (start-up) of business cycle.

With the great contribution that the small business sector made in South Africa towards the alleviation of poverty and unemployment, the support of this sector was therefore very important. Alone the sector could not survive the challenges of the environment in which it operated as has been highlighted in the literature study in chapter two: regulation and access to finance. While regulation was highly responsible for the amount of credit to be issued, the financial market forces influenced banks to price loans above the minimum prescribed rates.

The growth and development of this sector was therefore dependent on the support of the stakeholders: the DTI, provincial government, Parastatals, local economic development, NGOs and organised businesses (see figure 1.2: 9) who had direct influence over the sector's external environment, including, but not limited to financing institutions and government. The literature study in chapter three showed that the government of SA had tried to alleviate some of the challenges facing SMMEs. Government established different DFIs to assist this sector to access credit finance.

The current study opened up for further research to be conducted. It scrutinised the reasons why access to finance was still a problem for SMMEs. The study was expected to assist entrepreneurs, financing institutions, policy makers, business support services and government to identify the gap and address the problem of access to SMME finance.

The primary aim of the study was done in order to investigate why access to finance was still difficult for SMMEs in the Free State when the DFIs were established to fill the gaps left by the commercial banks. To achieve this government's development goal, the DFIs therefore were set to target mainly the SMME market that was not necessarily served by the banks. This was one of the developmental strategies of government of South Africa for development of small businesses in a pursuit to alleviate poverty and reduce unemployment. This chapter is based on the synthesis of the findings relative to the research objectives, summary and overview of the study, recommendations and conclusion of the research.

6.2 Summary and Overview of the research

The current section aims to provide a brief account on what each of the chapters of the study covered. The account shows how the chapters were joined to each other to give the portrait of the study.

In chapter 1, the study presented the background to the research in order to demonstrate where the previous researchers made their point of exit. This was followed by the identification of the gap left by the previous research through development of the research problem and research objectives which helped to create the platform for the current study. The research methodology was briefly discussed here to give shape to how the study was to be carried out. The outlay

of the study, terminology of important words and the rationale of the study concluded the chapter.
Chapter 2 was based on the literature review or theory on the role played by commercial banks as the major suppliers of finance and element of comparison. The chapter, however, opened by giving a brief highlight on the importance and the constraints facing the SMME sector. This was done in order to justify the developmental support for SMMEs including access to credit finance. The ways in which credit financing was handled by commercial banks in South Africa were investigated to further understand the gap in the field. The study also showed that factors that impede SMME financing by banks include lack of collateral, poor business plans, information asymmetry and the regulation (see paragraphs 2.6.1: 28 and 2.6.2: 31).

The literature study focusing on government intervention for the support of SMMEs that could not be assisted by commercial banks to access credit finance was presented in chapter 3. This chapter demonstrated that government had established different development financing institutions to fill this financing gap. Each of these DFIs had been scrutinised to indentify different products they provided to SMMEs.

Chapter 4 dealt with the research design and descriptive explanatory study within the qualitative mode. Within this methodology, the study showed the instruments used and the reason behind the selection thereof. The chapter showed that the primary data was collected through face-to-face and telephonic interviews. Lastly the chapter concluded with the unit of analysis used.

The presentation and interpretation of research results obtained from interviews with the financing institutions in the Free State was detailed in the fifth chapter. The discussions were done by aid of themes to show main trends and patterns in the data with reference to the research questions. The chapter showed that FIs has special programs that are specifically designed to assist SMMEs. The

chapter further highlighted that while banks, on the one hand, issued loans to any business that met bank's lending criteria, different DFIs on the other hand had different target SMME market including their lending requirements. Furthermore, the chapter demonstrated how different FIs priced their business loans. Chapter five was concluded with challenges and proposed solutions for FIs in the small business financing arena.

Chapter 6, the current chapter, is the final stage of the study, highlights the main findings that have been obtained in the study by drawing together the results from the previous chapters. The results were interpreted in terms of the literature or theory. By doing this, the study was aimed at applying information obtained from the literature study and empirical study as the basis to provide a solution to the body of knowledge.

6.3 Research Objectives

The following the research objectives were formulated.

6.3.1 Primary Objective

To investigate whether DFIs in the Free State are successful in fulfilling the gaps in financial needs of SMMEs that would not necessarily be assisted by banks in terms of their access to credit finance.

6.3.2 Secondary Objectives

1. To examine the operations of DFIs and commercial banks with regard to programs, tools and methods in assisting SMMEs to access credit finance.
2. To explore the funding requirements in order to access credit finance from the FIs.

3. To find the problems that financing institutions encounter in assisting SMMEs to access finance.
4. To investigate the extent to which development finance institutions are complementing or supplementing banks.

6.4 Main findings with recommendations of the research

This section discusses the main findings of the study with the most relevant recommendations. Access to credit finance by SMMEs was the problem facing the Free State province. The main intention of this study was to observe the operation of development finance institutions and commercial banks in their efforts to assist small business to access finance. To achieve this, the study investigated whether development finance institutions operated differently from commercial banks in assisting SMMEs to access.

6.4.1 Operations of banks and DFIs with regard to programs, tools and methods used to assist SMMEs in the Free State to access credit finance

The results showed that financing institutions (banks and DFIs) had programs that were designed to assist SMMEs in the Free State to access credit finance. The different programs were designed to assist different entrepreneurs at different levels of their businesses: start-ups, expansions and tender (contract) finance. The study reveals that banks preferred established businesses that had been in operation for at least two years to be able to provide the trend on how the business had been operating and to overcome the problem of information asymmetry (see paragraph 2.6.2: 31). The study showed that loan amounts went as low as R1000 for micro loans. This implied that there were different sources of business funding in the Free State that entrepreneurs could choose from, depending on the type of funding the business required. The study had revealed that some programs that were provided by the DFIs were irrelevant for SMMEs in the Free State (see paragraph 5.2.1.6 (e): 114). Subsequently the objective of

identifying programs that FIs had to assist SMMEs to access finance had been achieved.

6.4.1.1 Banks

It was evident from the results that banks on processing loans used different tools, such as credit assessments or risk analysis, credit scoring and different pricing approaches. These results proved what the theory stated: banks checked the default probability of the individual loan applicant, how the applicant handled credit and how much the individual applicant could afford to pay back the loan. Based on the information provided by these tools, the loan was either approved with specific amount or declined if the SMME did not meet the lending criteria (see figure 5.11: 102). Banks had the advantage of getting the applicant's credit information from credit bureaus. Banks were even more advantaged for using credit scoring as it helped reduce subjectivity of the loan that result from relationship-based lending (see 2.6.2.1.1 (c): 40). Relationship lending benefited only few clients that had the relationship with the banks, while credit scoring increased the banks' profitability as it accommodated more people.

Banks used different methods to price their loans: cost-based, risk-based, relationship-based and competition-based pricing. The interest rates' ceilings were, however, regulated by NCR. The current study showed that for SMME lending banks used risk-based lending. The rate charged on the loan was dependent on the risk profile of the individual loan applicant. Start-ups, were perceived as a high risk market by the banks, hence were charged a higher interest rate. The loan rates were charged daily from the first day the loan was issued. Due to daily accumulated interest, the cost of the loan became high. Given the high rate charged on risky start-up businesses the increased loan costs became even higher. Therefore it became difficult for small businesses to service the loan and the working capital was affected negatively, ultimately making SMMEs fail to survive.

The results revealed that on Khula Credit Schemes, banks decided on who qualifies for the Credit Guarantee Scheme and hence Khula's targeted market was not entirely served because black people did not benefit the credit schemes. The main role that Khula played in the scheme becomes prominent when the entrepreneur defaulted with the loan repayment. Some banks made profits out of high risk loans through credit schemes. The implication was that banks benefited more on credit guarantee schemes by providing loans to high risk applicants who were charged high rates. Therefore Khula's credit's schemes benefited banks rather than SMMEs.

Proposed solutions for banks

Instead of using risk-based lending, banks may redesign their lending criteria specifically for SMMEs to include the following issues:

- Entrepreneurs undergo business skills training;
- There must be a fit between the entrepreneur and the type of business idea to eliminate the risk of high business failure;
- Develop mentorship programs for SMMEs upon obtaining start-up finance from banks to assist start-up businesses on how to profitably manage the finances, particularly the loan;
- SMMEs provide monthly progress reports to the bank in order for the bank to immediately realise if business is struggling to move forward according to the plan;
- SMMEs must open a current account with daily business banking as this will help to build up the relationship with the bank. The bank can, however, minimise the transaction costs to encourage continued SMMEs banking;
- Improve access to long term financing; and
- Assign relationship banker to carry out quarterly site visits to the business.

With the above issues in the lending criteria, the risk factor is minimised and therefore, prime linked pricing can be used for SMMEs as well. Due to lack of collateral, term loans can be issued to help minimise the default risk.

6.4.1.2 DFIs

The study showed that DFIs did only credit assessments. For DFIs that had lending partnerships with banks (FDC and NYDA), depended on banks' expertise to make the final decisions. On loan pricing, DFIs used the bank rate as the bench mark and do not do credit scoring, perhaps because banks were better equipped with facilities and expertise. Subjectivity plays a great role within DFIs because the bad experience with a specific industry might compromise individual entrepreneurs who had potential of succeeding (see 5.2.1.6.8). The investment committee might be inclined to decline the loan due to many failed businesses in a certain industry.

The findings contradicted the theory that the DFIs served the market that was not served by banks if entrepreneurs were declined on account of the industry's poor performance (see 3.1). IDC managed to use all the tools used by banks, hence that was why their minimum cost of processing individual loan is about R250 000. IDC, like banks had an advantage of making its sole decision, because it worked directly with its clients, there was no partner with which IDC shares decision making in their lending programs (see table 5.5). With regard to loan pricing, DFIs' loans were cheaper than banks' loans because they were priced lower than bank prime rate with the exception of IDC. IDC's pricing was similar to banks' pricing which was risk-based lending. DFIs' pricing benefit entrepreneurs found loan prices expensive.

Recommendations for DFIs

DFIs may adopt the use of credit scoring as the theory advocates that credit scoring is very objective and consistent with regard to making loan decision. These qualities are desirable for any institution, particularly those that lack a strong credit culture, such as the DFIs dealt with in the study; they have indicated that they depend on their bank partners for their expertise with regard to tools used in issuing credit. IDC is the only DFI that have proven independent in this regard. Therefore the recommendation is that DFIs may adapt the IDC's good practice of independence.

6.4.2 Funding requirements expected from SMMEs to access credit finance from banks and DFIs

The study showed that there are some similarities and some differences with regard to the funding requirements by banks and DFIs.

6.4.2.1 Banks

The study revealed that in order to access finance from the banks, the firm should have a business plan which the entrepreneur related to and understand very well, the collateral to serve as a shield against default risk, the contribution of between 10-20% of the loan requested to show the level commitment to the entrepreneur which reduced credit risk (see 2.6.1and table 5.11). In addition the business should at least have had existed for at least two years to show movements on cash flow as the loan was to be serviced from the first day of issue included on monthly repayments.

6.4.2.2 DFIs

The results showed that DFIs required the business plan (or group institution for group lending) and owner's contribution just as banks required. For DFIs, owner' contribution was, however, not necessarily in monetary terms. Full involvement, relevant skills and experience of the entrepreneur all added values to the business to the business. The result also indicated that security or collateral were not very important to DFIs as one of the reason DFIs were established (3.1), DFIs preferred that entrepreneurs be committed and involved in the success and daily running of the business. In addition, some DFIs (FDC and NYDA) considered taking equity in the business if there was not security pledged against the finance. Entrepreneur's assets could be attached to the loan by FDC in case of default of payment. DFIs believed that the entrepreneurs were better known by their communities hence DFIs provided group lending where group members signed surety for each other within the group (see 5.2.1.3 and table 5.12).

6.5 The extent to which banks and DFIs complement or supplement each other

The findings revealed that DFIs to a certain extent did supplement banks and the other extend they did complement banks.

6.5.1 Supplements

The findings showed that DFIs supplement the banks because they provided financing to SMMEs which banks would not finance, because they considered such businesses as unbankable (see 3.1 and figure 5.). The results further showed that with regard to tools and methods of processing loans banks and DFIs did not operate in the same (see 2.6.2,and table 5.4), because banks did had facilities and expertise that DFIs lacked to process loans. Lastly, it was revealed by the current study that banks were businesses that strove to make

profit whereas DFIs were institutions that were supposed to develop SMMEs (see 1.1, 2.6.1 and 3.1).

6.5.2 Complements

The results had illustrated that banks and DFIs are complementing each other in the area of small business finance. DFIs complemented banks by providing the security for businesses that would not be assisted by banks on account of collateral. DFIs assisted unbankable businesses to access finance from banks by relaxing the requirements that would limit the chance of obtaining finance from the bank (see 2.6.1, 5.2.2, and figure 5.5.).

The research has realized that because banks were still the issuers of loans/ money despite the lending partnerships with DFIs (see table 5.5 page 87). The impact of the DFIs in the SMME lending was very minimal due to the lending partnerships with banks, because DFIs had a little role to play on the final decision making of loan issuing. The current section focuses on the problems from the perspective of the supplier followed by recommended solutions for each of the problems as displayed in table 6.1.

Table 6.1 Financing challenges and recommendations: suppliers' perspective

Problems	• Recommendations
Khula credit schemes	•joined decision making •direct lending
Unethical practices/beahaviourr within FIs	•monitoring •after care services
Lending partnerships	•joined lending criteria •joined decision making
Loan pricing	• prime pricing for Khula loans • more lenient
Incredibility of clients	• enhance dialogues • build relationships
Regulation	•enabling regulation
Limited budget	•report backed projections •referals
Marketing of DFIs' programmes	• more outreach programmes •more accessible
Centralised businesses units of FIs	•decentralise the services

Table 6.1 summarises the problems of access to small business financing the study discovered from the DFIs themselves. Each of the findings/problems will now be discussed in more detail with some main recommendation applicable to each of the problems as a solution.

- Khula Credit guarantee schemes

The study discovered that Khula did not have direct decision making power on who received the guarantee scheme and collection of loan repayment (3.2.4 and

5.2.1.6.2). Khula's lending program to SMMEs was accessed through bank partners of Khula. Khula did not have control over who actually received funding. On the other hand it became a challenge for banks to recover costs from Khula. This might have been an implication that Khula targeted market continued to fail to access credit finance.

Khula had the following two options as a solution to the problem above

- Joined decision making

To address this challenge, it is recommended that the decision making on who is covered must be a joint decision between Khula and the relevant bank. Khula and the relevant bank would be of the same understanding on who have been assisted. With regular reporting to Khula with regard to loan repayment patterns, banks would not have difficulty in claiming from Khula.

- Direct lending

Khula can consider lending directly to the SMMEs. SMMEs that lack collateral may apply directly from Khula for the guarantee scheme which, upon approval of the application, can award a certificate of the guarantee. With the certificate, the SMMEs can approach the bank.

b) Incredibility of clients

While subjective decision might have helped FIs to extend credit to SMMEs, the results have, shown that this practice had cost some bankers their jobs because clients are not always credible. People had lost their jobs on going out of their ways to assist potential clients who in the end proved to be bad loans costing shareholders' funds (see 2.6.1 and 5.2.1.6.7). For this reason people were reluctant to make extra efforts to assist SMMEs to access finance.

Recommendations for the problem above are the following:

- Encourage savings

SMMEs need to be encouraged to develop a saving culture. When the culture of saving is instilled, SMMEs will begin to have relationships with their banks. Relationships will lead to trust and loyalty that will help increase the understanding between banks and their SMME clients.

- Enhance the dialogues between bankers and SMMEs

Enhancing the dialogues between bankers and SMMEs where possible through a code of conduct, can improve the understanding of each other. This approach can even limit the problem of information asymmetry between the two and increase the relationships and ultimately minimise risks (see 2.6.1).

- Build sustainable relationships

Relationships between SMMEs and their banks must be maintained to be sustainable. This will help reduce the problem of information asymmetry that creates the above mentioned problem.

c) Unethical behaviour within FIs

While they are aware who should be assisted through Khula credit scheme, some banks became biased against the scheme's targeted market. In addition financial institutions were so unethical that they made profit out of risky loans with certainty that their loans would be recovered from Khula's scheme (see 5.2.1.6.8). Results have shown that some employees misused their positions within the DFIs and sold out people's viable business plans and entrepreneur became unhappy with the service they received from some employees.

The following were some recommendations for this problem of unethical behaviour

- Monitoring and use of score cards

Monitoring of how the client was awarded the loan through Khula scheme can help eliminate improper practices by some banks. Perhaps use of score cards can be used by Khula to make certain that all clients served fall within the Khula target market which covers all potential business from targeted areas such as: women, black people, rural areas, youth, small manufacturers, farms, traders without bias against or towards any of the groups mentioned as per the DTI's mandate (see figures 1.2 and 5.7).

- Monitoring and aftercare services

Monitoring of the performance of the employees toward SMMEs and providing aftercare services FIs can minimise unethical behaviours. This can be done through use of log books where entrepreneurs make a short note about their experiences with institutions and the feedback they received. This would help the management to know of the improper behaviours of employees and improve their customer service.

d) Lending Partnerships

DFIs and their lending partners might not have had similar views on the funding decisions. The study had shown that different institutions had their own lending criteria (see 2.6.2, figure 5.11-12, and table 5.5). Therefore lending partnerships resulted with opposing views towards qualifying loan applicants. In the end the decision lies with the partner that made the final decision and the other partners mandate was compromised. The problem of access to finance remained.

The recommendations to the problem of lending partnerships are:

- Joint lending criteria

Parties in lending partnerships may have their lending criteria tabled together for a specific lending program; this will help reduce confusion for entrepreneurs on funding requirements to be met.

- Joint decision making

Joined decision where both lending partners decide together on the approval of the loan can help to determine if the specific lending program works for SMMEs. In the end none of the parties carries the blame of not assisting SMMEs, particularly banks, as they were always blamed for not being willing to afford credit finance to SMMEs as theory indicated (see 2.6.2).

e) Loan pricing

The study showed that loan prices were very high in SA. The theory stated that the lower concentration of the market lowered the prices and vice versa. SA financial market was, however, highly concentrated (80%) dominated by Big Four Banks (Standard Bank, ABSA, FNB and Nedbank), which meant that their prices were very high hence were considered highly profitable (see 2.6.2.1and 2.6.3). The bank rate was still the benchmark for DFIs' loan prices; 60% of DFIs that lend directly to SMMEs, price their loans against bank prime rate and on risk-pricing (see 2.6.2.1.1.2, table 5.1, figures 5. 3 and 5.14). This implied that if the bank rate went high, DFIs' loans would be high as do risk-based pricing. Moreover, loan pricing for secured loans through credit guarantee schemes were still priced on client's riskiness yet the purpose of the scheme was to also to reduce risk exposure of banks (see 3.2.1: 62). Low level of competition and high concentration in the banking industry might have been also be held accountable

for high loan fees. Loan prices remain high even with intervention of the government.

The following recommendations are proposed:

- More lenient to SMMEs

Banks may be lenient to SMMEs by structuring repayments periods that can accommodate SMMEs' situations and reducing their loan prices without compromising costs, can help banks increase their profits. Theory has it that SMMEs are a profitable market for banks (see 2.5: p25 and 5.2.1.7: p120); therefore leniency will increase the number of small businesses in banks' client base. This can be done through designing lending that would target SMMEs outside normal lending that banks provide without exposing banks to options such as term loans and group lending

- Prime lending for Khula loans

Loans that are secured under Khula scheme have risk factor reduced, therefore should be priced through asset based pricing (see 2.6.3.1.5: 41). Because the scheme helps reduce the risk exposure, banks therefore must price Khula backed loans similar to their trustworthy clients that are charged at the bank prime lending rate, most importantly because the asset used (the guarantee) is very liquid, which means that it can be easily converted into cash (see 2.7.1 and 3.2.1).

f) Marketing of DFIs' programs

DFIs acknowledged that their products were still not known to their entire entrepreneurial market. DFIs' offices were physically located in the areas that were not easily accessible to SMMEs from rural areas as per their mandate.

Moreover, the media used by some DFIs did not reach all the targeted market (see 1.1 and 5.2.1.6.10).

The following are some recommendations

- Use of different marketing strategies, such as placing offices where they are easily accessible to the market;
- Frequent out-reach programs together with mobile offices can help reach out even to entrepreneurs who cannot afford site visit; and
- Use of media that is easily accessible for people in the rural areas.

g) Centralised business units of financing institutions

The current research found that some FIs had their head offices in Johannesburg where programs were designed and final decisions are made. Because of this centralisation, the former led to some products being irrelevant to some provinces although they could be relevant to others. The latter led to very objective decisions that could have been fruitful if were made from where the loan application was made where subjectivity would assist. FIs such as FNB that were able to make subjective decisions, because their credit department was close to them, proved to be at more advantaged than FIs other three banks that had their credit departments in Johannesburg (see 5.2.1.6.6). Access to finance would continue to be an objective decision.

Proposed solution to the problem of centralised business units

- If SMME lending can be redesigned with regard to leniency towards small firms, decentralising the credit departments for small business lending can help address this problem. Results have shown that this solution works for FNB. Caution must, however be taken with regard to subjective decisions.

h) Regulation

Regulation and policies helped to bring balance between two forces of financial markets: demand (SMMEs) and supply side (FIs) by relaxing the constraints the former (demand) were faced with, without compromising the profits or returns for the latter (banks). The results showed that the very regulation was one of the factors aggravating the problem facing small businesses towards access to credit finance (see 2.6.1 and 5.2.1.6.10).

Suggested solutions:

- Enabling legislation for easy access to financial markets.

SMMEs need enabling legislation, instruments and intermediaries that allow them to have easy access to the capital markets. Instead of the regulation requiring that individuals be screened by credit bureaus, the regulation may stipulate the development of the SMME credit risk database that can be used to improve the current fundraising environment in which the SMMEs operate without collateral

- Enabling legislation for new financial market entrants.

This will encourage new entrants in the financial markets and competition will prevail. With competition controlling the market, the dominance of the market by the four banks will be eliminated.

i) Limited budget

To be able to assist SMMEs to access finance, DFIs needed to have budget big enough to cover their projections. The findings indicated that the problem of limited budget impeded DFIs to reach all their targets; hence SMMEs continued

to fail accessing finance. The study, however, failed to discover actual figures to support this argument and what attempts were made by the DFIs to address this challenge.

Recommendation for the problem of limited budget:

- Budget higher than projected

It may help to provide projections that are backed by reports on how limited budgets have impacted on service delivery of financing SMMEs.

6.6 Shortcomings of the study

Some limitations were identified during the study. Firstly, there has not been much documented research on the operations of the DFIs. This limited the study only to the information provided by the DFIs themselves which created the frontier for rich arguments. Secondly, one DFI declined to participate in the study which might have made an impact on the results generalisation were made. The institution was excluded from the final results generalisation. It was an intention of the study to collect data through face-to-face interviews, but due to logistical concerns and time constraints, telephonic interviews were opted for and still earned the desired results.

6.7 Contribution of the study

The purpose of this research was to investigate credit financing for SMMEs in the Free State. This was done through comparing the operations and observation of various lending products/ programs of commercial banks to those of development finance institutions. The study compared these institutions in order to investigate if development finance institutions complement or supplement banks in trying to address the problem of SMMEs' access to credit finance. The research is crucial for small businesses, finance institutions, the DTI and policy makers involved in small business development and economic growth.

6.8 Final overall recommendations

j) Policy prescriptions in the area of access to credit finance should be focused towards the implications of available funding options. The funding options need to address the needs of the start-ups with high growth potential, but owned by individuals who are socially excluded (who cannot afford high loan fees yet need new risk capital).

k) Development Financing Institutions should be able to reach out far enough to reach the rural areas where most of these programs are not well known. This can be achieved by opening satellite offices at local municipalities to ensure that each region is attended to. Organising regional business summits can help disseminate information

l) FIs involved with SMMEs access to finance should have clearly defined financial targets that concentrate more on maximising outreach and turnover than on profit.

m) Access to credit finance for SMMEs needs to be supported by resources from government and other non-government institutions in order to offset the high risks perceived by banks.

n) SMMEs need to be aware of the sources of credit finance available to them for the purpose of start-up, expansion and acquisition purposes.

o) The agents that are appointed to assist SMMEs in drawing-up business plans need to include SMMEs in the whole process in order that SMMEs that understand and be familiar with their own business plans.

p) The establishment of regional business support centres/ SMME support centres to within the five districts of the Free State. The function of the centres may include support of SMMEs on matters such as:

- Tendering
- Credit gathering
- Business planning
- Business skills training including financial management and marketing
- Research and development
- Capacity building for SMMES

q) Government needs to explore the possibility of affording finance directly to SMMEs with minimum partnerships as the model used by IDC.

r) Financial market regulation must distinguish enterprise development financing from normal lending practices.

s) More co-operative banks must be encouraged in the Free State.

t) Further research must be done on

a. How other financing institutions (both non-government development institutions and other micro lenders) can assist small businesses to access finance.
b. How business lending can be designed to accommodate high growth potential start-up businesses without imposing too much regulation.

6.9 Conclusion

Despite the stated limitations or shortcomings, the study managed to achieve the primary and secondary objectives. The study was intended to investigate the reasons why access to credit finance is still a problem to SMMEs in the Free State if the DFIs were established be finance the gap left by banks. The study also aimed at discovering the extent to which DFIs had been successful in implementing the developmental strategy Act of 1996.

The findings showed that while the strategy was being implemented, the lending partnerships between banks and DFIs, high loan prices were responsible for continued problems facing SMMEs. The conclusion reached therefore is that IDC's direct funding model can be used. The model would work best if the more accessibility was considered together with relaxed pricing strategies for developmental finance. Continued monitoring performance of the DFIs would also prevent unethical practices.

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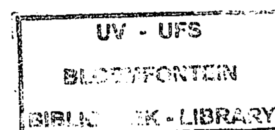
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Appendix 1

Letters of consent

I want to thank you for taking time to meet with me today. My name is Lisebo Agnes Ntiso and would like to know about your experiences with regard to participating in credit financing of SMMEs. As part of my masters' research, I am observing the operations of banks and development finance institutions in order to capture the lessons that can be used to address the problems of access to finance for SMMEs in Free State.

The interview should take less than an hour. I will be taping the session because I don't want to miss any of your comments. Although I will be taking notes during the session, I can't possibly write fast enough to get it all down. Because we are on tape, please be sure to speak up so that we don't miss your comments.

All responses will be kept confidential. This means that your interview responses will only be shared with research team members and we will ensure that any information we include in our report does not identify you as a respondent. Remember, you don't have to talk about anything you don't want to and you may end the interview at any time.

Are there any questions about what I have just explained?
Are you willing to participate in the interview?

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Interviewee Witness Date

Appendix 2

Interview Guide

- What lending programs are available for SMMEs (in alignment of the small business development strategy of the 1996)? **DFIs**
- What products/services does the bank have for SMMEs? Can you elaborate? **Bank**
- How many SMMEs have been assisted by the institution over last three years? **DFIs**
- Does the institution manage to achieve its financing budget every financial year? Please elaborate. **ALL**
- To what extend have lending programs been achieved, and what hinders program implementation? Please explain. **ALL**
- What methods and tools are considered in processing loan applications? (e.g. interest rates charged, guarantee schemes, applicant analysis, value of collateral, credit worthiness, payment periods, Business Plans as well as financial statements of the business, control measures for default, etc) **ALL**
- Which of these methods and tools would consider being key elements? Please explain. **ALL**
- What make your programs work well/ not well? Please elaborate. **ALL**
- What methods and tools should be discontinued? Why?
- What are some barriers and challenges you face in your efforts to assist SMMEs? (E.g. legislation? Lack of key support? Target industries? Illiteracy of entrepreneurs and lack of business skills?) **ALL**
- How do you overcome these barrier(s)? **ALL**
- What are the possible reasons for applications to be rejected? **ALL**
- What would you do differently next time? Please explain why **ALL**
- What can be done to assist small businesses? **ALL**
- What recommendations do you have for future programs such as these? **ALL**