4 Featured Schemes

This chapter focuses on a number of government schemes, as well one private-sector initiative, which the South African government can draw key lessons from to boost support to small businesses.

The chapter is structured into three main sub-sections which detail various Brazilian and Indian schemes to assist with financial support, market support and business support for small enterprises. Where applicable these are contrasted to such support in place in South Africa.

The author selected the below schemes from a number of government support schemes in Brazil and India which are aimed at small businesses. For a list of some of the most prominent of these schemes, as well as some of the South African government's most important SME support schemes, see Appendix 3.

4.1. Financial Support

This section on financial support covers three schemes that South Africa can learn from, namely: how Khula can boost lending by learning from India's Credit Guarantee Trust Micro Small Enterprise (CGTMSE) to boost lending through credit guarantees, how to improve access to finance from India's experience with credit ratings and how to improve access to finance and promote localisation: the experience of Brazil's development bank BNDES.

Credit Guarantee Scheme: Khula Vs CGTMSE (India)

- Banks shun the Khula guarantee scheme due to high default rate, poor quality of applications and a claims process marred by red tape.
- Near failure of Khula's guarantee scheme has led Khula and policymakers to develop Khula Direct
- India's CGTMSE offers various lessons to Khula in improving the performance of its guarantee scheme.

Overview

With the Minister of Economic Development Ebrahim Patel's announcement in March 2010 that his department would be looking at how to increase funding to small businesses, his officials would do well to look East, at an impressive credit guarantee scheme in India.

While in the 2009/2010 financial year Khula Finance Limited, the government's small business finance agency, handed out a mere 53 credit guarantees through its Credit Indemnity Scheme valued at R30.26 million, India's Credit Guarantee Fund Scheme for Micro and Small Enterprises (CGTMSE) in the same financial year disbursed 149 867 guarantees, valued at Rs68.72 billion (valued at about R10.7 billion in December 2010).

The CGTMSE has shown impressive growth in recent years. Just two years ago the scheme handed out 30 000 credit guarantees. The nearly 150 000 it gave out last year is equal to the total number of loans disbursed in the previous eight years of the scheme's existence. This impressive vault in lending took place at a time when not a single employee at the scheme received performance incentives.

Interestingly, staff are spurred on by the CGTMSE's fifth chief executive OS Vinod who joined the scheme at the end of 2007. He sends SMS alerts out to his team each morning to motivate them. Each alert contains a breakdown of the number of guarantees handed out the previous day and the total for the financial year so far. Vinod is aiming higher and believes the scheme can reach 300 000 guarantees a year by the end of the 2010/11 financial year.[51] So why is he so confident and how has the scheme which recently joined the 16 member Asian Credit Supplementation Institution Confederation, been able to lend out so many credit guarantees?

Khula was set up in 1996 as the government's small business finance agency. Khula does not lend directly to business owners, but through banks and a network of retail finance intermediaries. The agency has various products, including its credit indemnity or guarantee scheme also launched in 1996. The scheme is aimed at business owners who lack sufficient collateral to access traditional bank finance.

Khula's guarantee scheme disburses amounts of between R10 000 and R3 million, covering between 50% and 90% of the loan amount, depending on the amount of security a business puts up for the loan

The Indian scheme guarantees up to Rs10 million (R1.5 million), covering between 75% and 85% of a loan. The first Rs5 million of a loan is covered by a 85% guarantee, while the second Rs5 million is covered by a guarantee of 50%. The initial ceiling of guaranteed loans stood at Rs2 million when the scheme first started. This had been lifted to Rs5 million and then to Rs10 million on request from the World Bank. The CGTMSE uses only primary security such as a project or a contract.

About 83% of the guarantees taken out through the Indian scheme last year were for amounts under Rs500 000 (R77 000). Businesses in India's more literate states[52] take out the highest number of credit guarantees.

However unlike Khula which obtains most of its funds from its balance sheet, the scheme is backed by a corpus of Rs25 billion (valued at about R4 billion in December 2010), of which Rs5 billion is from the Small Industries Development Bank of India and Rs20 billion from government – committed over the last 10 years. So far the corpus stands at Rs19 billion with a further Rs6 billion still to be committed. This compares to the mere R330 million that Khula was capitalised by when it was set up in 1996.

So how has the CGTMSE managed to scale up lending so significantly?

Amid the depressing performance of Khula's credit guarantee scheme, the CGTMSE provides a glaring example on how a credit guarantee scheme should operate – not only on how to drive up lending numbers, but also on how to settle claims quickly. A look at the Indian scheme's performance also reveals just how bad South African entrepreneurs are at paying back loans: Khula's default rate on its guarantee scheme between 2005/2006 and 2009/2010 came to 42.15% of the total loan amount, with 80.1% or 1 381 loans in those five financial years being defaulted upon. In India the equivalent figure, in terms of the total value of loan defaulted on, was 2.5%.

If Khula and other development finance institutions fail to attend to the re-payment problem as a matter of urgency, any government attempt to increase lending to small businesses – such as the latest, Khula Direct – set to begin piloting at the end of 2010, will make little impact and could run up millions in bad debt. Khula guarantee scheme has long been dogged by under-performance. What is notable is that in its over 14-year existence, the number of guarantees given out by Khula has never topped 800. The highest number of guarantees ever handed out was 797 in the 2001/2002 financial year.[53]

In a 2005 AGM, the then Minister of Trade and Industry, Mandisi Mphahlwa, admitted that Khula's impact was limited. Just days after the AGM, then finance Minister Trevor Manuel was quoted as saying that the R1.4 billion that the government had earmarked for small businesses was not reaching business owners.[54] Then in 2009 lending through the scheme, hit an all time low. In June that year Absa, which

[51] Interview with OS Vinod, Mumbai, April 2010.

[52] These are Uttar Pradesh and Kerala. Both also have the highest coverage with a high number of branches participating. The scheme's chief executive OS Vinod points out that Kerala is one of the most literate states which encourages awareness of the scheme. The worst performing areas are the poor north-eastern states.

[53] "Few benefit from government finance agency", Bignews Oct 2005: http://www.businessowner.co.za/Article.aspx?Page-=23&type=27&Item=2901

[54] "Few benefit from government finance agency", Bignews Oct 2005, http://www.businessowner.co.za/Article.aspx?Page=23&type=27&Item=2901.

had once long outperformed other banks in the scheme, reported a 62% decline in the number of Khula guarantees disbursed, as banks tightened up lending with the then onset of the global financial crisis. At the time an Absa spokesperson[55] reported that more than a third of Absa Small Business impairments for 2008 were made up of Khula-backed business, which had lead to “drastic strategy changes”[56] in order to decrease impairments. An assessment by Absa of applications from 2005 until May 2008 revealed that the quality of applications was poor on Absa’s as well as on Khula’s side, which the bank believed was the reason for the high percentage of impairments.[57]

A quick comparison (see Table 4 below) between Khula’s credit guarantee scheme and the CGTMSE reveals just how bad things have become at Khula.

Khula’s default rate on its guarantee scheme between 2005/2006 and 2009/2010 was a whopping 42.15%, with 80.1% or 1 381 loans in those five financial years being defaulted upon. The worst performing year was 2009/2010 when the amount in defaults (R98.8 million) came to over triple the amount in guarantees given out that year (R30.26 million), far worse than the 85% rate of impairments raked up in 2008/2009. In terms of number, during those 2006 to 2010 financial years, Khula gave out 1 710 credit guarantees – with almost half (996) through Absa. In comparison, the CGTSME gave out 271 012 guarantees during the same period.

Added to this the CGTSME’s default rate between 2005/2006 and 2009/2010 was a mere 2.5% – with the worst of the years (2005/2006) touching just 6.4%. And while Khula’s default rate soared to an astronomical 313% in 2009/2010, the Indian scheme in the same year recorded an all time low in defaults with a rate of just 1%!

55 Busi Mngomezulu

56 At the time Absa changed the applications process and centralised assessment, placing a limit of R100 000 in finance for start-up businesses – despite the guarantee scheme offering up to R1 million in finance. It also took the decision at the time not to finance certain high risk industries (“Absa decreases its Khula guarantees”, Bignews, July 2009).

57 “Absa decreases its Khula guarantees”, Bignews, July 2009.

Table 4. Khula Vs CGTMSE on loans and total credit guarantees given out between 2006 and 2010 and default rate[58]

Total guarantees per annum per Bank (amount)						
	2005/06	2006/07	2007/08	2008/09	2009/10	Total
Standard Bank	15,611,849	29,809,259	22,093,629	14,105,000	2,348,000	83,967,737
Absa Bank	146,088,114	110,191,553	126,483,544	50,577,587	2,407,120	435,747,917
Nedbank	19,078,544	49,024,505	27,976,280	48,824,013	22,885,482	167,788,823
First National Bank	39,958,524	78,605,300	64,236,100	9,075,513	2,622,000	194,497,437
Total Khula	220,737,031	267,630,617	240,789,552	122,582,113	30,262,602	882,001,914
Total CGTMSE (rands, 09-12-2010)	659,497,959	1,012,491,372	1,508,021,882	3,216,389,772	10,460,927,703	16,857,328,688
Total CGTMSE (rupees)	*Rs4,276,729,000*	*Rs6,567,748,000*	*Rs9,784,870,000*	*Rs20,868,585,000*	*Rs67,872,607,000*	
Total number of taken up guarantees per annum per Bank						
	2005/06	2006/07	2007/08	2008/09	2009/10	Total
Standard Bank	28	65	28	16	4	141
Absa Bank	335	284	275	97	5	996
Nedbank	58	86	53	82	37	316
First National Bank	46	110	79	15	7	257
Total Khula	467	545	435	210	53	1710
Total CGTMSE	12 190	26 744	29 415	52 796	149 867	271 012

Value of Reported Defaults						
	2005/06	2006/07	2007/08	2008/09	2009/10	Total
Standard Bank	5,350,550	7,092,517	8,513,614	13,741,018	7,897,092	42,594,791
Absa Bank	41,869,774	25,898,726	40,048,820	58,969,123	37,394,322	204,180,764
Nedbank	10,842,444	5,134,476	8,179,631	16,353,728	22,806,460	63,316,739
First National Bank	756,145	3,004,220	14,927,419	16,289,457	26,706,300	61,683,541
Total Khula	58,818,912	41,129,939	71,669,484	105,353,326	94,804,174	371,775,835
Khula default rate	26.65%	15.4%	29.8%	85.95%	313%	42.15%
Total CGTMSE	42,078,570	57,767,860	93,295,098	114,930,050	108,867,349	416,939,927
Total CGTMSE (rupees)	*Rs272 668 500*	*Rs374 495 400*	*Rs605 036 400*	*Rs745 230 100*	*Rs705 918 300*	
CGTMSE default rate	6.40%	5.70%	6.20%	3.57%	1.00%	2.50%
Number of Reported Defaults						
	2005/06	2006/07	2007/08	2008/09	2009/10	Total
Standard Bank	19	22	26	33	27	127
Absa Bank	190	97	171	231	164	853
Nedbank	62	20	23	47	65	217
First National Bank	5	9	50	42	78	184
Khula defaults	276	148	270	353	334	1381
Khula percentage loan default	59%	27.2%	62.1%	168%	630%	80.1%
CGTMSE defaults	673	986	1 683	2 343	1 985	7 670
CGTMSE percentage loan default	5.5%	3.7%	5.7%	4.4%	1.3%	2.8%

Sources: Khula Finance Limited, CGTMSE.

58 The default rate is the percentage of loan repayments that are overdue.

Lesson 1: Targeted lending can drive uptake and guarantees

Unlike in South Africa, a big driver of lending for the CGTMSE is the Indian government's priority lending policy which requires commercial banks to lend 40% of their net bank credit to priority sectors – of which small businesses form an integral part. Foreign banks are required to lend 32% to priority sectors, with 10% specifically earmarked for the small-scale sector.[59]

The Reserve Bank of India penalises those banks that fail to meet these targets by making them deposit an amount equivalent to that of the respective bank's shortfall in priority sector lending, in the Rural Infrastructure Development Fund.[60]

South African banks are not required to lend a certain percentage of their credit to small businesses. Furthermore the Financial Services Sector Charter, which compels banks to spend a certain amount on black small business owners, lapsed in 2009 when banks and the financial services sector could not agree on targets in the charter. The charter could be used as an important tool to encourage banks to become involved more in lending to small businesses and could drive bank's involvement in Khula's guarantee scheme, as banks can score valuable points on the BEE scorecard for meeting targets under the charter. The banks have done very well in this regard[61] but it is not clear why the banks have performed so well under charter targets.

Lesson 2: Strong IT system

Vinod, CGTMSE's chief executive, attributes the scheme's performance to two things – a significant buy-in from member banks and a web portal which allows member banks to feed applications for guarantees back to the scheme's offices for processing. With the online system business owners can apply for and receive a guarantee within 24 hours. The longest waiting period is two or three days, if the application falls on a weekend, he says.

All the branches of banks participating in the scheme have access to the CGTMSE's website using a user ID and password. Filing an application is easy: a banker simply accesses the scheme's website and feeds an application into the system. This, together with over 100 tweaks which Vinod recently carried out on the portal, has helped streamline the handling of applications. The system is working so well now that a Japanese consultant who recently visited the scheme's head office in Mumbai returned saying there was nothing he could find to improve the working of the system.

Business owners like Asheesh Pal, managing director of Stryka Consultants, are a testament to the effectiveness of the new system. Pal was able to take out a collateral-free loan for his business through Punjab National Bank in the state of Himachal Pradesh. Said Pal: "It was pretty easy for me to get the loan sanctioned and I got the payment the very same day of my actual application, but I had to convince the bank chief manager for the business plan. But, one truth, people are really unaware of these schemes, capacity building in terms of information flow is required."[62]

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59 The regulations for priority sector lending evolved in the late sixties, at the time when the government nationalised the top 14 banks in 1967, in order to focus attention on the need to ensure adequate credit facilities to certain neglected sectors of the economy particularly in the rural areas. (http://www.articlesbase.com/business-articles/priority-sector-lending-by-commercial-banks-1106151.html#ixzz11O-pSvWaL)

60 In the 2008/2009 financial year commercial banks lent out 11.3% of their credit to small businesses., while in the same financial year, most of the 27 foreign banks lent out about 10% of their net bank credit to small business (Reserve Bank of India, Draft Technical Paper by the Internal Working Group on Priority Sector Lending, 2005) & (Reserve Bank of India, Appendix Table IV.4 Advances to the Priority Sectors by Public Sector Banks, Trend and Progress of Banking in India, October 22 2009) http://www.rbi.org.in-/scripts/AnnualPublications.aspx?head=Trend and Progress of Banking in India)

61 For example in 2006 banks lent out R9.84 billion to black small business owners, with a turnover of between R500 000 and R20 million, almost double the Charter council's R5-billion target. ("Banks favour urban loans", Bignews, January 2008).

62 Inteview with Asheesh Pal, LinkedIn.com, May 2010.

While Khula aims to finalise applications for guarantees within three days, the agency's marketing manager, Zimbili Mosheshe said bank's processes often meant applications could take "weeks" to finalise. There is no back end IT system at Khula and applications to the guarantee scheme are simply emailed by the banks to the agency.

Lesson 3: Better Communication with banks to get buy-in

Workshops and meetings with member banks have also helped drive up CGTMSE's lending rate, with the scheme roping ordinary bankers into workshops to explain to them the significance of guarantee lending. Last year the scheme conducted 1 384 seminars and meetings its 111 member lending institutions – 858 of these were workshops each attended by groups of about 25 bankers. Member lending institutions have about 60 000 branches in all, with the State Bank of India making up over 13 000 of these. The make-up of the lending institutions on March 31, 2010 included: 27 public sector banks, 16 private sector banks, two foreign banks, 60 regional rural banks and six other institutions (NSIC and Sidbi among others). The scheme also advertises in newspapers, which by law have to offer government advertising rates 12 times cheaper than those they offer private-sector clients.

Business consultant Dolly Bhasin believes credit guarantees through the CGTMSE, may have gained some additional momentum over the last few years, from entrepreneurship drives run by many not-for-profit organisations and the National Entrepreneurship Network, an online resource for entrepreneurs in India, as well as by start-up support organisations.

In South Africa getting buy-in from banks has long proved a headache for Khula. It may well have prompted the cabinet to back the agency's request to lend direct to business owners through the Khula Direct scheme, which is expected to be rolled out this year. Malose Kekana, Khula chairman said it was necessary for the organisation to meet with banks to review processes, and admitted that when he joined Khula in 2010, it had been a long time since the organisation had met with banks. He added that banks experienced a high turnover of staff that dealt with the credit guarantee scheme and that this also made marketing the scheme difficult.

One banker said that in the early days of the scheme Khula had held monthly meetings with banks through a steering committee, but that these had since become quarterly meetings. The banker noted that it was important for bankers which handle the scheme at their respective banks to be committed. It is also notable how when one banker left one of the top performing banks for Khula guarantees, how the number of guarantees had drastically declined.

Lesson 4: Improving timely claims

Probably one of the most important factors in the Indian scheme's ability to vamp up lending, has been the rate at which it responds to paying out defaulting loans. For Khula the time it takes for the agency to pay out defaults remains a big concern for banks. Khula requires a bank to first seek a default judgement against a business owner before it lodge a claim, which can take between one to three months to obtain[63] or up to five years, according to one banker. Kekana agreed that the time that it took to pay out a claim to banks was too long. In contrast, at the CGTMSE the first payment is made within the same day an application is posted. This, maintains Vinod, is the scheme's "unique selling proposition".

The CGTMSE's claims procedure stipulates that when a member bank or lending institution lodges a claim to the trust, that a lock-in period of 18 months will apply.[64] Claims are paid out extremely quickly in India. Immediately on instituting legal action to recover the defaulted amount, the trust will honour the bank 75% of the guaranteed portion in default subject to maximum of 75% of the guaranteed cap amount (or 85% for select category of borrowers). So far example if a business owner took out a Rs1 million loan (of which the trust covers Rs750 000), the bank will be illegible to immediately recover a

[63] Emailed response from Khula's then managing director Setlakalane Molepo, April 2010.

[64] The 18 months run from either the date of last disbursement of loan to the borrower or the date of the guarantee cover coming into force in respect of the particular credit facility, whichever is later.

sum of Rs562 500 – which is 75% of the guaranteed amount. The remaining 25% of the default is paid on conclusion of recovery proceedings by the lender, according to the Indian scheme.

Vinod said the CGTSME had learnt from the failure of a previous government guarantee scheme, the Deposit Insurance and Credit Guarantee Corporation which eventually closed down after struggling to settle claims on time. In a 2008 interview, Vinod said the first payment on a claim was concluded within one day. "The bank makes a claim today and tomorrow morning, the cheque is out," he said. He added that there was no due diligence. "If something goes wrong, they have to file the claim with us. While filing the claim, there are five or six columns they have to tick." One is whether the guarantee is valid. Second is whether they have classified the specific loan as an non-performing asset (NPA) in their books; third is if they have classified it as an NPA, have they issued a recall notice; fourth is whether they have filed in the appropriate forum; and, fifth whether there is a certification (form) from an AGM-level officer. "If these things are there, we simply issue a cheque. There is nothing more we need to know. Once that has been done, there is no value addition from our side. We pay 75% of the guaranteed amount immediately. The remaining 25% we pay after the total process is over. After the decree (default judgement) is obtained. Ultimately we share the default 3:1."

Vinod claims the default rate was "negligible" at August 31 2008 when he estimated the defaults to be Rs110 million out of Rs33 billion lent out at that time.[65] At the time he claimed there was "not a single case pending with us for pay out".[66]

While according to the CGTMSE's 2008/2009 annual report the scheme recorded just 2% bad debt in 2008/09, the Report of Working Group to Review the Credit Guarantee Scheme of the Credit Guarantee Fund Trust for MSEs released by the Reserve Bank of India on March 6th, 2010[67], recommended among other things that the procedure to claim on defaults be further simplified.[68]

Unlike with the CGTMSE, settlements Khula makes are paid in one lump sum when a claim is made to banks, yet the process is cumbersome. Though Khula settles a claim within 30 days of receipt of all the information, banks first have to secure a default judgement against the principal debtor as well as all sureties in court against the defaulting business owner before they can lodge a claim. However, according to one banker, who oversees Khula guarantee lending, "it rarely takes less than a year to pay out claims". Added to this banks have to submit five or six different pieces of documentation along with each claim form.

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65 The trust had received 1 263 claim applications from 25 member lending institutions as of March 31 2009. It had settled 784 eligible of these claims, paying over Rs187.7 million towards the first installment. Of the remainder, 73 applications were not eligible within the purview of the scheme. A further 397 applications were incomplete as stipulated conditions for claims settlement had not been satisfied on the date of filing the claim. As on March 31 2009 just nine applications for Rs3.8 million were pending for settlement. As of March 31 2010 there were 2 506 claims totalling Rs5.3bn in settlements of a cumulative of Rs1.16 trillion lent out through 300 105 guarantees.

66 Dare.co.in, 31 August 2008, http://www.dare.co.in/people/featured-investor/os-vinod-cgtmse/Page-2.htm

67 http://www.Rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=585

68 At present, banks have to initiate legal action in all cases before filing claims with the scheme. A suggestion was made for legal proceedings as a pre-condition for invoking of guarantees to be waived for credit facilities up to Rs50 000; another suggestion was for the final claim to be paid by the trust to the bank after three years of obtention of decree of recovery instead of the present procedure of releasing the final claim by the trust only after the decree of recovery becomes time barred, or in other words after 12 years after obtaining decree (See: http://blog.taragana.com/business/2010/03/06/report-of-working-group-to-review-the-credit-guarantee-scheme-of-the-credit-guarantee-fund-trust-for-mses-released-38866/).

Table 5. Yearly Value and Number of Claims (Khula vs CGTMSE)

Value of Claims Paid						
	2005/06	2006/07	2007/08	2008/09	2009/10	Total
Standard Bank	987,289	0	1,105,447	3,095,208	6,225,826	11,413,770
Absa Bank	14,928,513	14,533,152	15,524,356	18,746,755	17,386,540	81,119,317
Nedbank	0	505,771	1,260,267	1,395,548	132,669	3,294,254
First National Bank	234,660	425,005	0	1,291,180	4,666,975	6,617,821
Khula claims paid	16,150,463	15,463,928	17,890,070	24,528,691	28,412,010	102,445,162
Khula percentage of default*	27.46%	37.60%	24.96%	23.30%	29.70%	27.56%
CGTMSE claims paid	256,534	441,002	22,073,757	26,449,713	98,210,862	147,431,868
Total CGTMSE (rupees)	*Rs1 663 540*	*Rs2 860 890*	*Rs143 158 800*	*Rs171 585 400*	*Rs636 893 300*	
CGTMSE percentage of default	0.61%	0.76%	23.67%	23.00%	90.20%	35.40%

Number of Claims Paid						
	2005/06	2006/07	2007/08	2008/09	2009/10	Total
Standard Bank	11	0	8	12	19	50
Absa Bank	106	81	72	105	95	459
Nedbank	0	4	7	5	1	17
First National Bank	3	3	0	7	15	28
Khula claims paid	120	88	87	129	130	554
Khula percentage of defaults	44.00%	59.50%	32.00%	61.00%	38.90%	40.00%
CGTMSE claims paid	62	111	292	347	1 778	2 590
CGTMSE percentage of defaults*	9.20%	11.30%	17.30%	14.80%	89.60%	33.80%

Note:* - the percentage that the number of claims paid out for that year of the number of defaults recorded for that financial year.

Sources: Khula Finance Limited, CGTMSE.

According to Maggie Mazzullo, the manager of loss control at Khula,[69] this documentation is as follows: bank statements for all accounts from date of default to date of submission of claim; salvage schedules reflecting dates and amounts if proceeds have not been credited to respective accounts; a copy of the attorney's accounts together with the bank's original tax invoice addressed to Khula for the fees being claimed; a copy of relevant pages of the liquidation accounts in event of liquidation; proof of compliance with any special conditions attached to the facility; and a brief summary of legal action taken.

As an example of the red tape that has mired the scheme, one banker pointed to some 500 pages the bank had to file just to recoup a single loan valued at R1.2 million for a deal made in 2007 that had since gone bad. The banker said the number of steps in the claims procedures had grown in size since the agency launched the scheme in 1996, as Khula had continually added additional annexures or schedules.

Khula's finance manager Des de Jager said banks were concerned about the processes that they need to follow and added that this had been cited by the banks as a factor in them not being "overly enthusiastic" about the scheme. He reported that Khula was currently in discussions with the banks to revise the process in which claims are made.

69 Email from Maggie Mazzullo, October 2010

One banker believed that the "credit indemnity" styling of the Khula-backed finance contributed to business owners walking away from struggling businesses rather than trying to turn them around. "… The reality for these business owners is that Khula insists that we get final judgement on the defaulters, take them for whatever they've got, and then they pay out a percentage of the balance still owing. It can take years for Khula to pay out on the indemnity."

Lesson 5: Sharpen the assessment process

While the CGTSME approves credit guarantees in under two days, it can takes days for banks to grant an approval for a Khula guarantee. Said one banker: "the assessment is more intensive and the documentation requirements are more onerous than in our ordinary credit applications. Yet, the default rate among non-Khula backed transactions in our business credit portfolio peaked at 5.8% compared to the Khula portfolio." He said this indicated that the assessment criteria demanded by Khula is not as robust as the banks' own credit assessments. He said added to this the administration of Khula transactions is costly to run and does not lead to earlier identification of those businesses that later find themselves in financial trouble.

The same banker said a related problem was that Khula does not accept behavioural scoring as a credit assessment tool, which could speed up approvals. "We can and do provide a five-minute answer to small business clients using our behavioural scoring methodology. If Khula accepted this as a valid means of assessment, then the turnaround time would be measured in days, not weeks," he said.

The banker said the real problem was that only about one out of every 20 applications makes it past the initial screening stage, and that only a fraction of those selected are ultimately approved.

Another banker complained that the indemnity required both the banks and Khula to approve each loan. "This process is not completed in parallel; instead banks are required to approve loans first and then pass the applications onto Khula, which creates a bottleneck. In addition, there is not an adequate workflow system set up between the banks and Khula which results in applications taking a couple of weeks to be approved by both parties."

One bank, Standard Bank, said it had proposed the system of portfolio guarantees where applications are solely managed by the bank itself. This allows the bank to screen all applications and provide finance independent of a Khula assessment. Under this proposal the bank would agree to operate within defined thresholds. "This will improve the process issues and administrative burden created by the current scheme. In addition, the bank would like to work with Khula around their non-financial initiatives to maximise these efforts and ensure effective ongoing support is provided to SME's," a Standard Bank banker said.

A third banker said Khula was wrong to recently get banks to sign "portfolio agreements" and believed that the move would not increase participation in the scheme. The agreement would allow banks to negotiate a blanket cover to cover a portfolio of loans, which would allow Khula to spend less time vetting each individual application, thus freeing the agency's team up to concentrate on Khula Direct applications. But the portfolio agreement could backfire as banks could mistakenly believe that they can lend out more loans more rapidly, which could see banks making relatively careless approvals.

The banker said Standard Bank had "burnt their fingers" some years ago by not sticking to the lending criteria for the guarantee scheme, with Khula allowing this to happen. When it came to paying out settlements on loans that had gone bad, Khula turned around and said the banks had not followed the application procedure to the book. The resulting backlash at Standard Bank had led to the bank virtually pulling out of the scheme. The problem is thus complex.

Box 2: The sickness that is South Africa's high default rates

The experience of CGTMSE once again brings home the biggest headache that development finance institutions experience, namely that of non-repayment. This is a signifcant problem in South Africa. Nationally:

- In an answer in Parliament in May 2010, the Minister of Trade and Industry Rob Davies reported that the National Empowerment Fund's (NEF) had a repayment rate of 74%. Davies said at the time that preliminary results revealed that between 5.5% and 8% of all loans advanced would be written off;
- Added to this, Khula wrote off R220.6 million or 13% of the R1.68bn in total disbursements it made between 2003/04 and 2009/10, while the repayment rate declined from 83% in 2008 to 74% in 2009;
- Over two-thirds or 69% of the Industrial Development Corporation's (IDC) arrears for the 2010 financial year were from enterprises with turnover of below R50 million. IDC wrote off R90 million in the year to March 31, 2010;
- Further to this, the South African Micro Apex Fund (Samaf), which provides finance to micro enterprises, recovered just 66% of its loan repayments in the 2010 financial year, with losses of 17% of its loan book or R6.4 million recorded that year.[70] This was similar to the National Empowerment Fund's (NEF) Imbewu fund, which is aimed at small businesses, where 35% of loan repayments were not paid back on time during the 2009 financial year.[71]

At provincial development finance agencies the problem is worse. In 2008 the Eastern Cape Development Corporation (ECDC) was offering defaulters discounts on the interest owed if they commit to repay outstanding debts. The Free State Development Corporation (FDC) was suffering from about a 30% bad debt rate in 2008, a level similar to KwaZulu-Natal's Ithala Development Finance. Bad debt at Limdev, Limpopo's development finance agency, reached 50% in 2008 and 1 500 of all business owners on the agency's books had outstanding debts of more than 90 days. According to Limdev spokesperson, Leo Gama, the problem stemmed from business owners' perception that the money was not that important to pay back. "The mentality is that it is public money so why do we have to pay it back", he said. He reported that some business owners spent their loans on luxury cars or used it as collateral to draw a further loan from their bank. "Some business owners ran to politicians when the organisation began instituting legal proceedings against them", he added.[72]

Said one banker: "A great deal of the entitlement culture we currently witness today, together with 'loans being perceived as grants' is largely due to the historical perspectives of many reluctant entrepreneurs".

Another banker said a robust risk assessment, which involves evaluating both the strength of the entrepreneur as well as the business model is required as well as adequate non-financial support in order to increase lending to SMEs and grow entrepreneurs.

One bank is currently working on solutions to ensure that finance is provided to black-owned SMEs in a sustainable way with or without an indemnity scheme. This involves setting up structures together with corporates, development finance institutions and provincial governments which will ensure that the technical expertise and or general business support is provided to entrepreneurs. But one banker reported that the real issue preventing greater access to finance is the lack of non financial support for business owners and the high default rates. However, a number of mentors who are contracted to provide non-financial to assist SMEs applying for loans under the Khula scheme merely provide a "cut and paste" business plan without any post loan drawdown support he added. "This often results in the entrepreneur not having thought through the business model in detail which leads to the ultimate failure. In addition, without any effective post drawdown support many of entrepreneurs fail."

In addition, there are various other issues which result in high default rates. These include entrepreneurs not using the finance for the project for which it is intended and building up a bad track record with the banks and a lack of adequate screening and assessment processes when awarding tenders and or work resulting in the ultimate downfall of small enterprises.

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[70] Business Day, May 20, 2010.

[71] Since 2003, and up to March 31 2010, 156 worth R457m went to small black-owned businesses or franchisees through the Imbewu Fund (NEF, Annual report 2010).

[72] "Small business funding stretched by defaulters", Bignews, May 2008.

According to Khula's former managing director Setlakalane Molepo, the central factors which drive the high default rate are an entitlement mentality by entrepreneurs and entrepreneurs' lack of education. "Entrepreneurs often believe that as development finance institutions are government-owned and most of them are primarily recapitalised by government, they don't have an obligation to pay back the monies." He said that when lending to less "sophisticated" entrepreneurs, especially in the micro and small enterprises, one needed to stay "very close to the operations". "In Brazil, CrediAmigo, owned by Banco do Nordeste (the Bank of the Northeast), has recovery rate of between 98% and 99%. Why? Because the loan-officers are on the entrepreneur's face when he/she defaults. The loan officer knows the customers intimately to such an extent that they have an obligation to him or her to pay their debts." [73]

CREDIT-RATING SCHEME

- Via a subsidy, the scheme helps business owners to access finance more easily from banks and at better terms and helps SMEs to obtain better credit terms from suppliers.
- However, few business owners have taken advantage of the scheme as they don't see the benefits.
- Those that have accessed the scheme say banks don't recognise the credit rating.

Overview

The Indian government claims that a scheme in India, which subsidises the cost of a credit rating, helps businesses to access loans or negotiate with banks for lower interest rate terms, but many say banks do not recognise the credit ratings when business owners approach them with the ratings. The challenges associated with this scheme offers a lesson to South Africa should a similar initiative be considered in the country.

A credit rating provides a business owner, their bank and even their suppliers, with an independent, trusted third-party opinion on the capabilities and credit worthiness of a business. The scheme was launched in 2005 after being drawn up in consultation with the Indian Banks' Association and rating agencies.[74]

The National Small Industries Corporation (NSIC), which implements the scheme[75], claims that 67% of business owners who have accessed the scheme have been able to take out more credit from their bank after informing their banker about their rating status. The NSIC says that almost a third of business owners that have accessed the scheme have reported that the rating helped them gain increased recognition from buyers and customers, while 17% revealed that rating helped them in negotiating lower interest rates when borrowing from banks.[76] The NSIC maintains banks were granting concessional interest rates of between 0.5% and 2% to those business owners who scored good credit ratings.[77]

According to a presentation by the NSIC, of those business owners that have accessed the subsidy nearly 16% experienced higher sales and almost same proportion received more customer queries after getting a rating. A further 23% of those businesses rated improved human resource management systems and

[73] Setlakalane Molepo, via email, September 14, 2010.

[74] The NSIC subsidises 75% of the cost of a credit rating up to Rs40 000 (R6 100)See:http://smetimes.tradeindia.com/smetimes/news/top-stories/2010/May/15/nsic-aims-to-provide-credit-rating-to-over-9000-msmes17361.html)

[75] According to business consultant Dolly Bhasin, the scheme was one of the measures identified by the organisation of Southeast Asian Nations (Asean) and the OECD to improve the access to credit for SMEs.

[76] NSIC presentation by Dr HP Kumar, Institutional Framework for Small Business Development, Undated. http://www.nsic.co.in/creditrating.asp

[77] Interview with HP Kumar, New Delhi, March 2010

policies equipping them for higher competitiveness and 38% felt that their employee pride had increased with rating of their units.[78]

Briefly the process for rating a firm works as follows: Officials from a rating agency visit a business owner's business place and study the business' audited reports for the last three years. They then compile a report looking at the strengths and weaknesses of the organisation's management and its infrastructure capabilities, while providing feedback on how the business owner could improve their performance. The whole process takes about a month to conduct and a rating is valid for one year. After the initial rating expires, it is then up to the business itself to cover subsequent ratings.[79]

Criticism: Banks don't recognise rating

According to the Minister of State (Independent Charge) for Micro, Small and Medium Enterprises (MSMEs) Dinsha Patel, up to 31st March, 2010, a total of 19 207 small and micro enterprises had obtained a rating under the scheme, since its inception. Added to this a further 1 652 applications were being processed at that time. Seven rating agencies were part of the scheme.[80] Only 7 505 business owners benefited from the scheme in 2009/2010, a slight increase over the year before when 5 011 accessed the scheme.[81] The NSIC has set a target to provide credit rating to over 9 000 businesses in 2010/11.[82]

Yet, despite the benefits that the NSIC claims the scheme has had for business owners, the scheme is reported to have made very little impact. One key criticism is that the credit rating is often not recognised by banks, because it was not a rating on a firm's financial stability, but rather on its processes.[83]

Bhartendu Dev, who runs Uptodate Plastics & Packagings Pvt. Ltd, based in Laxmi Nagar, Delhi said his business was able to get a credit rating through the scheme about two years ago. However he said his business did not benefit from this. "Banks continued to treat us as before. "Recently we were approached again by the same credit rating agency – Dun and Bradstreet – but seeing no advantage we refused. If you are a good organisation banks know and help to give needed credit. We now believe that such ratings are meaningless for small organisations," he said.

Dev paid about US$1 000 for the rating. His business was rated as "2A" which, he explained, meant his firm was "high on performance and very high on finance". However he said the banks opt to use their own financial examination of the borrower business. Dev said his business didn't need a loan but rather wanted the bank to reduce its interest rate on working capital. "The bank said our rate of interest was already low," noted Dev, who added that the bank was only interested in having him take out more loans – with or without a credit rating. "These ratings help larger organisations to buy out smaller companies (using the) business information from these agencies … for their (own) benefit", he said.[84] Similarly, Mohini Kelkar, who together with her husband Ketan owns Precision Engineers, said her company too did not benefit from taking out the subsidy even though she believed the company would get some rebate

[78] NSIC presentation by Dr HP Kumar, Institutional Framework for Small Business Development, Undated http://www.nsic.co.in/creditrating.asp

[79] Interview with Gaurang Dixit, the NSIC's general manager of finance, New Delhi, March 2010.

[80] In a written reply to a question in the upper house (Rajya Sabha) of India's parliament, SME Times, 24 Apr, 2010

http://smetimes.tradeindia.com/smetimes/news/top-stories/2010/Apr/24/credit-rating-not-necessary-for-mses-to-get-loan61336.html

[81] Interview with Gaurang Dixit, the NSIC's general manager of finance, New Delhi, March 2010.

[82] "NSIC aims to provide credit rating to over 9 000 MSMEs", Saurabh Gupta, 15 May, 2010:http://smetimes.tradeindia.com/smetimes/news/top-stories/2010/May/15/nsic-aims-to-provide-credit-rating-to-over-9000-msmes17361.html

[83] Rajeev Karwal from Milagrow and Anil Bhardwaj, the secretary general of the Federation of Indian Micro and Small and Medium Enterprises

[84] Interview with Bhartendu Dev, email, May, 2010.

from the bank after taking out a rating. She said the bank used "different norms" to those of the credit ratings.[85]

In contrast, Binoj Cherian, who runs STJ Electronics reported that his business did, in time, benefit from the rating, after he accessed the subsidy through the NSIC. "In the first two years there was no impact on the existing banker, however stronger banks started approaching us with lower interest and lower collateral requirements. This allowed us to move out to better banks. Regarding Suppliers, we shared this data only with one of the suppliers. This was our main international supplier and the feedback was positive. They have more trust in the transactions as it is a third-party document," he said. Cherian used rating agency Crisil and the rating cost him around Rs16 000 whereas ratings are usually between Rs75 000 and Rs100 000. He has since renewed the rating five times, which he described as a fairly easy process as the rating agency simply updated his rating with new data that he submitted to them.[86]

One rating agency head commented that some business owners are afraid to take advantage of the scheme fearing they may not get a good rating. Also, some financial statements do not paint an accurate picture of applicants as rating agencies had a tendency of only rating entities which have a certain amount of financial statements they can produce. The rating agency head however said Icra considered other factors when compiling a rating, such as the strength of a firm's management and what relationships a firm has with its suppliers and the quality of the firm's product. It also compares the entity with other firms that are of a similar size and operate in the same sector.[87]

According to Dolly Bhasin, a business consultant in India who consults with many small business development agencies[88], the usefulness of credit rating has never been properly communicated to Indian SMEs which has led to its poor take up. Added to this she believed that despite the subsidy a rating still remained too costly for many business owners.

Conclusion: Ratings need to be made viable

If a similar scheme is proposed in South Africa, careful thought must be put into ensuring that the rating will be taken seriously by banks and that business owners will see the benefits to accessing such a rating and not view it as an unnecessary auditing-type cost. Another problem is that ratings often only look at those businesses that already have some form of existing financial statements in place. In South Africa many small business owners do not keep financial records. Any rating scheme will have to take cognisance of this particular problem.

CARTÃO BNDES (BRAZIL)

- Credit card which uses an e-commerce facility which simplifies access to finance for small businesses through banks via government funding and promotes the local production of goods;
- Legislation drives use of card in Brazil along with existing database of suppliers;
- However the Department of Trade and Industry (South Africa) believes that there are various challenges to implementing such a card in South Africa.

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85 Telephonic interview with Mohini Kelkar, June, 2010. Her business has 150 employees

86 Binoj Cherian, interview by email, June 2010.

87 Rajesh Dubey, Executive Director, of rating agency Icra Online Limited, quoted in SME Times, 13 April 2010 http://smetimes.tradeindia.com/smetimes/face-to-face/2010/Apr/13/smes-need-to-avail-benefits-of-credit-rating-rajesh-dubey555555.html

88 Including Unido, Inwent, USABF

Overview

A Brazilian development bank's innovative credit card, which has caught the eye of everyone from Singapore to South Africa's Department of Trade and Industry, could help boost funding to small businesses in South Africa, while promoting local industrialisation.

Banco Nacional de Desenvolvimento Econômico e Social (BNDES) expects to lend out R$4.2 billion (valued at about R17.5 billion in September 2010) to small businesses in 2010 through Cartão BNDES. The card allows small enterprises to source goods and services from pre-approved suppliers. Disbursements through the card have grown from R$1.2 million in 2003 when Cartão BNDES was launched, to R$2.46 billion last year, and as of August a total of R$12.1 billion in credit had been advanced through the card.

The idea of the card, which combines the concept of a credit card with that of an e-commerce platform, is to simplify the red tape associated with bank loans. To access finance for the goods listed by suppliers on Cartão BNDES's website business owners approach one of the scheme's five participating banks to that BNDES advances finance to which is then channelled through the card to business owners. The application process through banks typically takes about 20 days, according to BNDES. The card also promotes local production as BNDES vets suppliers and requires that products have a minimum of 60% local content to ensure that the domestic economy benefits. Suppliers that wish to make an imported product available on the card's website are required to prove to the bank that no similar product exists on the local market. To qualify as a buyer a business must have an annual turnover not exceeding R$90 million.

Ricardo Albano Dias Rodrigues, the manager of the department of internet operations at Banco Nacional de Desenvolvimento Econômico e Social (BNDES) said the card's website currently lists 303 000 small, medium and micro enterprises as buyers.[89] Rodrigues said 88.3% of buyers were, at the time of interview in August 2010, micro enterprises (those with an annual turnover of below R$2.4m), 9.9% small enterprises (with a turnover between R$2.4 million and R$16 million) and 1.8% medium-sized firms (firms with a turnover between R$16 million and R$90 million).

The site also contains 23 000 suppliers – 12 000 of these being manufacturers and 11 000 distributors. A total of 135 000 goods and services are listed on the card's website, including machinery, construction materials and raw materials for production, while some suppliers offer financial services, design and prototyping services and technology transfers. In August BNDES also began offering professional qualifications such as language and tourism courses through the card's website.

Rodrigues said business owners can buy goods of up to R$1 million at a time, but can arrange with their own bank to finance any shortfall, if need be. Purchases through the website are limited to a minimum of three and a maximum of 48 instalments and an interest rate of 0.97% per month was being charged in August 2010.

The card's website allows the entrepreneur to search for the product and buy it on the site, but Rodrigues pointed out that 99% of buyers prefer to approach the supplier directly. After negotiating a price the supplier is then able to enter the card's website and put the transaction through, themselves.

Ensuring take-up of the card

The idea for the card said Rodrigues, who currently oversees a team of 25 – with 10 staff designated to analysing suppliers – came from a retired employee of BNDES and an employee of the development bank. It was not difficult for BNDES to source suppliers as the development bank drew most of the initial batch of suppliers for the card, from those that were already registered with another of its funds, he said. But one of the challenges the development bank did face when putting the card into the market was to get business owners to feel comfortable about the product. In order to counter this the bank ran workshops and seminars as well as a television campaign to market the card.

[89] Interview with Ricardo Albano Dias Rodrigues, Rio de Janeiro, August 2010.

Four of the five participating banks are state banks[90] (with Bradesco being a private bank) and a key factor that drives the banks participation in the scheme is that by law public banks are mandated by article 58 in Lei Geral to report weekly to Brazil's central bank on the number of loans they grant to small businesses as well as the conditions of accessing the loans.

Rodrigues said member banks were drawn to using the card as it offered clients access to a large number of clients, assured their loyalty and offered attractive terms to business owners. He said while participating banks also benefited from the earnings on the interest rate charged to business owners, they could also gain from banking some of the suppliers that registered with the card.

The participation in the card is also spurred on by the fact that the Brazilian government – through BNDES and the various state banks – has historically been very involved in finance and banking in the country. However while state banks accounted for a significant percentage of assets 30 years ago (state and federal banks held 40% of all bank assets in 1985[91]) today public banks account for less than 8% of all bank assets.[92]

Way forward

The success of the card in Brazil is evident not only by its uptake by small businesses, but also in the fact that new products are continually being offered on the card's website.[93] Luiz Sakuda, professor of entrepreneurship and innovation at FEI university, Sao Paulo believes that as Cartão BNDES offers pre-approved credit, the card is a good way to bring down the amount of red tape entrepreneurs face when trying to access finance. The concept he said was a good one, as BNDES screens both buyers and suppliers.

Commenting on the innovative card, the Department of Trade and Industry's Acting Deputy Director-General of Enterprise Development, Sipho Zikode, said he believed the card could be a useful financial instrument to help small enterprises to fund such things as working capital and some overheads.[94] But he anticipated there would be challenges to carrying out the card in rural areas where the majority of small and micro enterprises were informal and lacked banking facilities. However, he added that such a card could work well in urban areas.

A further challenge would be that of creating awareness around the card, especially as the low level of literacy and lack of record keeping among many business owners would be stumbling blocks. It would also be a challenge to get the banks to enter the sector, particularly when it came to how to lower the systemic risks the banks would face lending to the small business sector.

Zikode said there was a real need for a public/private partnership to look at developing a small business bank which would operate on a different set of rules and requirements. "To expect traditional banks to lower their requirements and standards could be a huge challenge," he said.

Rodrigues said small, medium and micro businesses accounted for 75% (66% being small and micro) or 343 000 of the bank's total number of disbursements between January to July 2010, accounting for R$41 billion or 50% (31% being small and micro) of the development bank's total disbursements.[95]

90 Banco do Brasil, Nossa Caixa, Caixa Econômica and Banrisul

91 According to Werner Braer in 'The Brazilian Economy: Growth and Development' (Sixth edition), Lynne Rienner Publishers, 2008.

92 Debt Report, Inter American Development Bank, August 2009

93 In August BNDES began offering professional qualifications such as language and tourism courses through the card's website.

94 Email from Sipho Zikode, September 2010

95 Between January 2009 and June 2010 72% of BNDES funding went to large businesses (R$83.45 billion) with 23.5% going to SMEs. Of this 6.9% or R$8.03 billion went to small enterprises, 6.7% or R$7.76 billion to micro enterprises and 9.9% or R$11.46 billion to medium size businesses. The remainder went to public administration and physical persons (Pessao fisica).