

# Access to credit for small business in South Africa towards a value-based decision framework

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## **ABSTRACT**

The focus is on access to credit for small businesses in South Africa. The literature study revealed that in South Africa more businesses are shutting down than opening. One of the main contributors identified was the reluctance of banks to provide credit to small businesses. A small business for the purpose of this study is based on the number of employees'  $\leq 50$ , and excludes survivalist enterprises.

The main objective of the study was to develop a value-based decision framework for small business lending. By establishing this, there will be more value to the bank, the small business customer, and ultimately to the economy in South Africa, by enabling more job opportunities.

In order to achieve the objective, it was important to understand access to credit for small businesses in South Africa from a broader perspective. This included a literature review and an empirical study. The legislation investigated was the National Credit Act (NCA), and from a Government support perspective, the Khula Credit Guarantee Scheme.

The empirical study was divided into two parts; Empirical Study A and Empirical Study B. The main study (Empirical Study A) method was a questionnaire comprising 112 items which included closed and open-ended questions. The results were positive with 323 "usable" questionnaires received.

The aim of Empirical Study B was to identify whether there were any variables which may contribute to the probability of default.

The empirical results revealed that one of the biggest challenges for banks to grant credit to small businesses is the high cost involved compared to the return earned. Considering that banks have a responsibility to protect the depositors funds, the focus from a bank perspective will always be on the customer segments which can provide the required financial documentation which demonstrates repayment ability, and which can provide a higher return on equity (ROE).

For the NCA regulation that was investigated, the results revealed that small businesses have less access to credit as a result of the NCA, and that the NCA does not allow for more credit to be advanced to businesses.

The results of the Government Khula Credit Guarantee Scheme revealed that it is not creating any "additionality" in that it mainly guarantees the credit advanced to businesses which the bank would have approved anyway (even without the guarantee).

Based on the identified challenges, gaps, and recommended solutions, the study concludes with a proposed Bank Guarantee Securitization Model and Small Business Lending Framework.

#### KEY TERMS

Access to credit for small businesses, challenges, reasons for failure, SMME finance, models, qualities of a successful entrepreneur, influence of the NCA on small business lending, Khula Credit Guarantee Scheme.

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# **CHAPTER 1:**

## **CREDIT FOR SMALL BUSINESSES: AN ORIENTATION**

### **1.1 Introduction**

The World Bank has officially adopted the poverty line of \$1.90 per day per person in 2011 using the purchasing power parity (PPP) exchange rate method. This method is used to track the regional and global incidence of extreme poverty. Compared to the estimates produced in October 2016, the total number of poor increased by 2.5 million (from 766.0 to 768.5 million), leaving the share of the global population that is considered extremely poor unchanged at 10.7% in 2017 (Worldbank, 2017).

South Africa is one of the most prominent countries who has fallen victim to this poverty dilemma. The provision of credit for business enterprise (which includes microfinance to the poor) is a strategy promoted by governments globally to reduce poverty. Since the United Nations' International Day of Microcredit and Muhammad Yunus and the Grameen Bank were awarded the Nobel Prize for Peace for their contribution to the reduction in world poverty, microfinance became more relevant to international development (Abed, Dwivedi & Williams, 2015; Banerjee, Duflo, Glennerster & Kinnan, 2015). Providing financial solutions such as loans, insurance and savings to small and micro-enterprises is generally referred to as microfinance, where credit is only one component of microfinance (Ferrari, 2007). Microcredit alludes to loans provided to the poor to help them start their own business (Quadrat-Elahi & Rahman, 2006). Overall the role of SMMEs is increasingly recognised worldwide (Ayandibu & Houghton, 2017).

The National Small Business Act (102 of 1996) (as amended) categorizes businesses in South Africa into distinct groups, namely; survivalist, micro, very small, small, and medium, hence the use of the term "SMME" for small, medium and micro-enterprises (Mago & Toro, 2013). However, the National Credit Regulator (NCR) (2011:26) notes that despite the classification of an SMME by the National Small Business Act (102 of 1996) (as amended), these categories are not used consistently by state agencies or by private sector databases, thereby making research studies and comparisons difficult in most instances. An analysis of both the South African and international definitions of SMMEs shows that there is agreement on what constitutes an SMME in terms of the number of employees (Dlova, 2017). For example, a recent study by Masama and Bruwer (2018) include the number of employees up to 50 (including the owner) to define an SMME. Furthermore the Department of Trade and Industry (DTI) (2008) report states that the terms "small business" and "SMME" are sometimes used

as synonyms. The government also often combines the two when implementing initiatives to support business development in South Africa (Bhorat, Asmal, Lilenstein & Van Der Zee, 2018). The definition of a small business for the purpose of this study is based on the number of permanent employees'  $\leq 50$ , and excludes survivalist enterprises. A "start-up" is defined for the purpose of this study as a business that has been in existence for  $< 2$  years. For ease of reading and consistency, the term "small business" will be used in this study instead of "SMME", unless it is required for a specific distinction to be made.

Considering the poverty position in South Africa, the promotion of small businesses has always been a primary focus of the government (Rogerson, 2018). Statistics indicate that the small business sector contributes immensely to gross domestic product (GDP), job creation, poverty alleviation, economic growth, and provides an incubator and breeding ground for entrepreneurship and innovation (Lose, Tengeh, Maziriri & Madinga, 2016; Rungani & Potgieter, 2018). However, according to Statistics South Africa (2015), various challenges and impediments prevent the creation of new small businesses and cause the high failure rates of new small businesses in South Africa. One of these impediments is the unavailability of credit to small businesses (Fatoki & Odeyemi, 2010; Beegle, Christiaensen, Dabalen & Gaddis, 2016). Moreover, research suggests that the financial and non-financial frameworks implemented by the South African government to support small business growth are not working as effectively as intended (Balogun, Agumba & Ansari, 2016).

Whilst it is acknowledged that there is various challenges and impediments that could prevent the growth and development of small businesses in South Africa, the focus of this study is on the credit aspect, specifically how to improve the position of access to credit for small businesses. However, in order to obtain a proper understanding of the position of the limited access to credit to small businesses, it is important to explore any background information and any current influences on the provision of access to credit for small businesses.

## **1.2 South Africa's economic conditions**

South Africa has on average a population of 51 million people with 60% of the population living in urban environments, and 40% living in rural settlements (Organization & Unicef, 2015).

According to the Poverty Trends Report for 2006 to 2015, 30.4 million people (55.5% of the population) is living in poverty, this is up from the 53.2% or 27.3 million people reported in 2011 (Poverty trends in South Africa, 2006-2015; Africa, 2016). The number of people living below the 2015 food poverty line of R441 per person per month, or in extreme poverty, increased to 13.8 million in 2015, compared to the 11 million reported in 2011 (Africa, 2016).

Rural areas remain the regions of highest poverty concentration where 65.4% of the population lived below the poverty line in 2015, compared to urban areas where 25.4% of the population were poor in 2015. Eastern Cape, KwaZulu-Natal (KZN), and Limpopo are consistently the poorest provinces. As a consequence, one may argue that 14% live in informal dwellings in informal settlements (Statistics South Africa Quarterly Labour Force Survey (QLFS), 2016). Statistics South Africa defines an 'informal dwelling' as a "makeshift structure not erected according to approved architectural plans, for example, shacks or shanties in informal settlements or in backyards". Of the rural population, 19% lack access to a reliable water supply, and 33% do not have basic sanitation services (Africa, 2016).

One of the main contributors to poverty in South Africa is its high unemployment rate which reached a 14-year high of 27.7% in the third quarter of 2017, associated with slow job creation as economic growth slowed in recent years (Worldbank: Overcoming poverty and inequality in South Africa, 2018). The results of the Quarterly Labour Force Survey for the second quarter of 2018 released by Statistics South Africa indicate the official unemployment rate to be 27, 2%. Of the 20,2 million young people aged 15-34 years, 39.3% were not in employment, education or training (NEET) – an increase by 0,4 of a percentage point compared to the second quarter of 2017 (QLFS Q2, 2018).

Moreover, more than two-thirds of unemployed people have been without a job for a year or longer according to Statistics South Africa (2016) (Rector, Fatoki & Oni, 2016). Chiliya and Roberts-Lombard (2012) state that high unemployment is often highlighted as the single most significant impediment to poverty reduction in developing countries, including South Africa. One of the major reasons for unemployment in South Africa is the disproportional dependence of labour market entrants on formal sector jobs (World Bank, 2015; Dlova, 2017). Balogun *et al.* (2016) state that in South Africa more than 700 000 job seekers enter the labour market annually, but only 44,000 new jobs are created annually in the formal sector.

A consequence of the formal sector's inability to accommodate new entrants is the establishment of businesses often set up to escape the plight of unemployment, often referred to as "forced entrepreneurship", rather than to exploit a promising business opportunity (Balogun *et al.*, 2016). Even though this may be a "forced" situation, one has to take cognisance of the fact that South Africa lags behind other developing economies in terms of promoting the growth and sustainability of small businesses (SBP, 2015). In South Africa, less than 20% of all employed people are self-employed or employers. In contrast, the norm for upper-middle-income economies, excluding China, was around 40% during 2016 (The Real Economy Bulletin, 2017:4).

Coupled with poverty is the HIV/AIDS prevalence. South Africa is the country with the largest percentage of HIV infections in the world (Statistics South Africa, 2017). It was estimated in 2007 that 721,000 people died from AIDS in South Africa (World Health Organisation Report, 2009:55). The estimated overall HIV prevalence rate is approximately 12.6% among the South African population. The total number of people living with HIV is estimated at approximately 7.06 million in 2017. For adults aged 15-49 years, an estimated 18% of the population is HIV positive (Statistics South Africa, 2017).

It can therefore surely be predicted that AIDS is likely to increase the shortage of skilled workers and produce bottlenecks in the economy. The impact where a major income earner or business partner is affected due to illness is the permanent revenue loss for the household and consequently the inability to repay loans (Mogale, 2007). The FinScope Survey (2010) emphasizes the reality that most South Africans are dramatically uninsured against risks such as death and disability, leaving their dependents financially exposed. Based on the above circumstances, where access to credit for business enterprises is available, the family members may be enabled and empowered to continue a livelihood for the household.

In 2003, President Thabo Mbeki refocused the debate around the stubborn persistence of poverty and underdevelopment due to apartheid in South Africa, when the two economies concept was re-introduced into the policy arena. These two worlds are commonly referred to as the 'first' and 'second' economies or the 'formal' and 'informal' economies (Turner, 2017). This dualism in the economy is illustrated in Figure 1-1:

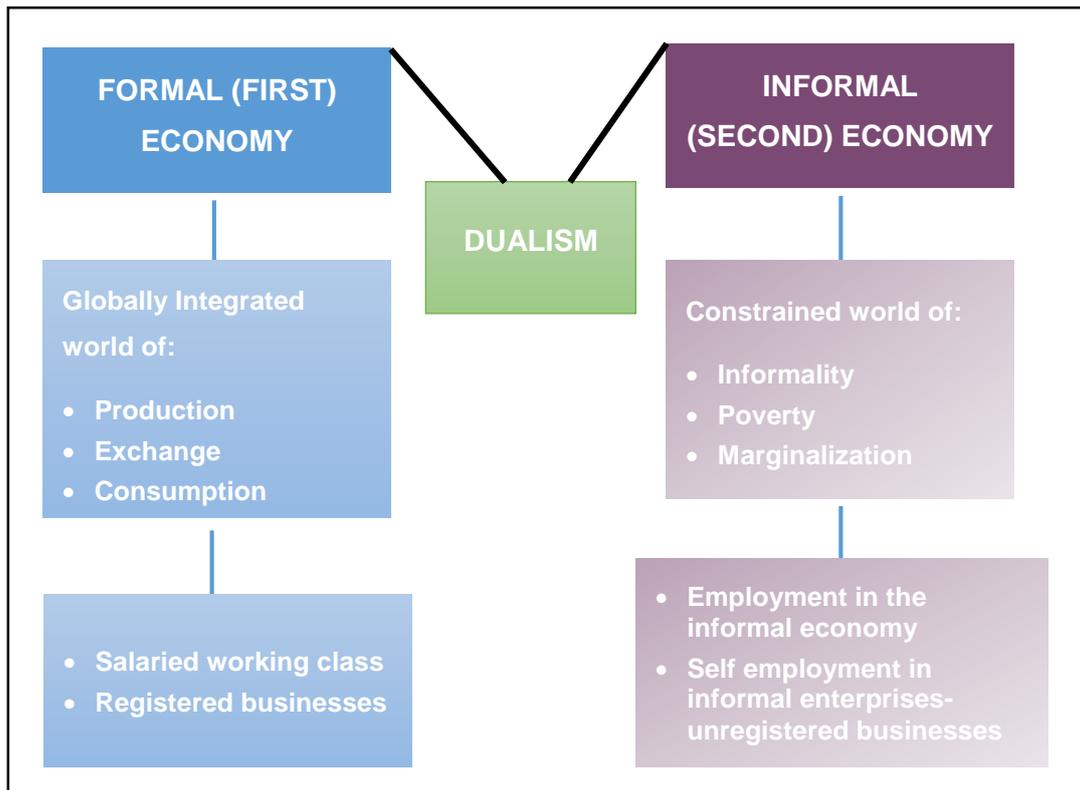


Figure 1-1: Dualism in the formal and informal economy in South Africa

Source: Adapted from Stegman (2001)

Figure 1-1 highlights that poverty is concentrated in the informal economy. This dualism in the economy is arguably still evident considering a report by the Worldbank (2017) which states that with a consumption expenditure Gini coefficient of 0.63 in 2015, South Africa has one of the most unequal income distribution patterns in the world: approximately 60% of the population earns less than R42, 000 per annum (about US\$7,000), whereas 2.2% of the population has an income exceeding R360, 000 per annum (about US\$50,000). James (2018) confirms that the income inequalities are as a result of the apartheid era.

Although much has been done by government to reduce headcount poverty in the informal economy, such as the introduction of subsidized water, electricity, food and more schools being declared as “no-fee” institutions, the poverty in South Africa remains a concern. It is more than two decades after the end of apartheid, and considering all the efforts by government which can be traced back to the 1993 Reconstruction and Development Program, which was the first prescription of the post-apartheid era which identified the reduction of poverty as a central goal, and yet millions of people still live below the poverty line (Statistics South Africa, 2016).

The divide in the economy has also had an impact on the provision of financial services in the two economies in South Africa. It is described in terms of a pyramid of financial institutions in Figure 1.2.

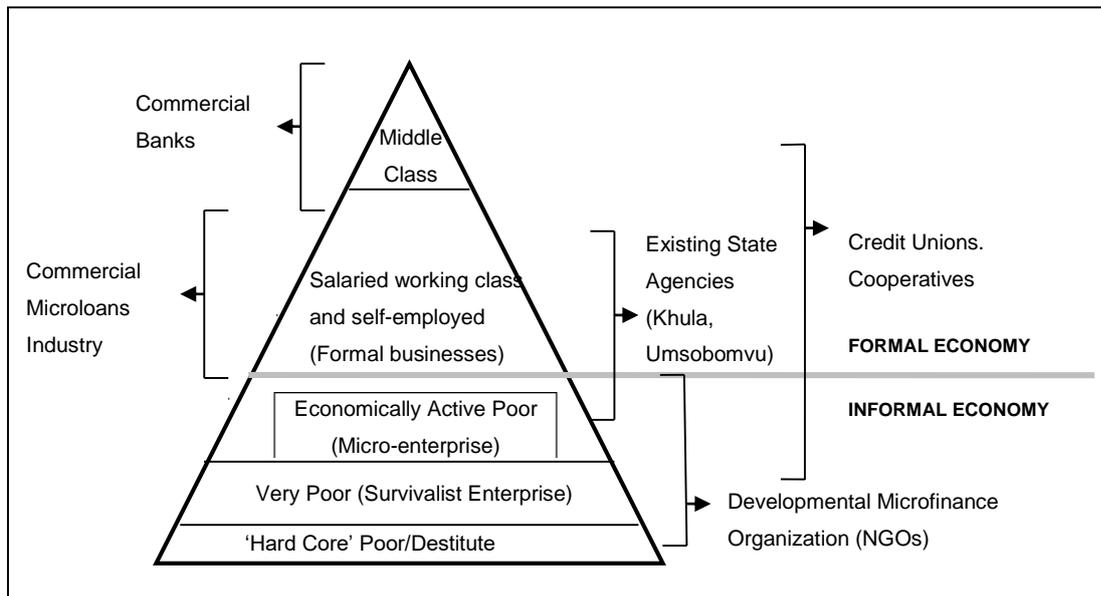


Figure 1-2: Pyramid of Financial Institutions

Source: Adapted from Rau (2004)

At the top of the pyramid, the middle class is fully serviced by the Big 4 banks, namely ABSA, Standard bank, Nedcor and First National Bank (FNB), which between them have more than 80% market share of the banking industry in South Africa. More recently, Capitec has been included to form the Big 5 banks in South Africa (Church, 2016). The salaried working class and people earning a regular income from self-employment through formal businesses are able to access savings and loans through the commercial banks and the micro-lending industry (Turner, Varghese & Walker, 2008). The Big 4 banks provide 96% of the banking services for small business and offer programs of assistance (Church, 2016), however, Worku (2015a) states that these programs of assistance are vastly underutilized by operators of start-up businesses.

Up until the end to the apartheid era in 1994, financial services in South Africa were predominantly accessible to the non-black community and therefore, by default, excluded the economically weaker households at the bottom of the pyramid (Masama, 2018). Following the Financial Service Charter (FSC) policy recommendations, the 'Mzansi' account which was launched in 2004 offered entry-level savings accounts aimed at the people at the bottom of the pyramid. This was a joint venture between the Big 4 banks in South Africa and Post Bank (Kostov, Arun, & Annim, 2015).

Within seven months of the launch, the Banking Association South Africa reported that 600,000 accounts had been opened. By August the same year, the number of new Mzansi account holders had risen to over 1.5 million (Masarira, 2014). In addition to this positive tenor, the South African Insurance Association (SAIA) designed a Mzansi insurance product for informal settlement dwellers to match the Mzansi bank account. The insurance covers household contents and the structure of the dwellings of people earning less than R3, 000 a month at affordable rates (Kostov *et al.*, 2015). The FinScope (2013) study confirmed that the population with access to bank accounts increased significantly from 46% in 2005 to 75% in 2013, however access to credit for the poorer population, specifically for small businesses remains a challenge (Scope, 2013; Bureau for Economic Research (BER), 2016; Masama & Bruwer, 2018).

This is a concerning state of affairs as statistics show that from 2008 to 2015, small business was the largest source of employment in South Africa (Anand, Kothari & Kumar, 2016). In 2015, there were 710,000 small business owners who employed a total of 4.3 million people. In contrast, the large businesses employed 3.6 million people (Anand, Kothari & Kumar, 2016). With a total population of 46.4 million (2015), small businesses contributed approximately 42% of South Africa's gross domestic product (GDP) and accounts for 60% of employment (Statistics South Africa, 2015; Rungani & Potgieter, 2018).

Government departments put out tenders worth an estimated R50 billion each year to empower local businesses, including the small business sector to participate effectively in local development. These businesses, however, must comply with the Broad-Based Black Economic Empowerment (B-BBEE) policies. B-BBEE policies aim to redress past imbalances and broaden the economic access to members of historically disadvantaged communities, and this way, facilitate socioeconomic transformation. The goal is to increase the number of black South Africans that either own or manage businesses (Rogerson, 2018). If one considers that Black South Africans consistently exhibit the highest poverty rates, as statistics show that in 2015, 47% of the households headed by black South Africans were poor (Worldbank, 2017), one could question how the historically disadvantaged communities could participate in the government tenders. Rogerson (2018) confirms that small businesses cannot participate in the procurement opportunities without having their own capital or access to credit.

Furthermore, a paper released by the South African National Strategy Team highlighted that the lack of credit limits the poorer population from benefiting from global trends. The paper explains that whilst there are many medium to long-term measures in place, such as public expenditure increases which are directed at skills development and education, there is an

urgent need for more short-term solutions to reduce the country's poverty. One of the most effective solutions the paper identifies, is developing and promoting export where cooperatives can act as mediums to export products of the poor, or where inputs for export production can be sourced in the country so that it could create local economic benefits or spill-overs (Herrington & Kew & Kew, 2014:23).

The paper by Morgenthaler (2007) explains that in order to grow, it is important to either create more value, or expand the area of trade. Sustainable wealth and job creation must do both of those all the time. This is evident in the developed world such as the United States where there is more self-sufficiency and a lot of trade within the nation, trading less than 10% of their economy outside of the nation. Also, for countries with a small workforce, prosperity depends on being able to export in areas such as the service sector, goods production sector, and primary industries (Anand, 2016).

Unfortunately, access to credit is one of the prohibiting factors for local businesses to produce goods for export. Effectively the lack of access to credit does not only inhibit economic growth, but it also keeps people trapped in poverty (Olawale & Garwe, 2010). The International Monetary Fund (IMF) Working Paper (2016) reports that the total external trade for small business remains tiny, whilst large businesses account for more than 90% of export sales during this period (Anand, 2016). This position does not seem to be improving considering the finding of Purfield, Farole and Fernando (2014) who state that large exporters dominating South Africa's trade have underutilized the country's large pool of unskilled workers, and failed to turn the export activity into a major contributor to employment growth and poverty reduction.

Anand (2016) furthermore states that this position is not expected to improve, as nearly one quarter of the small businesses in a given period are likely to become inactive the following period. Moreover, the probability that a small business will grow to become large in the following period is minuscule. Government, however, continues their efforts to try and provide opportunities for the growth of small businesses. The National Development Plan (2030), seeks to eliminate poverty and reduce inequality by 2030, and identifies the triple challenge of high poverty, inequality, and unemployment as a major challenge for the country. However, various authors/publications argue that not much can change if the small businesses are not growing to the extent that more job opportunities can be produced (Dlova, 2017). Access to credit for small businesses is continuously raised as a stumbling block to the formation, growth, and expansion of small businesses (Olawale & Garwe, 2010; Dlova, 2017; Worldbank, 2017).

This state of affairs emphasizes the importance of restructuring financial assistance, specifically credit, to improve the income earning potential of small businesses which, can be argued, will ultimately positively impact on wealth creation in the economy of South Africa. This assumption is based on the potential of small businesses to create value on a long-term basis, through the propensity to increase the earning potential of the business, and the job creation prospective. It is appropriate at this point to discuss the relation of “value-based management” to this study.

### **1.3 Application of value-based management**

Wealth creation is generally linked to Value-Based Management (VBM), where “VBM = Performance” (Iltner & Larcker, 2001). The National Treasury (2015) indicates that job creation, wealth generation, and improved standards of living for all South Africans are major issues that are capable of transforming the South African economy. However, Machirori and Fatoki (2013:115) point out that existing large firms and the public sector have been unable to solve major economic problems; hence, the importance of the small business sector as a contributor to resolving the economic crisis should be acknowledged (Rungani & Potgieter, 2018).

When the term “value-based management” is used, the inference is normally linked to “profits” and “maximizing shareholders value” which is arguably linked more to the larger, more established businesses. However, in South Africa where the poverty and unemployment rates are so high, any form of job creation is valued. Brink, Cant and Ligthelm (2003) emphasizes that a job gives a person not only income, but also self-respect. Moreover, a job provides people with the opportunity to contribute to the productive growth of the nation (Zulu, 2017). A report by FinMark Trust (2006) states that one of the best ways to address unemployment is to leverage the employment creation potential of small businesses, and to promote small business development (Porteous, 2007). Ultimately, there is an opportunity to add value in the form of wealth creation for the South African economy.

The value of small businesses, although some may be trading in the informal economy, should not be disregarded. In support of this, Mago and Toro (2013) confirm that many micro-enterprises provide the livelihoods of millions of people in South Africa. A study by Mwangi and Cheluget (2018) noted that innovation consists of firms developing new products or new production processes to better perform their operations. The study adds that financial inclusion of small businesses reduces liquidity constraints, and encourages investment, which in turn influences industrial structure, firm size, and competition in an economy. Financial inclusion aims at drawing the unbanked population into the formal financial system to enable them

access to a wide range of financial services including savings, payments, money transfers, credit, and insurance (Mwangi & Cheluget, 2018).

It can be argued that entrepreneurship must 'start somewhere', by entering an industry already competitive or saturated, or with an 'idea', a 'gap' in the market identified which no one else spotted. The word "entrepreneur" which is rooted in the French word *entreprendre* (meaning to undertake), implies wealth creation (Tan, 2007). An entrepreneur can be defined as "a person who undertakes a wealth-creating and value-adding process, through incubating ideas, assembling resources and making things happen" (Kao, 1993). If funds are made available to entrepreneurs with a feasible business idea, this idea may eventually evolve into a successful business.

But what is success? According to Ries (2011), a business can be considered successful if it meets the aspirations of its stakeholders and is financially secure. Dockel and Ligthelm (2005:18) state that a generation of new entrepreneurs has become the creators and leaders of entire companies and even industries in the United States of America (USA), and add that "Since World War II; small entrepreneurial businesses have been responsible for half the innovation and 95% of all radical innovation of new technologies, products, processes and services in the USA".

It is acknowledged that not all small businesses will flourish into large profitable businesses, but no matter how small the business; there is the potential to create value. There is an opportunity to provide for the immediate family needs of the household where the family may otherwise have been destitute or surviving only on government grants. Woodward, Rolfe, Ligthelm and Guimaraes (2011) concede that whilst many small businesses remain small, employing only a few people, they nevertheless provide a standard of living above the subsistence level. Moreover, some informal activities become growth enterprises as they respond to local opportunities (Rogerson, 2018). There have been examples in South Africa where shebeens grew to become successful restaurants, and spaza shops grew to become wholesale dealers for beverage companies (Woodward *et al.*, 2011).

The opportunity, therefore, exists to expand and grow a business to a point where it can employ more people, and thereby assist in the government's efforts to create employment opportunities. What must also be emphasized is that the people employed in the informal sector are generally known to be predominantly uneducated or with very little education (Statistics South Africa, 2015), therefore, the opportunity for this disadvantaged population to obtain formal employment is unlikely. This emphasizes the contribution that can be made to the overall economy in South Africa by stimulating the growth of small businesses.

The potential also exists for the entrepreneur to develop the small informal business to such an extent where the business is not only self-sufficient, providing only for the minimal financial needs of the household, but also where it becomes profitable and formalized; that is, where the business is registered with government and for tax. The Human Development Report (UNDP) (2005:96) emphasizes that by formalizing local informal economy business, this sector's growth and expansion, and ultimately its ability to provide employment, would be significantly promoted (Watkins, 2006). Alimi (2015) states that from moving from self-sufficiency to more specialization, is a move towards prosperity. Prosperity is an outcome of doing everything yourself. Alimi (2015) explains that people specialize to produce things of value for others, who have also specialized because they cannot do everything for themselves either. It is success in that choice of specialization and trade that changes the economy, creates wealth, and engages more people in specialized businesses.

From the above statements, and considering that a gap in the market exists for increasing access to credit for small businesses, the impact on wealth creation may be substantial from a bank lending perspective and by creating new employment opportunities. It is generally known that banks are always looking for avenues to expand market share, as it can be argued that the existing markets which banks operate in are saturated. This poses an opportunity for banks to increase revenue and shareholder wealth, provided that the small businesses can service the debt.

#### **1.4 Motivation for the focus of the study**

From the preceding, it was established that the South African Government faces a huge challenge to improve its people's living conditions and to remove inequalities. One of the avenues identified to assist in poverty alleviation is the development and growth of small businesses.

The lack of provision of credit was, however, identified as one of the key barriers to the establishment and growth of small businesses in South Africa. It is widely acknowledged that banks have a responsibility to protect the interest of their shareholders and therefore cannot invest in any areas considered to be risky. It is also widely acknowledged that the government has various strategies in place to assist and promote the growth of small businesses in South Africa. A perspective that has gained considerable ground over the years according to Schoombee (2009), is that governments need only to create an enabling environment and provide incentives for the financial services sector to undertake the high cost of lending to small businesses by providing guarantees to mitigate the risk of loan default.

The motivation for the study is, therefore, to explore a value-based decision framework for small business lending which banks can use, which optimizes government support initiatives to mitigate the banks credit risk, and allows for a more convenient service to the small business customer. This is by no means suggesting that banks are to now take over the role, objectives, implementation, or any cost of the government initiatives to improve access to credit. It is exploring a methodology where the strategy of the banks and the government can be more efficiently aligned to enable more access to credit for small businesses. A value-based management approach according to Young *et al.*, (2000), focuses all decision-making on the fundamental drivers of value. It involves the improvement of decision-making at all levels, and aligning objectives toward the maximization of shareholder value. Ultimately, the proposed value-based decision framework for small business lending should benefit the small business customer, the bank, and promote small business growth in the economy of South Africa.

### **1.5 Problem statement**

From the preceding, a deduction can be made that despite the efforts of the Government to promote access to credit, small businesses in South Africa struggle to survive, and access to credit remains limited. It is, however, unclear at this point what the typical profile of a small business is in South Africa, what the challenges are to obtain credit, and why the businesses are closing down.

From a credit provider's perspective, specifically banks, the literature review revealed that there is a reluctance to provide credit to small businesses. What the bank criteria is for small business lending, the credit evaluation frameworks applied, and the challenges to lend to small businesses is also unclear at this point.

Furthermore, the influence of the Government initiatives to promote small business lending, specifically through the Khula Credit Guarantee Scheme, and the influence of legislation, specifically the National Credit Act (NCA), on small business lending is also uncertain.

In order to obtain insight to the above, and considering the motivation of the study which is to explore a value-based decision framework for small business lending; specific research objectives were identified and will be described in detail below.

## **1.6 Objectives of the study**

The research objectives were divided into primary and secondary objectives. The primary objective of this study is to develop a value-based decision framework for small business lending. However, in order to achieve this objective, it was important to gain an understanding of all the dynamics which may play a role or influence the provision of credit to small businesses. From a credit provider's perspective, the focus is on banks considering that the literature review highlighted that banks are the main providers of credit services to small businesses.

The secondary objectives that were identified in order to meet the primary objective are listed below under the relevant chapter. It is further stated on how each objective is to be attained, either through the conduct of a literature review, or an empirical study.

The secondary objectives driving the study can be summarized as follows:

### **Chapter 2**

Through a literature review, address the following objectives:

- To obtain a general profile of small businesses in South Africa.
- To identify the challenges faced by small businesses in South Africa, specifically from a credit access perspective; and
- To identify the prominent reasons for the failure of small businesses in South Africa.

### **Chapter 3**

Through a literature review, address the following objectives:

- To identify the basis upon which banks typically grant credit to small businesses; and
- To identify what the challenges are for banks to provide credit to small businesses.

### **Chapter 4**

Through a literature review, address the following objectives:

- To determine the influence of the National Credit Act (NCA) on small business lending; and

- To determine the influence of the Khula Credit Guarantee Scheme on small business lending.

## **Chapter 5**

Through an empirical study, address the following objectives:

- Identify what the challenges are to provide credit to small businesses.
- Identify what a suitable credit policy may be for small business lending.
- Identify any variables which may contribute towards identifying credit risk when lending to small businesses.
- To determine the influence of the NCA on small business lending; and
- To determine the influence of the Khula Credit Guarantee Scheme on small business lending.

## **Chapter 6**

- Based on the empirical study results, develop a proposed value-based decision framework for small business lending in order to meet the primary objective of the study.

### **1.7 Research design and methodology**

In order to achieve the objectives for Chapters 2-4, the sources of secondary data was utilized. Secondary data is used to provide a theoretical background of the research and to support data from survey research (Ghauri & Grønhaug, 2005). The secondary data was obtained in published and electronic forms such as academic books, journals and databases, published reports, and electronic theses.

In order to achieve the objectives for Chapter 5, primary data was collected directly from a research population through fieldwork. The primary information was obtained through a survey and a self-administered questionnaire to gather information to address the following objectives:

- Identify what the challenges are to provide credit to small businesses.
- Identify what a suitable credit policy may be for small business lending.

- To determine the influence of the NCA on small business lending; and
- To determine the influence of the Khula Credit Guarantee Scheme on small business lending.

The structured questionnaire comprised of closed and open-ended questions. The questionnaire was distributed to certain institutions in the banking, accounting, and finance industry to distribute to personnel for completion.

A mixed method was used for data collection, data analysis, and interpretation. The larger part is quantitative analysis, with a smaller contribution of qualitative analysis. A mixed method approach is one in which the researcher collects, analyses, and integrates both quantitative and qualitative data in a single study, or in multiple studies in a sustained program of inquiry (Creswell, 2013). The reason for collecting both quantitative and qualitative data are to bring together the strengths of both forms of research, as the research problem was too complex to explore using only the one method. Open-ended questions was required to allow the respondents to elaborate on a certain topic, and also to provide alternative solutions or recommendations for improvement. Creswell (2013) states that a mixed method permits an examination of more complex issues/questions as the different methods assess different phenomena to expand the range of the study and address insufficient information.

The above addresses four of the five research objectives for chapter 5, leaving one remaining objective:

- Identify any variables which may contribute towards identifying credit risk when lending to small businesses.

In order to address the above objective a quantitative method was used for data collection, data analysis, and interpretation. The primary data was collected using a designed checklist. The exercise was conducted at the premises of the Small Enterprise Finance Agency (SEFA) utilizing the existing commercial data of credit providers, after signing a non-disclosure agreement. A statistical analysis was then conducted to determine whether there is a relationship between the variables identified and the likelihood of default.

### **1.8 Anticipated contributions of the study**

It is envisaged that the study will make a contribution to knowledge development, practice, and policy.

### **1.8.1 Knowledge development contribution**

The results from the research undertaken will provide information which can assist in the design of an appropriate value-based decision framework for small business lending that will improve accessibility to credit for small businesses, and may provide pointers which can hopefully be shared worldwide.

### **1.8.2 Practice and policy contribution**

Merriam and Tisdell (2015) state that insights gleaned from in-depth research can directly influence policy, procedures, and future research. It is envisaged that the results from the study will inform recommendations for the finance sector regarding Credit Policy and other factors for providing credit to small businesses. These can be adjusted for any financial institution striving towards providing credit to small businesses, locally and internationally.

### **1.9 Limitations of the study**

There are certain limitations to the study, for example, survivalist enterprises have been excluded. Furthermore, not all the legislation which may influence small business lending was researched; the focus was on the influence of the National Credit Act (NCA) on small business lending. With regards to government initiatives to support small business lending, only the Khula Credit Guarantee Scheme was considered.

It must also be noted that the research population which completed the self-administered questionnaire included “Accountants in practice” which makes up 23% of the research population. The view of the “Accountants in practice” is consolidated with the view of the “Bankers”. A motivation for including the “Accountants in practice” is included in Chapter 5.

### **1.10 Layout of the study**

The layout of the study is as follows:

#### **CHAPTER 1: CREDIT FOR SMALL BUSINESSES: AN ORIENTATION**

This chapter contextualizes the study and includes a description of value-based management as it applies to this topic.

#### **CHAPTER 2: ACCESS TO CREDIT: A SMALL BUSINESS OWNER PERSPECTIVE**

This chapter comprises of a literature study to identify a general profile of small businesses in South Africa, to identify the credit needs of small business owners, what constitutes a

successful small business, the challenges to obtaining credit, and the prominent reasons for business failure.

### **CHAPTER 3: ACCESS TO CREDIT: A CREDIT PROVIDERS PERSPECTIVE**

This chapter comprises of a literature review which was aimed at obtaining a general understanding of the credit lending principles applied by banks, and what the challenges are when assessing small business credit applications.

### **CHAPTER 4: INFLUENCE OF REGULATION AND GOVERNMENT INITIATIVES ON SMALL BUSINESS LENDING**

This chapter focused on the influence of government initiatives on small business lending, specifically through regulation and government initiatives aimed at promoting access to credit for small business. From a regulation perspective, the focus was on the National Credit Act (NCA), and from a government initiative perspective to improve access to credit, the focus was on the Khula Credit Guarantee Scheme.

### **CHAPTER 5: RESEARCH METHODOLOGY AND EMPIRICAL RESULTS**

This chapter includes the research methodology, and the empirical results are presented.

### **CHAPTER 6: VALUE-BASED DECISION FRAMEWORK FOR SMALL BUSINESS LENDING**

This is the concluding chapter, which provides a summary of the key findings, confirms the attainment of the set objectives, and provides a conclusion and recommendations. This is followed by the proposed value-based decision framework for small business lending in South Africa, which is based on the results of the empirical research conducted.

## **CHAPTER 2: ACCESS TO CREDIT: A SMALL BUSINESS OWNER'S PERSPECTIVE**

### **2.1 Introduction**

Chapter one touched on the importance of small businesses for the economy. It was further identified that despite the efforts of the government to promote small business development in South Africa, access to credit for small businesses from formal financial institutions remains a challenge. Based on this, it is important to gain a general understanding of small businesses in South Africa, the challenges faced by the small business owners, factors that may contribute to the success of a business, and what the main reasons are for the failure of a business. It is also important to attain a basic understanding of how capital is attained from the start-up phase and as the business grows and expands.

The abovementioned will be explored from a literature review perspective, and where appropriate the literature will cover areas from an international perspective to obtain a broader and enriched view in certain areas.

### **2.2 A general profile of small businesses in South Africa**

The National Small Business (NSB) Act (102 of 1996) defines SMMEs as a separate and distinct business entity, including cooperative enterprises, sole proprietorships, partnerships, close corporations, and non-governmental organisations, managed by one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or sub-sector of the economy (Government Gazette of the Republic of South Africa, 1996; Dlova, 2017).

Furthermore, the National Small Business Act (102 of 1996) (as amended), as indicated in Chapter 1, categorizes businesses in South Africa into distinct groups, namely; survivalist, micro, very small, small, and medium, hence the use of the term "SMME" for small, medium and micro-enterprises (Mago & Toro, 2013). The most common categorization of SMMEs uses the number of employees per enterprise size category, combined with the annual turnover categories, and the gross assets, excluding fixed property (Abor & Quartey, 2010; Ramasobana, Fatoki & Oni, 2017).

A brief description of SMMEs is provided below:

### **Survivalist enterprise**

This category is considered pre-entrepreneurial and normally includes business activities by individuals who are unable to secure a paid job or enter into the economic sector of their choice (Abor & Quartey, 2010). Poverty and the need to provide basic sustenance are the main drivers for establishing this category of business. The businesses trade in the informal economy, no capital is invested, and there is very little or no skills training. The income generated is less than the minimum income standard or the poverty line (Mago & Toro, 2013). Examples of survivalist businesses include hawkers, vendors, backyard manufacturing and services, subsistence farmers and occasional home-based evening jobs (Berry, Von Blottnitz, Cassim, Kesper, Rajaratnam & Van Seventer, 2002). In practice, survivalist businesses are often categorized as part of the micro-enterprise sector, however, survivalist businesses have very limited opportunities to hire employees and grow into a viable registered business (DTI, 2008).

### **Micro enterprise**

Micro-enterprises are mainly owned by one owner, some have family member involvement, and for those that do have paid employees, usually employ no more than 5 people (NCR, 2011:25). These businesses normally trade in the informal economy, as many do not have business licenses and/or operating permits where required, do not meet formal registration requirements, and usually have a turnover of below the Value-Added Tax (VAT) registration limit (Mago & Toro, 2013). The businesses are usually home-based, typically have a limited capital base, no proper accounting systems, and have very basic technical and business skills (Berry *et al.*, 2002). Examples include spaza shops, minibus taxis and household industries (Fatoki, 2016). Micro-enterprises are, however, considered to have the ability to advance into small businesses (Dlova, 2017).

### **Very small enterprise**

These are enterprises employing fewer than 10 paid employees, except for the mining, electricity, manufacturing and construction sectors, in which the figure is 20 employees. Their turnover is between R150, 000 and R500, 000 (NCR, 2011:25). These enterprises mainly operate in the formal economy and have access to technology (Abor & Quartey, 2010; Dlova, 2017).

### **Small enterprise**

Small enterprises are generally more established than very small enterprises and exhibit more complex business practices. They are usually owner-managed or directly controlled by an owner, with employment levels ranging between 5 and 50 employees (NCR, 2011:25).

These businesses are likely to conduct operations from a business or industrial premises, are registered for value-added tax, and usually fulfill other formal registration requirements. Examples of small businesses can be found in sectors such as construction, manufacturing, retailing, and professional services (Dlova, 2017).

### **Medium enterprise**

Medium enterprises constitute a category of businesses between small and large business. These businesses are often characterized by the decentralization of power to an additional management layer, and there may be more complexity to the shareholding (Abor & Quartey, 2010). The maximum number of employees is 100, or 200 for the mining, electricity, manufacturing and construction sectors (Dlova, 2017). The capital assets (excluding property) of about R5 million is perceived as the maximum thresholds (The Real Economy Bulletin, 2017).

The above definition of SMMEs encompasses a very broad range of businesses which include formally registered and informal businesses. To put the South African small business market into perspective, it must be noted that there is uncertainty about the size and composition due to businesses which may not be registered which makes record-keeping difficult (Ladzani & Netswera, 2009). In South Africa, if a business is not registered for example for Value-Added Tax (VAT), with the Unemployment Insurance Fund (UIF), or with the South African Companies and Intellectual Property Registration Office (CIPRO), it would normally be considered as trading in the informal economy. A sole proprietor or partnership would not be required to register at CIPRO; however, it should register for tax depending on the earnings, and where employees are appointed, to register with the unemployment insurance fund. It is important to note, however, that if a business is operating in the informal economy, it does not necessarily mean that it is a survivalist or micro-enterprise.

There are various reasons for business owners not wanting to register the business. Schneider and Klinglmair (2004) confirm that the main reasons for becoming informal in the formal economy are due to direct and indirect taxation and government regulations. In the labour market, the costs which businesses (and individuals) have to pay when officially hiring an employee are increasing due to indirect tax, social contributions on wages, and due to the legal regulations attached to employment. Examples of indirect taxes on wages are the

training, levy, and contributions to the unemployment insurance fund. This is especially true in Europe, where both are calculated on the wage bill of a company (Schneider & Klingmair, 2004). In South Africa, these challenges are also prominent. Ferreira (2007) notes that many small businesses in South Africa are unable to reach their objectives due to impediments such as red tape, cumbersome regulations, and tax. Several studies (SEDA, 2016; Musara and Gwaindepi, 2014; Oyelana and Fiseha, 2014; Dlova, 2017) highlight that the business environment in South Africa inhibits the establishment and growth of small businesses. Furthermore, Worku (2015b) states that the cost of doing business in South Africa is arguably the highest in the world. Abor and Quartey (2010) add that the licensing and regulatory requirements impose an excessive burden on small businesses in South Africa.

From the above, it was ascertained that small businesses include businesses which trade in the formal and informal economy of South Africa. A further breakdown is provided below to provide an indication of the number of small businesses, and the geographic and demographic information. Where possible, the information was further separated to distinguish between the businesses operating in the formal and informal economy in South Africa. One of the main variables used to distinguish whether a business operates in the formal or informal economy, based on the information included in Tables 2-1 and 2-2, is whether the business is registered for VAT. In 2015, VAT registration was legally required for businesses with a turnover of >R1 million (SARS, 2015). The Tables were compiled using the information from various sources (SARS, 2015; SEDA, 2016; Statistics South Africa, 2016; BER 2016; Statistics South Africa's Quarterly Labour Force Survey (QLFS), 2015; Statistics South Africa Labour market dynamics (LMD), 2015; The Real Economy Bulletin, 2017):

Table 2-1: Statistical profile of small businesses in South Africa

<b>SMALL BUSINESSES (2015)</b>
<ul style="list-style-type: none"> <li>• Total 2.2 million businesses.</li> <li>• 650 000 businesses registered for tax with taxable income between R250, 000 and R20 million.</li> <li>• Employment provided by formal small businesses: 5.8 million people.</li> <li>• Main sectors: Retail, construction and business services.</li> <li>• Main provinces: Gauteng, Western Cape, KZN (mainly in metros).</li> </ul>

Source: Authors own compilation

Table 2-2: Formal and Informal small businesses in South Africa

2015	Formal	Informal
Numbers	670 000	1.5 million
Employment status	69% of owners are employers, 31% employ only themselves	20% of owners are employers, 80% employ only themselves
Average monthly income	R8000 – R12000pm	R2000 – R4000pm
Majority ownership by race	49% owned by black people	94% owned by black people
Ownership by gender	Women 24%, Men 76%	Women 40%, Men 60%
Main geographic distribution	Gauteng, Western Cape & KwaZulu Natal	Limpopo and Mpumalanga
Primary industries	Retail, financial, construction and business services	Trade and accommodation sector
Education levels	Degree or diploma 15% Matric 38% Do not have matric 47%	Degree or diploma 5% Matric 25% Do not have matric 70%

Source: Authors own compilation

The above provided a general profile of small businesses in South Africa, with a further distinction between formal and informal small businesses. Furthermore Burger, Marais and Van Rooyen (2017) state that in comparison to informal small businesses, formal small businesses typically have more capital, more advanced technology, more employees and higher incomes, where the owners are mostly professionals or artisans with significant skills. Provinces with larger economies tend to have the largest share of formal small businesses (The Real Economy Bulletin, 2017). In contrast, the businesses operating in the informal economy show high failure rates, the income generated is very low, and have low capital amounts available, especially in the more rural provinces (SEDA, 2016).

The reason for the high failure rates of small businesses will be addressed later in the chapter. Below the capital requirements during the lifecycle stages, and the possible capital sources for small businesses will be further explored.

### 2.3 Business lifecycle stages

The business lifecycle has become more prominent in recent years. During these various stages in the business lifecycle, different financing requirements have been observed (Mbedzi, 2011b). The business lifecycle begins at the start-up phase of the business, through the growth phase, and into a stable phase.

Kreitner and Kinicki (2003) explain that similar to people who make up a business, the business itself goes through lifecycles. Businesses are born and barring early decline, eventually grow and mature. If the decline is not reversed, the business dies. Just as people face new problems and challenges during different phases in their lifetime, so do businesses (Kreitner & Kinicki, 2003). Figure 2-1 depicts the similarity between the business lifecycle and the 'human' lifecycle where after prime stage the rate of improvement begins to decline and alter.

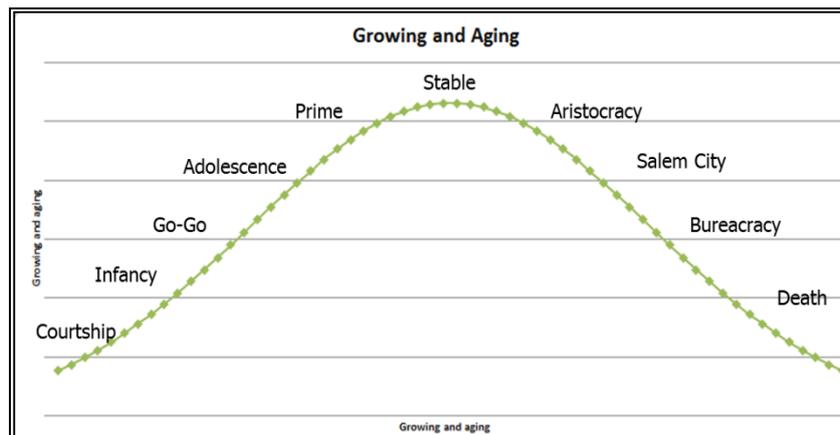


Figure 2-1: Similarities between the business lifecycle and the 'human' lifecycle.

Source: Adapted from Adizes (2004)

During "courtship" the business is not yet established, only the business idea is formed. During infancy the business ideas are transformed into reality and at this stage the business requires operating capital and the focus of the founders (Adizes, 2004). Kinicki and Kreitner (2003) confirm that businesses are more dependent on financial intermediaries during the early stages of the business lifecycle.

At the "go-go" stage the business has a successful product and/or service and the business is flourishing. At "adolescence" profitability is the most important goal. At "prime" the business curve includes both growing and aging conditions. At the "stable" stage, the business is strong but is starting to lose flexibility and the decline in flexibility becomes more prominent during the "aristocracy" stage. Early "bureaucracy" arises when the business is unable to reverse its downward spiral stemming from early bureaucracy. At the "bureaucracy" stage, the business is unable to generate sufficient resources to sustain it. Ultimately "death" occurs when the business cannot generate the cash required, and the outflow finally exhausts any inflow (Adizes, 2004).

Based on the needs of a business in its different lifecycle stages, it can be assumed that the efforts of government and financial institutions should be aimed more at small businesses during the early stages of the lifecycle. The infancy stage of the business lifecycle will, therefore, be further explored with an emphasis on the financial needs of small businesses during this stage. According to Berger and Udell (2006), some form of investment is needed when a business starts production. At this stage, there is fixed and variable costs, however, there will usually only be a cash inflow after putting the product to market and selling the product or service. Cash availability at this point for start-ups is significant as there is no existing reputation in the market to sell the product or service offering. Normally with the aid of financial assistance an infant business establishes its products or services within the marketplace and begins to enjoy strong demand, consistent sales growth, a healthy cash flow from sales, and that would facilitate the organization transition into the next stage of its lifecycle, namely the “Go-Go” (Adizes, 2004).

Judging from the businesses lifecycle, it seems evident that businesses have varying capital requirements during the different stages. Young businesses may be able to draw capital from internal informal sources such as family and friends (Mahembe, 2011). However, as a successful business grows, more capital is required to finance the growth, hence the business owner would need to approach external sources such as banks for credit (Mbedzi, 2011b). The need for credit starts to decline as the business reaches the maturity stage (Cole & Sokolyk, 2016).

From the above, the importance of small businesses having access to credit was highlighted, specifically during the early stages in the business lifecycle. Other factors which may contribute to the success of a small business will now be further explored.

#### **2.4 Factors which contribute to small business success**

According to Dockel and Ligthelm (2002), the factors which contribute to small business success can be grouped into three categories, namely economy-based, industry or sector-based, and firm-based. It is useful to consider the external macro-economic factors collectively by combining economy-based and industry-based factors as external to the business, and distinguishing these from the micro-economic factors over which the individual owner has control, which is classified as firm-based and hence endogenous (Dockel & Ligthelm, 2005).

For government interventions, it is also beneficial according to Dockel and Ligthelm (2002), to make the distinction between firm-based and external factors impacting on small businesses, specifically when targeting policy to address specific problem areas. For example, if the

identified risk is predominantly endogenous, then policy measures should be aimed at the firm level, such as providing training and education and small business support structures. If the causes of failure are predominantly external, then policy should be aimed at changing the economic environment in which the firm operates (Woodward *et al.*, 2011).

In this regard, it is necessary to acknowledge the warning by Rogerson (2018), that in South Africa there is a marked difference between the success factors at the upper end of the business market and at the lower end of the market.

The firm-based and external economic factors will now be further explored.

#### **2.4.1 Firm-based factors**

Firm-based factors are those internal to the business in the form of the availability of resources which includes entrepreneurship, finance, and the effective use of the resources to achieve a favourable outcome (Dockel & Ligthelm, 2005).

Fatoki and Asah (2011), further distinguishes firm-based factors as business characteristics and entrepreneurial characteristics. Business characteristics are traits specific to the business which can affect positively or negatively the performance of the business. Business characteristics include factors such as the age of the business, the size of the business, the availability of collateral and business information. Entrepreneurial characteristics are those traits or attributes that are specific to the owner of the business which can impact on the performance of the business positively or negatively. Entrepreneurial characteristics include, for example, the managerial competency of the owner of the business, networking, and gender (Momani, Alsharayri & Dandan, 2010; Fatoki & Asah, 2011).

The World Bank (2014) reports that the viability of a business is also closely linked to the motivation for starting the business, where successful businesses with potential for growth tend to be started by choice, as entrepreneurial ventures (Herrington *et al.*, 2014). Opportunity-driven entrepreneurship is often embarked upon by those who might have jobs but seek better opportunities (BER, 2016). This form of entrepreneurship is different from necessity-driven entrepreneurship, which is said to relate to involvement in business as a result of having no better choice for work, hence also referred to as “forced” entrepreneurship (Herrington *et al.*, 2014). These businesses are not hiring employees or growing the business, and if given the option of formal employment, would more than likely close the business to become an employee of a company. For example, survivalist micro-enterprises which are established due to a lack of other employment options seldom turn into successful larger firms (Eijdenberg, Paas & Masurel, 2015). The 2014 Global Entrepreneurship Monitor (GEM) survey reported

that entrepreneurial activity driven by opportunity has yielded a greater likelihood of survival and propensity to create employment, than necessity-driven entrepreneurial activity (Herrington *et al.*, 2014).

A study conducted in India, for ladies in business, indicated that the most frequently cited motives for starting a business was; the fulfillment of the person's ambition, followed by pursuit of the person's interest, independence in working was rated third followed by financial necessity (Carter, Gartner, Shaver & Gatewood, 2003).

As explained in Chapter 1, a person who starts a business is referred to as an "entrepreneur". An entrepreneur can be defined in many terms and ways. An entrepreneur is an individual who establishes and manages a business for the principal purpose of profit and growth (Levy & Scully, 2007). This individual is typically referred to in the credit lending world as the "jockey" of the business. For a start-up business, there is for example a potential feasible business "idea", but the idea requires a capable entrepreneur to convert it to reality. Investors and credit providers know this, hence the saying "bet on the jockey (entrepreneur), and not the horse (idea)." This also applies to an existing business, a business cannot survive without capable individuals managing the business (Zwilling, 2012).

The entrepreneur is characterized by innovative behaviour and will employ strategic management practices in the business. An entrepreneur is, therefore, a behavioural characteristic of a person, and not an occupation (Levy & Scully, 2007).

Ladzani and Netswera (2009) state that personality traits of an entrepreneur such as creativity, innovation, risk-taking, taking the initiative and the motivation to succeed result in the provision of new goods and services. This ultimately results in organizational renewal, both improving existing businesses and the establishment of new ones. According to Burger (2008), 'personality' can be defined as consistent behaviour patterns and intrapersonal processes that originate from within an individual. It is logical to think that skills and knowledge can be learned.

A study conducted by Farrington, Venter, Schrage and Van der Meer (2012) revealed that individuals who have high levels of the personality traits 'extraversion', 'conscientiousness' and 'openness to experience' are more likely to have successful small businesses. 'Openness to experience' was cited as the most significant, as it has a positive influence on both the financial and growth performance of the business. The three identified attributes are elaborated on below.

The trait of 'extraversion' represents sociability and expressiveness and is frequently associated with individuals being sociable, assertive, talkative and active. Typically, people

high in extraversion seek out the company of others and enjoy environmental stimulations, whereas those low in extraversion prefer to spend time alone and are more reserved, quiet and independent (Pettersson, Turkheimer, Horn & Menatti, 2012). Extraverted leaders tend to take the initiative in social settings, to introduce people to each other and to be socially engaging by being humorous, introducing topics of discussion, and stimulating social interactions (Farrington *et al.*, 2012)

Conscientiousness or ‘conscience’ relates to dependability, being cautious, meticulous, organized and responsible. In addition, people who are conscientious are hardworking, have a high drive to achieve, and persevere to achieve the targeted goals (Farrington *et al.*, 2012).

Openness to experience or ‘intellect’ is associated with traits such as originality and open-mindedness as well as being artistic, insightful, imaginative and intelligent (Antoncic, 2009; Farrington *et al.*, 2012).

The above provides the results of a study; however, there are varying opinions on what personality traits contribute to a successful entrepreneur. Table 2-3 encapsulates the most prominent cited personality requirements of an entrepreneur based on the opinion of various authors (Rogerson, 2001; Antoncic, 2009; Farrington *et al.*, 2012; Pettersson *et al.*, 2012; Van Aardt & Bezuidenhout, 2014; Worku, 2015):

Table 2-3: Cited personality requirements of a successful entrepreneur

<b>Personality attributes of a successful entrepreneur</b>	
• Creative	• Innovative
• Ability to take risks	• Problem-solving orientations
• Perseverance	• Intellect (openness to experience)
• The need to achieve	• Tolerance for ambiguity
• Inner drive	• Extravert
• Conscientious	• Intelligent
• Internal locus of control	• Assertive

Source: Authors own compilation

The above lists the personality traits of a successful entrepreneur. It was previously mentioned during a study that “openness to experience” came out as the most important attribute. This is closely associated with innovation which is rated very highly by various authors. Rogerson (2001) emphasizes that innovation and entrepreneurship are closely related concepts. Entrepreneurship, in its narrowest sense, involves the conversion of innovative ideas into new products and services (Johnson, 2001). Booyens (2011) adds that the latter can be achieved

with the application of new knowledge, which is directly associated with innovation. New knowledge is generally created through research and development activities which often precede innovation activities.

Knowledge is arguably also closely related to “experience”. The experience of the entrepreneur has been cited as an important factor affecting many aspects of entrepreneurial businesses. Chilya and Roberts-Lombard (2012) argue that experience takes on many forms, for example, industry experience and start-up experience. Experience is shown to be an important factor driving the performance of businesses where the number of previous jobs and knowledge of the business industry will positively impact on the performance of a small business (Schmude, Welter & Heumann, 2008).

Wanigasekara and Surangi (2010) elaborate that most of the researchers have found a strong link between business experience, education, and business success. The likelihood of failure was also found to be associated with the owner's work experience prior to business launch and the owner's level of education (Woodward *et al.*, 2011). For example, businesses where the owners had ten or more years of work experience and/or four or more years of college/university education were less likely to fail (Boden & Nucci, 2000). Rogerson (2018) emphasize that entrepreneurs with a greater level of education and training are better able to adapt their business operations to the constantly changing business environment.

Based on the above contributing factors to a successful entrepreneur, and considering the most prominent featured characteristics, the following conclusion can be drawn; a successful entrepreneur is = Innovative + Knowledgeable + Educated.

From a government perspective regarding training initiatives for entrepreneurs, the programme should therefore arguably encompass psychological, socioeconomic and business aspects. Marcati, Guido and Peluso (2008) state that governments which aim to encourage the adoption of innovations within small businesses should not only focus on external factors such as financial support but should also aim to utilize human capital by considering internal factors (Stam & Wennberg, 2009). According to Mazzei, Flynn and Haynie (2016), innovative businesses are likely to grow faster than traditional start-up businesses. Worku (2015) note that innovation in South Africa is stifled by the failure of small businesses to form strong upward linkages with larger businesses. This failure denies the businesses the opportunity for technology diffusion. The Global Entrepreneurship Monitor (GEM) (2014) report proposes that government should provide incentives for research and development. The aim would be to foster innovation and to attract and strengthen lasting linkages among domestic and foreign knowledge-intensive businesses (Herrington *et al.*, 2014).

The above focused more on the attributes of an entrepreneur that is associated with the positive performance of a small business. Other firm-based factors that could positively impact on business performance includes, but is not limited to, the participation in business alliances and partnerships, larger size, longer period of existence, larger ownership structure, access to credit, proper staffing, positive capital inflows, and access to appropriate technology (Hyder & Lussier, 2016).

The external factors contributing to a successful business are now further explored.

#### **2.4.2 External factors**

Industry-based factors are associated with the sphere of industry in which the firm operates and can relate to supply and demand factors inherent in the sector, barriers to entry, and degree of competitiveness, among other things. Economy-based factors are associated with national economic variables related to the state of the economy, and the economic environment created by the national government for business growth (Dockel & Ligthelm, 2002).

Other examples that can impact on a small business is the tax policy, business support, trade liberalisation, government guarantees and infrastructure (Cumming, Fischer & Peridis, 2015). The GEM South Africa (2014) report highlights the importance of infrastructure for small business development. Ease of access to communication infrastructure, utilities, transport, and land or space at affordable prices can be instrumental in supporting new businesses. The GEM (2014) report further extends the concept of infrastructure to commercial and professional infrastructure, which refers to the presence of commercial, accounting, and other legal services and institutions. These services are critical to promoting the sustenance of existing small businesses and the emergence of new ones (BER, 2016).

Cant and Wiid (2013) further reported that there are some variations regarding business success factors based on the type of enterprise. Sole proprietors rated financial issues as being of particular importance for business success, while private Companies attached a high importance to marketing and macro-environmental issues. Human resource issues were rated higher by Partnerships and Close Corporations.

Below the primary sources of capital available to small businesses will be further explored.

## 2.5 Sources of capital

Whilst there are various sources of capital which may be available to small businesses, the most prominent sources of capital will be elaborated on below.

According to Gitman (2003), the capital structure of a business is defined as the mix of debt and equity that a business uses to finance its operations, where the equity capital can be raised either internally or externally. Internal equity is normally funds obtained from the current owner/s of a business, family, friends, or from the retained earnings within an existing business. External equity refers to capital acquired from external channels such as the issue of equity through a public listing on the Johannesburg Stock Exchange (JSE) (Beck, Demirgüç-Kunt & Maksimovic, 2008). A motive for obtaining external equity may be to share the risk with less risk-averse investors (Abdulsaleh & Worthington, 2013). On the contrary, one of the reasons for not opting for external equity is that the owner/s may not want any undesirable changes in the ownership of the business (Abdulsaleh & Worthington, 2013).

As previously identified in the lifecycle stages of a business, the capital structure decisions are influenced by the age of a business. The public listing option is unavailable to a business in the early stage of the business lifecycle, as a business needs to be relatively large, and must be able to meet the minimum size requirements for listing (Fatoki, 2014a). Berger and Udell (2005) state that only in the more advanced stages of a business's growth cycle, when the business becomes more informationally transparent will the business develop access to securitized debt and publicly listed equity markets.

According to Abdulsaleh and Worthington (2013), equity finance is preferred over debt finance during the early stages of a business lifecycle. As a business progresses through the business lifecycle the capital structure is adapted accordingly. Ideally, as the business grows and develops, it starts to establish a good credit history and the ability to provide collateral. There is a smaller dependency on internal equity and the business begins to rely more on retained earnings or seeks external financing (La Rocca, M., La Rocca, T & Cariola, 2011). For start-up businesses in South Africa, it is common knowledge that the initial source of capital is through internal equity. This is confirmed by a Survey of Employers and the Self Employed (SESE) study by Statistics South Africa (2013) which reports that 73.4% of the surveyed small businesses borrowed money from friends and relatives to start the businesses (Dlova, 2017).

The problem, however, arises where the initial capital through internal equity is not sufficient and/or may not be able to support the growth of the business (Makina, Fanta, Mutsonziwa, Khumalo & Maposa, 2015). Debt finance is normally not an option at the stage of start-up due

to the unique characteristics of a business in its early stages, such as the lack of credit history, lack of collateral, and the high risk of failure (Abdulsaleh & Worthington, 2013). There are a number of alternative finance sources available during the early growth phase in the business lifecycle. The most prominent sources are equity finance in the form of venture capital and capital investment from Business Angels. Finance options are normally through trade credit and debt finance. These options will be further explored.

### **Venture Capital**

Venture capital can be defined as funds which are raised from investors and re-deployed by investing in high-risk informationally opaque businesses which are in the early growth lifecycle stages or at the start-up phase (Prajogo, Laosirihongthong, Sohal & Boon-Itt, 2007). Venture capital organizations are normally public corporations, small business investment corporations and private limited partnerships (Balogun, Agumba & Ansary, 2015).

There are many benefits to obtaining funds from venture capital organizations. Firstly, venture capital does not require repayments by the owner/s during the term of the loan, and the capital increases the businesses' net asset value which makes the business more feasible for debt financing or future investors. Secondly, venture capitalists normally assist in the strategic planning and decision-making of the business. The venture capitalist organization may also assist businesses with access to new suppliers and customers, as well as strategic partners. Thirdly, the venture capital organization allows the business to have access to support structures and experts such as taxation, accounting, legal and technical experts (Da Rin, Hellmann & Puri, 2013).

Venture capital organizations normally have vast experience in business practices which will assist in ensuring the feasibility, development, and growth of a business. It is common that one of the members of the venture capital organization will be part of the board of directors of the business receiving the venture capital funding (Da Rin *et al.*, 2013). There is, however, also disadvantages as the receiving business will likely encounter ownership dilution, as previously identified. Secondly, venture capital is more costly than debt financing as the venture capital organization typically takes an ownership stake in the start-up business, often referred to as an "equity position". Essentially this means that the venture capital firm is a co-owner of the business. Thirdly, it is a time-consuming process to apply for venture capital as it entails a lot of paperwork and the expertise of legal and financial advisors (Kortum & Lerner, 2001).

Many business owners therefore, do not want to waste time and money to apply for venture capital funding due to the tedious process, as it takes on average six to nine months to secure

funding if successful (Cumming *et al.*, 2015). On average only 1 in 100 businesses secure venture capital funding (Shane, 2012). In South Africa, there are 65 venture capital funds controlling a total of R29 billion, with an average investment size of R15.4 million (South African Venture Capital Association, 2008). However, according to Fatoki (2014), new venture capital for small businesses is about R1.1 billion which is only a fraction of the funds. This implies that venture capital is limited for small businesses in South Africa.

### **Business Angels**

Business Angels can be defined as wealthy individuals or small investment groups of people that have vast business experience who invest in businesses by way of an equity contract, typically common stock (Abdulsaleh & Worthington, 2013).

According to Morrissette (2007), in comparison to venture capital organizations, Business Angels on average provide eleven more times the capital to businesses. The downside is that few Business Angels are prepared to provide additional capital during the growth stages of a business. Fatoki (2014) notes that in South Africa access to equity finance in the form of venture capital and from Business Angels is generally not available to small businesses (Fatoki, 2014).

### **Trade Credit**

Trade credit can be defined as the provision of goods and services by a supplier where there is an agreement between the two parties for the recipient to pay at a later stage, normally thirty to sixty days after receiving the goods or service. If payment is not made on the agreed date, interest is charged by the supplier which can make this form of finance expensive for a business (Baños-Caballero, García-Teruel & Martínez-Solano, 2010).

Trade credit is a very common and important source of external financing for small businesses, specifically for emerging businesses during the early stages of the business lifecycle when the business is considered high risk (Abdulsaleh & Worthington, 2013). There is a general belief by some authors that suppliers have an advantage over banks in determining the creditworthiness of their customers and on monitoring and enforcing the payment of credit. Some of the reasons cited are that suppliers may have an informational advantage over banks and that some suppliers are in the position of reselling goods in the event of default, or withholding future supplies (Berger & Udell, 2006).

Mateut, Bougheas and Mizen (2006) state that trade credit is more readily available than credit from banks during tight monetary policy periods. In South Africa however, this is not necessarily the case as small businesses struggle to obtain trade credit, as suppliers are

concerned that they may not receive payment for the goods or services offered (Dlova, 2017). A recent study by Enow and Kamala (2018) to investigate the accounts payable management practices of SMMEs in the Cape Metropolis, indicated that 70% of the sampled SMMEs purchase only on a cash basis, 22% purchase on both cash and credit, and 8% purchase only on credit. One of the main conclusions drawn from the study was that SMMEs may be viewed as risky ventures to which suppliers were reluctant to extend credit terms. Fatoki and Odeyemi (2010) state that similar to bank criteria, a feasible business plan, and good credit history with the bank, location of the business, and the competency of the owners are important determinants of whether a business will qualify for trade credit.

## **Debt Financing**

Debt financing is a method of financing in which a business borrows money from a financial institution to finance its operations. Debt finance is normally in the form of bank loans, overdrafts and credit card financing (Blumberg & Letterie, 2008).

The benefits to the business of debt financing are that the business owners maintain full ownership and control of the business, and the interest on debt finance is tax deductible (Abdulsaleh & Worthington, 2013). Small businesses according to Fatoki (2014a) prefer debt financing from commercial banks over equity financing in order to keep full ownership and control of the business.

Debt financing is, however, limited for small business, specifically in the early stages of the business lifecycle as previously identified (Fatoki, 2014a). It would be prudent at this point to look at the challenges faced by small businesses, from a credit access perspective, and also considering other challenges which may impede the development and growth of small businesses.

## **2.6 Challenges faced by small businesses**

### **2.6.1 Challenges to obtaining credit from banks**

Wiersch and Shane (2013) emphasize that if small businesses are unable to access credit, the business may underperform and even fail, thereby slowing economic growth and employment. In contrast, businesses that make use of external funds show growth rates far above what can be achieved from internal sources (Garwe & Fatoki, 2012). Finance is said to be the “glue” that holds together all the diverse aspects involved in small business start-up and development (Wiersch & Shane, 2013).

Mutezo (2005) confirm that as far back as 2003, the lack of access to credit was identified as the number one limiting factor for small businesses in South Africa. Abor and Quartey (2010) add that the results of a survey revealed that access to funds is a major constraint for establishing or expanding a business in South Africa. This situation has arguably seen no improvement despite government efforts (Oyelana & Fiseha, 2014; Musara & Gwaindepi, 2014; Mthimkhulu & Aziakpono, 2015:25).

This is a worldwide phenomenon according to Adebowale (2011), who states that insufficient liquidity (cash flow) is probably the most significant obstacle for entrepreneurs everywhere in developed, as well as in developing countries. Lack of access to credit is directly related to insufficient liquidity (Olawale & Garwe, 2010). A basic explanation for 'liquidity' is 'current assets – current liabilities = liquidity', where 'cash' is considered a 'current asset'.

When determining the financing needs of small businesses, Mbedzi (2011b) revealed research results which showed that businesses with large proportions of tangible fixed assets to total assets often access bank credit more readily than businesses with low collateral assets. The results also showed that profitable businesses, which are typically the larger businesses, depend less on bank credit due to their ability to generate funds internally for operations (Mbedzi, 2011b). This is, however, not the case for small businesses which depend more on credit to see the business through to the profitable stage.

According to Biekpe (2004), many small businesses wish to pursue relatively risky investments but do not have the growth potential to qualify for venture capital investments as previously identified, or do not wish to share equity with outsiders. These small businesses are often dependent on bank credit in order to be able to finance these investments. The problem is that the small businesses find it more difficult than large businesses to obtain credit (Turner, 2017).

Liberti and Petersen (2018) however, caution that small businesses' restricted access to credit may not be directly attributable to size, but rather to problems associated with the availability of information used to evaluate the business project. Liberti and Petersen (2018) state that small businesses face greater credit rationing due to the limited financial information. Businesses that are more informationally transparent, for example, those that maintain formalized records, have a higher probability of obtaining credit (Turner, 2017).

Banks generally prefer borrowers with good track records of profitability, some degree of longevity, longer-term banking relationships, and assets that can be used as collateral. In the absence of these, the small business may be considered as high risk (greater uncertainty of

repayment) (Turner *et al.*, 2008). To mitigate the perceived higher risk, banks may raise the interest rates charged (commonly known as pricing for the risk) (Berger & Udell, 2006).

Moreover, Rostov *et al.* (2015) argues that the comparative cost for disbursing a small value loan is similar or higher to that of disbursing a high value loan. The rate of return on the latter is, however, greater and hence more profitable for banks (Ferrari & Jaffrin, 2006).

Miller (2013) explains that larger loans are more cost effective due to the transaction costs. If the cost to the commercial bank is for example \$100 to make a credit decision on a \$10,000 loan, the bank will factor the 1% into the price of the loan (the interest rate). The cost of loan assessment does not fall in proportion with the loan size and hence if a loan of \$1,000 costs \$30 to assess, the cost to be included rises to 3%.

Sharma and Bhagwat (2006) revealed the results of a study conducted to identify the obstacles for small businesses to obtain credit from banks. Bank representatives argued that the bank would only lend to projects which are likely to make a profit. While the small business representatives wanted the banks to be partners, banks argued that small businesses which usually apply for credit lack financial information on projects, and do not show a willingness to repay on time. This latter attribute speaks to the “character” of the individual which forms part of the “5C’s” of credit that bank lenders are very familiar with. These are covered in detail during the next chapter; however, to provide a brief description, the 5C’s refer to the (i) Character (willingness to repay); (ii) Capacity (ability to repay); (iii) Capital (wealth of borrower); (iv) Collateral (security if necessary); and (v) Conditions (external and economic) (Njeru, Mohhamed & Wachira, 2017). These are ultimately used by credit lenders to determine the creditworthiness of a business.

Bhagwat and Sharma (2007) furthermore conducted a study in India to identify the challenges faced by small businesses when applying for credit. Sixty four percent of the respondents reported that they were aware of the business credit facilities offered by the banks. The highest challenges were perceived as the service issues by banks and the documentation procedures, followed by high-interest rates. Mbedzi (2011b) agrees that both inflation and interest rates are expected to have negative relations with bank credit, as small businesses are discouraged from obtaining credit from banks at higher interest rates.

More recently a study was conducted by Khoase and Ndayizigamiye (2018) to analyse the role and impact of the public and private supporting institutions interventions on SMMEs access to funding. A comparative study was done between Lesotho (Maseru) and South Africa. From a sample size of 379 SMMEs from Maseru in Lesotho and 384 SMMEs from

Pietermaritzburg in South Africa, a survey was conducted by means of a questionnaire to collect SMMEs owners' perceptions pertaining to accessing funding through supporting institutions and the current barriers that they face when requesting funding from these institutions.

The results revealed the following (Khoase & Ndayizigamiye, 2018):

- When establishing the business most of the funds came from personal savings: Maseru 60.4%, Pietermaritzburg 57.6%.
- When establishing the business most of the funds came from a loan from a friend: Maseru 6.3%, Pietermaritzburg 17.1%.
- When establishing the business most of the funds came from a bank: Maseru 2.2%, Pietermaritzburg 10.5%.
- When establishing the business most of the funds came from a business supporting institution: Maseru 6.7%, Pietermaritzburg 20.0%.
- Respondents who found it easy to access funding: Maseru 35.9%, Pietermaritzburg 18.1%.
- Respondents who agreed that collateral requirements are barriers to accessing funding from the supporting institutions: Maseru 64.4%, Pietermaritzburg 82.9%.
- Respondents who agreed that high interest rates are barriers to accessing funding from the supporting institutions: Maseru 63%, Pietermaritzburg 81.4%; and
- Respondents who agreed that the absence of a lease is a barrier to receiving funding from the supporting institutions: Maseru 61.5%, Pietermaritzburg 76.7%.

The above highlights that collateral requirements, high interest rates, and the absence of a lease are barriers to accessing credit for small businesses in South Africa. It also highlights that this position is not improving in South Africa, coupled with the finding that most funds to establish a business are obtained from owners own savings or from family and friends. It also highlights that access to credit for small businesses remains a challenge.

Whilst there are varying theories on what the challenges are for limited access to credit for small businesses, the most prominent reasons available from literature sources are summarized in Table 2-4. The challenges are further split for the bank, the small business owners, and the challenges which apply both to the bank and the small business owners based on the views of various authors/publications (Mbedzi, 2011b; Woodward *et al.*, 2011; Cant & Wiid, 2013; Chimucheka, 2013; GEM, 2014; Dlova, 2017; Khoase & Ndayizigamiye, 2018):

Table 2-4: Challenges: Access to credit for small businesses

<b>For the bank:</b>	<b>For the small business owner:</b>
<ul style="list-style-type: none"> <li>• Inability to determine the credit risk attributed to the lack of business information.</li> <li>• Perceived overall as high risk.</li> <li>• Risk of failure in the early stages poses an even higher risk.</li> <li>• High appraisal or due diligence costs.</li> <li>• Weak expected return.</li> </ul>	<ul style="list-style-type: none"> <li>• Unable to obtain credit.</li> <li>• Time to travel to the nearest financial institution.</li> <li>• Complex bank application process.</li> <li>• High transaction costs.</li> <li>• High interest rates.</li> <li>• Lack of quality business development support.</li> <li>• Finance and technical assistance costs.</li> </ul>
<b>For the bank and the applicant:</b>	
<p>Using the 5C's of credit:</p> <p>Entrepreneurs' Character/Capabilities - lack of:</p> <ul style="list-style-type: none"> <li>• Financial planning skills.</li> <li>• Business management skills/experience.</li> <li>• Specific industry knowledge.</li> </ul> <p>The capacity of the entrepreneur - lack of:</p> <ul style="list-style-type: none"> <li>• Accurate and reliable financial information.</li> <li>• Lack of timely payment from Government on contracts.</li> </ul> <p>Capital by the entrepreneur - lack of:</p> <ul style="list-style-type: none"> <li>• Equity contribution.</li> </ul> <p>Conditions of the business - lack of:</p> <ul style="list-style-type: none"> <li>• Demand for products or services.</li> <li>• Access to markets.</li> <li>• Bargaining power with suppliers and customers.</li> <li>• Diversity.</li> </ul> <p>Collateral:</p> <ul style="list-style-type: none"> <li>• Insufficient or no tangible assets to cede as security.</li> </ul>	

Source: Authors own compilation

The above provided an overview of the challenges faced by small businesses to obtain credit. Below any other prominent challenges faced by small businesses are explored.

### **2.6.2 General challenges faced by small businesses**

It was previously identified that there are small businesses in South Africa which are formal in the informal economy due to reasons such as the owner not wanting to register the business. The Small and Medium Enterprise (SME) Growth Index (2015) emphasises the regulatory burden as a critical challenge for small businesses in South Africa (SBP, 2015). The SME Growth Index is based on a survey of a panel of 500 established businesses, employing less than 50 people and operating in three sectors: manufacturing, business services and tourism. These challenges include regular changes in the regulatory environment, the need to keep track of overlapping and sometimes conflicting regulatory requirements across multiple

departments and levels of government, poor communication and access to information, and administrative inefficiencies in government departments and municipalities (Musara & Gwaindepi, 2015) For example, there are delays in obtaining permits and licenses for the businesses according to the World Economic Forum (WEF) 2015/2016 Global Competitiveness Report. The report listed government bureaucracy as one of the major obstacles to entrepreneurial and business activity in South Africa (Schwab & Sala-I-Martin, 2016). Dlova (2017) states that it can take up to 176 days to license a business in South Africa. The business owner therefore spends a large amount of time dealing with regulatory compliance (which includes labour disputes) and this takes time away from managing the core business functions, which ultimately results in loss of income. Moreover, studies indicate that small businesses can spend up to eleven days per case at the Commission for Conciliation, Mediation, and Arbitration (CCMA). The CCMA is an independent authority in South Africa that resolves labour disputes. Its main aim is to promote fair practices in the work environment. Reports reveal that the average small business is taken to the CCMA twice a year (SBP, 2015).

Furthermore, the SME Growth Index reports that small businesses spend an average of eight working days a month dealing with red tape (SBP, 2015). Not only is there an opportunity cost where time is taken away from managing the business, but there is the actual cost payable for compliance. The Davis Tax Committee Interim Report on Small Business indicates a median cost of R20 500 to comply with all tax requirements. According to the SBP report, the cost of regulatory compliance (75 hours a month) for a small business equates to approximately R18 000 a month, or R216, 000 a year. If a business has a turnover of R5 million, these costs represent 4% of turnover. This amount seems high for a small business, specifically in the start-up phase and clearly indicates the disincentive not to register the business and comply with business legislation (SBP, 2015).

A study conducted by Fatoki (2014a) argued that problems experienced with regulatory compliance and bureaucracy may be linked to small businesses engaging in corruption. The Transparency International Global Corruption Report (2008) defines corruption as “the abuse of entrusted power for private gain” (Dlova, 2017). Fatoki (2014a) observed that corruption further raises operational costs and ultimately limits the opportunities for growth of a small business.

The other prominent issue which is also adding to the cost for small business operations is the high crime experienced in South Africa. A study by the United Nations Office on Drugs and Crime (2013) revealed that South Africa was amongst the world’s five most dangerous nations (Dlova, 2017). According to the 2015 Economic Survey of South Africa, the high crime

situation was forcing small businesses to increase security spending (Burger *et al.*, 2017). The problem for small businesses is further exacerbated as some businesses may not have insurance to cover losses due to criminal acts (Fatoki, 2014).

The challenges faced by small businesses are however not limited to regulatory and criminal activities. Table 2-5 provides a summary of the general challenges faced by small businesses based on the views of various authors and publications (Fatoki & Garwe, 2010; Oyelana & Fiseha, 2014; Fatoki, 2014; GEM, 2014; Musara & Gwaindepi, 2014; Mthimkhulu & Aziakpono 2015; Love *et al.*, 2015; BER, 2016; Burger *et al.*, 2017; Dlova, 2017). The challenges have been split between firm-based factors and external economic factors:

Table 2-5: Challenges: Firm-based and external factors

Firm-based factors	External factors
<ul style="list-style-type: none"> <li>• Insufficient capital.</li> <li>• High operating expenses.</li> <li>• Poor management of consumer credit.</li> <li>• Poor cash flow management.</li> <li>• Lack of management skills.</li> <li>• Adapting to a changing business environment.</li> <li>• Time management.</li> <li>• Delegation and cooperative management.</li> <li>• Planning and prioritizing.</li> <li>• Inability to understand market expectations.</li> <li>• Inability to identify the target market.</li> <li>• Poor market access.</li> <li>• Poor location.</li> <li>• Lack of knowledge of competitors.</li> <li>• Ineffective marketing.</li> <li>• Unable to develop relationships with customers.</li> <li>• Inability to attract suitable employees.</li> <li>• Low employee productivity.</li> <li>• Poorly trained employees.</li> <li>• High employee turnover rate.</li> <li>• Lack of support networks.</li> <li>• Lack of access to appropriate technology.</li> <li>• Lack of access to appropriate physical infrastructure.</li> </ul>	<ul style="list-style-type: none"> <li>• Regulatory compliance.</li> <li>• Business registration.</li> <li>• License requirements.</li> <li>• Labour legislation.</li> <li>• Taxation.</li> <li>• Compliance with BEE.</li> <li>• Inefficient Government bureaucracy.</li> <li>• Municipal issues.</li> <li>• Crime and corruption.</li> <li>• Inflation.</li> <li>• Exchange rates.</li> <li>• Interest rate fluctuations.</li> <li>• Increased competition.</li> <li>• No support from large companies.</li> <li>• Access to electricity.</li> <li>• Lack of recognition of the importance of small businesses in economic development.</li> </ul>

Source: Authors own compilation

A recent study by Ayandibu and Houghton (2017:136), went one step ahead and ranked the internal and external challenges faced by small business in South Africa (Table 2-6), where (1) is considered the most prominent challenge, and (30) the least prominent challenge:

Table 2-6: Internal and External challenges in ranking order

<b>Internal and External challenges in ranking order</b>	
1. Lack of access to finance.	16. Recession in the economy.
2. Lack of collateral.	17. Lack of experience relevant to the venture.
3. Insufficient owners' equity contribution.	18. Founder not familiar with market/industry.
4. Crime.	19. Lack of networking.
5. Insufficient government support.	20. Lack of business skills.
6. High interest rate.	21. Shortage of skilled labour.
7. Inadequate demand.	22. Costs of registration and licenses.
8. Inadequate market research.	23. High inflation rate.
9. Location of the business.	24. High foreign exchange rate.
10. High competition.	25. Poor electricity supply.
11. Bad credit record.	26. Lack of training.
12. High production costs.	27. Corruption.
13. Lack of information technology.	28. Poor roads.
14. High transport costs.	29. Poor water supply
15. High taxes and other tariffs.	30. Poor telecommunication.

Source: Ayandibu & Houghton (2017:136)

The above provided a view of the challenges faced by small businesses, a significant one being the lack of access to credit (Ayandibu & Houghton, 2017). Access to credit seems to be a problem for small businesses worldwide. However, according to Mbedzi (2011a), in comparison to other developing countries, the contribution to job creation and economic growth by small businesses in South Africa is small and it is among those with the highest failure rate for start-ups (SBP, 2015).

The Statistics South Africa Labour Force Survey (2015) shows that small businesses that employ fewer than 50 people are becoming less important as job creators, to the extent that the GEM Report (2008) states that more small businesses in South Africa are shutting down than opening (Dlova, 2017). Mbedzi (2011a) identified one of the main contributing factors for small businesses not achieving success is due to poor or inadequate training in entrepreneurship. This was also highlighted in the GEM National Expert Survey which emphasized that only 9.3% of small business owners in South Africa received any form of training on starting a business (GEM Executive Report, 2010). The main reasons for the failure of small businesses in South Africa are further explored below.

## 2.7 Reasons for the failure of small businesses in South Africa

As previously identified and conquered by Brink *et al.* (2003), a business owner may be competent and have a viable business idea, but without an appreciation of business fundamentals, the business is bound to fail. The high rates of business failure cannot be underestimated. There are many publications emphasizing the failure of businesses due to lack of financing (Chimucheka & Rungani, 2011).

According to Biekpe (2004), the main reason for small business failure in sub-Saharan Africa is due to a lack of support from government and traditional banks. This is especially prominent in the first year of operations of the business. Effectively small businesses have difficulty financing the business operations and keeping afloat until the business breaks-even and starts to make a profit. This is referred to as the “finance gap” (Fatoki & Asah, 2011). According to Ladzani and Netswera (2009), the main causes of failure of small businesses in South Africa are limited access to credit, followed by inexperience in running and managing the business, followed by poor cash management and weak marketing efforts. Lack of access to credit was also identified by Ayandibu and Houghton (2017:36), as the top challenge faced by small businesses in South Africa. Ruirie (SMES) (2012) states that the lack of access to credit in South Africa is the second most reported contributor to low small business creation and failure, after education and training. These are in line with the factors that contribute to small business success where education and training (skill) was emphasized.

Franco and Haase (2010), note that a combination of firm-based and macro-economic factors are responsible for the failure of small businesses. The opinion of Franco and Haase (2010) makes sense, as logically thinking no matter how much funds a business may have, if the business is not managed by capable parties, the business is doomed to fail. Furthermore, the GEM (2014) report revealed that entrepreneurs with matric and higher education are more likely to survive the start-up phase (Herrington *et al.*, 2014). Fatoki and Asah (2011) state that small businesses mainly depend on initial funds from the owners, family, and friends; however this is normally insufficient to sustain the business. Access to external finance is needed to reduce the impact of cash flow problems during the start-up phase and thereafter to expand its business operations (Shaw & Pretorius, 2004).

The Department of Trade and Industry (DTI) (2008) report, stated that the majority of South Africa’s small businesses rarely survive beyond their nascent phases, lasting for an average of less than 3.5 years. The following pointers (Table 2-7) encapsulate the most prominent reasons for the failure of small businesses in South Africa, split between firm-based and macro-economic factors, based on the common opinion of various authors and publications

(RSA White Paper, 1995; Fatoki & Asah, 2011; Mbedzi, 2011; Van Scheers, 2011; Marjanova & Stojanovski, 2012; Altman & Sabato, 2013; Musara & Gwaindepi, 2014; GEM, 2014; Dlova, 2017):

Table 2-7: Prominent reasons for the failure of small businesses in South Africa

Firm-based factors	External factors
<ul style="list-style-type: none"> <li>• Many are necessity driven (forced entrepreneurs).</li> <li>• Inadequate capital structure.</li> <li>• Limited bargaining powers prevent small businesses from negotiating price concessions.</li> <li>• High cost of credit – due to the higher perceived risk of the small business market, higher interest rates are charged.</li> <li>• Poor market access.</li> <li>• For small businesses located in rural areas, the majority of unemployed people live in rural areas, therefore the buying power is limited, reducing the demand for goods and services offered by small businesses.</li> <li>• Domination by large businesses with strong ties to business units in popular market sectors.</li> <li>• Poor demand for products offered.</li> <li>• Poor image (mainly home-based) – may be perceived as unreliable or ad-hoc survival activities.</li> <li>• High cost of business premises.</li> <li>• Travel far for banking, more so in rural areas.</li> <li>• Access to information.</li> <li>• Lack of access to appropriate technology.</li> </ul>	<ul style="list-style-type: none"> <li>• Limited or no access to credit.</li> <li>• Poor market conditions.</li> <li>• Lack of institutional support.</li> <li>• Limited access to electricity.</li> <li>• Lack of access to appropriate physical infrastructure.</li> <li>• Poor transport – may be cut off from suppliers.</li> <li>• Tax burden.</li> <li>• A disabling legislative and regulatory environment: complex, time-consuming, and costly.</li> </ul>

Source: Authors own compilation

From the content of the Tables 2-4 - 2-7, it is clear that there is a significant overlap of challenges and reasons for business failure.

## 2.8 Conclusion

The literature study revealed that a business has different financial needs based on the lifecycle stages of a business, emphasizing that cash availability at the infant (start-up) stage is significant.

The literature review also implies that the business sophistication seems low as the majority of small businesses are sole proprietors operating in the informal economy, and fall under the 'micro-enterprise' category. Overall, when one considers the criteria set out by banks to qualify for credit, based on the general profile of the small businesses depicted from the literature review, the small businesses would typically not qualify for any credit. The FinScope (2010) study revealed that less than 2% of the sampled population has an overdraft facility. Furthermore, a more recent study by Khoase and Ndayizigamiye (2018) revealed that only 10.5% of the researched population received funds from a bank to establish the business.

This emphasizes the lack of access to credit for small businesses and raises the question as to who the banks are currently serving in the Small Business Divisions established by some of the banks. As stated by Perera (2010:5) "Commercial banks have made some effort to serve the poorer population; however, one suspects that these efforts are merely to boost their image". The lack of access to credit may also be one of the main reasons why more small businesses in South Africa are closing down than opening, as derived from the GEM Report (2014).

This is concerning considering the importance of small businesses in South Africa as job creators. Moreover, the Statistics South Africa Labour Force Survey (2016) states that small businesses that employ less than 50 employees are becoming less important as job creators.

Looking at the personal attributes of a successful entrepreneur, an assumption was made from the literature study that the criteria for a successful entrepreneur are to be; innovative, knowledgeable (have previous work experience in the relevant industry) and educated. Furthermore, the GEM Report (2014) revealed that entrepreneurs with matric and higher education are more likely to survive the start-up phase. Although innovation is difficult to measure, the data from the literature review revealed that the majority of small business owners in South Africa have not completed matric.

What was also significant from this chapter is that there is a familiarity between the prominent challenges faced by small businesses and the reasons for business failure. This implies that these are valid challenges as they may lead to the demise of a business.

These challenges highlight a huge gap which should be taken into consideration when reviewing any policies aimed at the potential and growth of small businesses in South Africa.

## **CHAPTER 3:**

# **ACCESS TO CREDIT FOR SMALL BUSINESSES IN SOUTH AFRICA: A CREDIT PROVIDER'S PERSPECTIVE**

### **3.1 Introduction**

In Chapter 2 it was established that the lack of access to credit, amongst other factors, was an inhibiting factor for the growth and development of small businesses in South Africa. One of the main reasons for the lack of access to credit that was identified was the reluctance of banks to provide credit to small businesses. The literature study of this chapter, therefore, focuses on access to credit for small businesses from a credit providers (lending) perspective, specifically banks.

### **3.2 Evolution by credit providers in South Africa to provide credit to small businesses**

It is important at this point to go back into history and identify who the main role players are with regards to the provision of credit to small businesses.

#### **3.2.1 Informal organizations**

To address the failure of banks to effectively service the low-income communities, Non-Governmental Organizations (NGOs) and Microfinance Institutions (MFIs) started initiatives to provide credit to qualifying customers. NGOs focus on the lower end of the market, namely survivalist enterprises and micro-entrepreneurs. NGOs, however, rely mainly on donor funds and do not have the distribution channels, financial capacity, and resources that banks have to effectively provide credit to small businesses (Perera, 2010).

The South African Enterprise Foundation (SEF) of Limpopo that provides small loans to the residents of Tzaneen, a small rural town, became the country's first NGO Microfinance Institution to achieve 100% operational and financial self-sufficiency (Morduch, 2005). SEF has imitated a Bangladesh Grameen Bank group lending methodology. 'Group lending' or a 'Joint liability' contract is based on models first employed in South Asia and Latin America in the late 1970s, which works on the ruling that group members guarantee the loan through a group repayment pledge (Ojah & Mokoaleli-Mokoteli, 2010).

Groups are typically restricted to between five and eight people, but sizes can vary. Customers are asked upfront to form groups. The reason for this is that members will know each other, they will know where each other resides, and this will assist with collecting of the loan as it will

not be easy for a member to abscond. Furthermore, each member has his/her own business operation. For example, one member may sell fruit and vegetables, another may be a seamstress. The members do not run a business together as implied by the term 'group' lending. Each member's financial needs may also differ, so each member applies for a separate loan amount. These individual loan amounts are added together which totals the 'group loan' amount (Crabb & Keller, 2006).

Each individual member is responsible for the monthly repayment of their own loan. Members usually meet monthly to combine the funds for the monthly repayment of the "one" loan. However, if one of the members should default on a repayment, resulting in a shortfall to the total monthly repayment, no further loans will be granted to the group, impacting on each individual member. This results in peer pressure to repay the loans, so typically, when one of the members default in payment for a month, the remaining members make up the payment. The group as a whole is jointly liable when any of the members default (Crabb & Keller, 2006). This 'ethical guarantee' replaces the traditional form of physical collateral. Administration costs for the lender may also be reduced if only one loan amount is disbursed to the group, which is distributed amongst the members, as opposed to the bank cost of distributing multiple loans (Schoombee, 2004:9).

SEF has found success in this type of lending, however, it has arguably not been successful on a broader basis in South Africa. Two prominent reasons could be the limited funds of NGOs and a limited outreach, as the focus is mainly in the rural areas. Urban-based micro-enterprises are to a large extent disregarded from the point of view of credit availability, relying mainly on remittances from family and loans from informal lenders to support business cash flow.

While poverty remains more prevalent in rural South Africa, there is a shift seen over the years to urban areas as citizens are increasingly migrating from rural to urban areas to find jobs, specifically young people and professional practitioners (Rogerson, 2018). Three provinces namely; Gauteng, KwaZulu-Natal (KZN), and Western Cape, are the most industrialized and have been the main recipients of migrants since 2002 (Mbedzi, 2011b).

For the poor that don't have access to NGO's, many rely on informal lenders, as explained above. Examples of informal lenders in South Africa are pawn shops and 'Loan Sharks' (also referred to as Mashonisas or Matshonisas). The term "matshonisa" when loosely translated refers to "making you poorer" (Dlova, 2017:53). Loan sharks typically lend money to low-income earners, and as the name suggests, charge borrowers interest rates up to 100% on outstanding loans. Usually, the end result for these individuals is what is known as the 'debt

trap' (James, 2018). This situation is brought about by the high interest rate that the Loan Sharks charge, forcing borrowers into a situation where they borrow continuously for subsistence (James, 2018). Loan Sharks flooded the South African market and were very active until strict regulations; specifically, the National Credit Act (NCA) was proclaimed (Schoombee, 2009). This Act will be reported on later in the study.

According to Makina *et al.* (2015) loans from informal lenders deplete the profits of a small business due to the high interest rates charged. Informal loans are also of small value and hence are used mainly for working capital, rather than business expansion. Informal lenders are, therefore, not only a more expensive option for lending but they also cannot provide the benefits to the small business customer which mainstream banks can, such as a tool for savings and an opportunity to build a financial and credit history.

### **3.2.2 Banks**

When one considers the evolution of commercial banks to provide credit to small businesses, three important strategies are prominent, namely: Up-scaling, Linkage banking, and Down-scaling.

#### **Upscaling**

Upscaling occurs when NGOs or socially motivated Microfinance Institutions (MFIs) “upgrade” to become a formal financial institution. This would mean no longer relying on donor funds and now being self-sufficient and profitable. Unfortunately, this model has had limited success as is evident from the limited number of financially self-sufficient MFIs (Tulchin, 2004).

According to Porteous and Hazelhurst (2004), over the past decade, only two examples of up-scaling are found in South Africa. Both had very little experience with micro-enterprise financing. One was Cash Bank which was formed in 1995 from group lending experiments by the Group Credit Company. Although its focus was more on housing finance, it experimented at one stage with business loans and the new African Bank was formed in 1998. It reversed the micro lending interests of two larger payroll micro-lenders and a cash lender into the restructured bank. Other assets were subsequently stripped out, leaving African Bank as the country's largest micro-lender. However, African Bank Limited (now Residual Debt Services Limited (RDS)) was placed in curatorship under the supervision of Tom Winterboer, being the duly appointed curator. Subsequently the newly registered African Bank was formed during April 2016. There are various views on the reason for the collapse of African Bank Limited, one of them being the allegation of reckless lending and the subsequent fine levied by the National Credit Regulator (NCR) (Bonorchis & Spillane, 2014).

Capitec is the other example, who as micro-lender secured a banking license, enabling it to offer deposit services. Established by a group of Stellenbosch businessmen and starting with the acquisition of a few micro-lending businesses in Johannesburg, its focus was on customers in South Africa's lower-income segments. Capitec has since transformed from a micro-lender to a successful mass market retail bank (Coetzee & Cross, 2002).

### **Linkage banking**

Linkage banking also referred to as 'partnering', is mostly found where banks link with informal financial sector self-help groups (SHGs), which are grassroots social organizations formed to address the needs of members in a collective manner. The high default risk banks face when lending to micro-entrepreneurs is solved to an extent by the social collateral (peer pressure) in the SHGs, as explained earlier in the group lending methodology, where group members guarantee a loan through a group repayment pledge.

In South Africa, First National Bank's People Benefit Scheme linked the bank to informal financial intermediaries, in this instance Stokvels. With the Stokvel methodology, members contribute fixed sums of money to a central fund on a weekly, fortnightly or monthly basis. Each month a different member receives the money in the fund, which was collected during that period. Defaults on contribution are quite rare as the member in default will not receive the lump sum when the member is due to receive it (Schoombee, 2009).

In addition to the institutional linkage, lending between the range of R1 500 to R20 000 was linked to borrower savings. Savings were used for both screening purposes (a minimum of six months with no withdrawals before approved lending) and for collateral purposes (loans limited to a maximum of 150% of pledged savings) (Schoombee, 2004). This scheme was operational for approximately five years until due to a lack of demand for loans it was discontinued in 1997. Members used the scheme almost exclusively for savings purposes, which in itself is important. The scheme was primarily implemented with the intention to create an opportunity for members, namely micro-enterprises, to gain access to loans.

### **Downscaling**

Downscaling is the third strategy which refers to efforts by commercial banks and other similar institutions such as financing companies to offer loans to smaller businesses. This process typically focuses on transferring the lending technology to the commercial bank and fitting it into the framework of the entire institution as cost-effectively as possible (Perera, 2010). In this case, banks abandon the conventional approach of providing loans to larger more established businesses to now also include the provision of loans to 'smaller scale' businesses, thus the term 'downscaling' or 'downgrading' (Gutiérrez & Hage, 2016).

In South Africa there are market forces such as governmental pressure which in principle induce local banks to go 'down market', the reason being that government wants banks to expand their customer base to service and make banking available to the lower-end of the market. Based not only on pressure from the government, but also realizing that a market opportunity exists, the Big 4 banks in the last decade created divisions to serve the unbanked in the local economy. These initiatives can be divided into two categories; those aiming to serve low income but salaried individuals, and those that aim to provide loans to small businesses. While all four banking groups were involved in the first category, there was far less interest in serving the self-employed operating the smaller businesses (Schoombee, 2000).

Schoombee (2004) confirms that in South Africa an 'operational champion' for providing credit to small businesses has not emerged in any of the banks, stating that the size of the Big 4 banks could be the problem. Schoombie (2004) emphasizes that research confirms that smaller banks performed better than larger banks, as problems were experienced when integrating micro lending into a big bank structure. It seems as if subsidiaries dedicated to the micro lending market were a better option than establishing separate divisions.

It can be argued that commercial banks have rigid lending criteria that must be adhered to. For example, where a loan is applied for in the name of a business entity, the owner is typically required to provide a business plan, a projected cash flow statement, and if it is an existing business, also financial statements. The bank's Credit Policy normally does not allow for any flexibility or deviation. The Credit Policy can, therefore, be considered more appropriate for the more sophisticated larger businesses. The rigid lending culture is also highlighted as a challenge looking at the experiences of banks abroad that have developed successful business lending operations for small businesses. Despite the challenges, banks do however consider the small business market as an attractive market. This is proven during a study where most banks (80% or more), worldwide, and independent of ownership type, perceive the small business segment to be big and with good prospects (Beck *et al.*, 2008a).

Considering that banks perceive small businesses as an attractive market, yet according to Schoombie (2004:2) an operational champion has not yet emerged, it can be argued that the banks have not yet developed a successful model for small business lending. Minnis (2011) states that with commercial lending in banks, credit managers face many uncertainties in deciding which businesses to fund, and therefore this is considered a critical area for research. Based on this, the banks existing proposition to small businesses and underwriting processes will now be explored.

### **3.3 Banks' existing proposition for small businesses**

According to Berger and Udell (2006), the most important function for commercial banks is the extension of credit to worthy borrowers. By making credit available to small businesses, commercial banks contribute to increased production and expansion of these businesses; however, this must at the same time be profitable for banks.

Banks' lending products to small businesses include mainly overdraft facilities, business credit cards, short-term or long-term loans, mortgage loans, and installment sale agreements. The purpose for lending mainly includes; where the small business requires working capital to improve short-term liquidity, to purchase commercial and industrial property, to purchase plant and equipment, for trading, to purchase a vehicle, and less commonly also includes supply chain financing (Neumark, Wall & Zhang, 2011). Unlike factoring which is debtor financing, supply chain financing is where the bank pays the suppliers of the business, therefore it is often referred to as reverse factoring. Once the bank receives the approval from the business owners, the bank makes payment of the business' invoices directly to the suppliers to settle amounts earlier in exchange for a discount. A business may also require credit to assist the business through seasonality factors or to increase the immediate buying power of the business (de Wit & de Kok, 2014).

There is, however, a risk for any business which obtains credit due to overbuying, overexpansion or overselling (Mutwiri, 2007). Working capital is normally applied for to assist a business to meet the short-term obligations such as rent, salaries, and accounts payable. This may be due to bad management of the debtors' book by the business, and not receiving prompt payments for goods or services rendered. An uncontrollable growth in sales can also result in an uncontrollable management of the debtors' book. A business may avoid cash flow problems by focusing on efficiently collecting on the debtor's book timeously (Berger & Udell, 2002).

The banks, according to Petersen (2004), prefer to provide credit for the purpose of the business investing in projects to increase profitability, market share, or to increase the net cash flow of the business. The funds obtained by the bank will typically be used to assist with production, distribution, selling, to hire more employees, expand infrastructure, or to expand the business.

The technologies used by banks are normally financial statement lending, small business credit scoring, asset-based lending, and factoring. Financial statement lending involves underwriting loans based on the strength of a business' (the borrowers) financial statements.

Small business credit scoring is a transaction lending technology based on hard information about the small business and its owner. A loan prediction model then makes decisions on whether to accept or reject applications. Financial statement lending and credit scoring will be discussed in more detail later in the chapter. A brief description will be provided for the other lending technologies.

With asset-based lending, the bank takes the asset which it finances as collateral security, therefore there is a high focus on the value of the asset. Examples of this type of financing include accounts receivable, inventory, equipment, and motor vehicle finance (Berger & Udell, 2006).

With factoring, just like asset-based lending, the focus is primarily on the value of the underlying asset. Factoring involves the purchase of accounts receivable by a “lender” known as a factor (Berger & Udell, 2006).

Any form of credit, however, is temporary capital, as it has to be paid back to the bank. Unlike a business partner or investor who provides 'permanent capital' into a business, banks are not in the business of taking equity risks, as credit is not provided to businesses that should be funded with equity funds (Berger & Udell, 2002).

In order to ensure the profitability in lending to small businesses there must be amongst other things, a combination of credit risk factors that must be taken into consideration, together with the correct pricing of the credit granted (Thomas, 2000). It is appropriate at this point to provide a brief on what factors are taken into consideration with regards to the interest rates charged by banks, with regards to cost and risk.

The “overhead costs” can be explained by splitting the costs into three broad categories: the cost of the general administration and network of branches and offices; the cost of loan assessment and credit processing and; any other cost associated with providing credit, for example, new products or services must also be funded by the interest rate margin (Miller, 2013).

The term “cost of funds” refers to the amount that the bank would pay to borrow funds in order to lend to prospective customers. For commercial banks, it is usually the interest that it pays on deposits or investments (Miller, 2013). The bank's lending capacity is hence derived from its depositors, so the risk must be managed within tight qualifications to ensure that the depositor assets are protected (Farrell, Macgibbon, Tomberlin & Doreen, 2011).

The banks must also absorb the “cost of bad debts” that must be written-off in the rate that they charge. This allowance for non-performing loans (NPLs) means that lenders with effective credit screening processes should be able to bring down rates in future periods, while reckless lenders will be penalized. The final charge to be taken into consideration is the “profit margin” which the bank wants to achieve (Miller, 2013).

Regulatory constraints may also directly limit a banks’ risk-taking and profit margin by limiting the banks’ portfolio composition, as the bank has a responsibility to protect the interests of its depositors by promoting prudent business behaviour and risk management (Kithinji, 2010). The Basle Accord which was first issued in 1988, with subsequent updates, focuses on the management of credit risk and defines the minimum capital reserves required by banks to serve as a cushion to protect depositors in case of loss. The capital adequacy ratio is measured in terms of total capital as a percentage of total risk-weighted assets which show the amount of capital an institution holds relative to the risk profile of its assets (Kithinji, 2010). Banks also have to comply with the National Credit Act (NCA) for all credit agreements that fall within the ambits of the NCA. The NCA sets a cap on the maximum interest rates that may be charged. It is therefore, key for banks to properly manage the credit risk of its portfolio.

Credit risk refers to the risk that the bank may not receive back the money that was granted to a borrower within the agreed term (Coyle, 2000). Credit risk management is defined as the identification, measurement, monitoring and control of risk arising from the possibility of default in loan repayments (Kithinji, 2010).

In order for the bank to determine the credit risk of an applicant, the bank does sufficient due diligence, which is the underwriting to assess the risk. Banks normally have a credit policy to govern their credit management operations which includes the assessment criteria guidelines which credit managers must abide by when granting credit (Moti, Masinde, Mugenda & Sindani, 2012).

The credit policy which banks typically follow when granting credit to small businesses, together with the process and business models used by banks will be further explored. The focus will not be on factoring or asset-based lending as these are focused more on the asset as previously described, rather than determining the creditworthiness of the borrower which is in line with the focus of the study.

### **3.4 Operational structure**

According to Beck *et al.* (2008b), based on a worldwide study of banks, most banks independently of the country of operation or ownership type, have set up separate

departments to manage the relations with small businesses. More than 60% of worldwide banks have a small business department which is separate from the division that deals with large businesses. Banks in developed countries are more likely to further distinguish between small and medium-sized businesses.

#### **3.4.1 Degree of decentralization**

Beck *et al.* (2008) reported that the study revealed that worldwide the bank's loan approval, risk management, and non-performing loan recovery functions tend to be centralized, in particular among developing banks. The study also revealed that whilst 45% of developed country banks approval process is done only or primarily at branches, only 19 % of banks operating in developing countries reported this option for small business lending. Similarly, 40% of developed country banks reported that risk management for small business lending is done only or primarily at branches, relative to 8% of developing country banks.

#### **3.5 Bank Credit Policy**

According to experts, a foundation of safe and sound banking is the design and implementation of a written credit policy to identify, measure, monitor, and control credit risk (Chakabva, 2015).

The credit policy should be a live document, updated as and when required, and reviewed at least annually to ensure its relevancy, also considering the influence of changing micro and macro-economic factors. The credit policy must be implemented through appropriate processes and procedures which are normally documented in detail in a 'standard operating procedures manual'. The standard operating procedures manual must, therefore, be read in conjunction with the credit policy.

In order for the policies to be effective, all credit employees must be aware of the content, hence it is important for the policies to be communicated throughout the organization. Any updates to the policy must be circulated to all relevant employees to ensure that employees follow the most recent version.

The credit policy should be clearly defined, consistent with prudent banking practices and must include the relevant regulatory requirements (Kithinji, 2010). Furthermore, the qualifying criteria are detailed, such as the applicant's identification requirements, acceptable proof of income, company registration documentation and other relevant supporting documentation, micro and macro-economic factors to be considered when assessing a credit application, financial ratios and key measures, and acceptable collateral (Flannery & Rangan, 2006).

In order to determine the creditworthiness of a borrower, the credit policy will cover the criteria traditionally based on industry established principles such as those well known as the “5C’s” of credit, as briefly explained in Chapter 2. The 5C’s refer to the; character, capacity, capital, collateral, and conditions. These categories of credit management establish the likelihood that a potential or existing borrower will successfully meet scheduled interest and principal payments (Njeru *et al.*, 2017).

By prescribing decision policies based on the 5C’s of credit or on similar frameworks, banks would reasonably expect any two credit managers to reach the same conclusion regarding a loan for any given applicant. Berger and Udell (2006), however, argue that despite the bank’s efforts to homogenize the credit decision-making process across credit managers, research suggests that the decisions made by credit managers actually vary according to the credit manager’s level of experience. The credit manager’s experience is a facet of human capital which includes the knowledge, skills, and experience used by an individual to accomplish organizational goals (Berger & Udell, 2006).

Cole, Kanz and Klapper (2012) state that any form of bank compensation will influence the decisions of credit managers. Cole *et al.* (2012) in their paper present direct evidence on the effect on incentives of lending decisions and risk assessment. The loan files evaluated in the experiment consisted of loan applications of entrepreneurs seeking their first commercial loan, which requires extensive screening effort and is therefore particularly sensitive to loan officer judgment.

By comparing three commonly implemented classes of incentive schemes, Cole *et al.* (2012), found a strong and economically significant impact of monetary incentives on screening effort, risk-assessment, and the profitability of originated loans. High-powered incentives that penalize the origination of non-performing loans while rewarding profitable lending decisions cause credit managers to exert greater screening effort, approve fewer loans, and increase the profits per originated loan. In line with the predictions of a simple model of incentives and loan officer decision-making, these effects are reduced when deferred compensation is introduced. The study also found that incentives affect not only actual risk-taking, but also the credit manager’s subjective perception of credit risk: more permissive incentive schemes lead credit managers to rate loans as significantly less risky than the same loans evaluated under pay-for-performance. However, it must be noted that in South Africa, at the larger banks, it is not the norm for credit managers to be incentivised for approving credit applications.

By providing a credit policy with the guidelines of the 5C’s of credit, it is the best effort that can be made to ensure some consistency as the credit managers will be determining credit risk

based on the same risk indicators. However, what one credit manager may perceive as a limited risk when assessing the same indicator, another may view as a higher risk of the same indicator (Emel, Oral, Reisman & Yolalan, 2012). As long as subjective lending (human judgment) is used, there cannot be a 'fool proof' solution to ensure consistency, so the importance is for banks to appoint highly-trained individuals in the area of credit risk assessment, which provides somewhat of a comfort that a correct credit decision was taken (Berger & Udell, 2006).

### **3.6 Credit application lifecycle stages**

A commercial credit application typically goes through various stages. These stages in the credit application lifecycle will now be explored.

#### **3.6.1 Introduction of the customer to the bank**

The method of introduction of the customer to the bank is considered important to credit managers. The most preferred method of introduction is the establishment of a relationship as a result of the bank's marketing efforts. The second most preferred method is for existing customers to introduce the prospective customer (Beck *et al.*, 2008a).

Following the introduction, the next two stages, namely the interview process and the pre-decision visit is considered by credit managers as the most important stages in the lending process (Beck *et al.*, 2008a).

#### **3.6.2 Interview process**

Lending to small businesses typically involves a three-stage process which begins with the screening of applicants. If the credit is approved, the second process would be contracting, and thereafter monitoring.

The Big 4 banks have set up separate departments for small business lending. As discussed above, this is a worldwide trend. Based on personal experience from a commercial lending background and information gathered from various authors, the process from application to a final decision for a credit application will be explored. The screening phase is the start of the lending process which begins with an interview. The interview process will now be further explored.

The applicant would be interviewed by a small business portfolio manager/bank official to obtain the basic information that a bank is interested to know with any credit application. The

basic information would typically include the following based on the citations of various authors (Carter, Shaw, Lam & Wilson, 2007; Krog, 2008; Harif *et al.*, 2011) (refer to Table 3-1):

Table 3-1: Interview questions

<b>Interview questions</b>
<ul style="list-style-type: none"> <li>• Age of the business (specifically how long the business has been trading for).</li> <li>• Business activity.</li> <li>• The purpose of the loan.</li> <li>• The amount required.</li> <li>• Whether the owners<sup>1</sup>/managers have the necessary skill and experience to manage the business.</li> <li>• How the business will generate sufficient revenue to repay the loan.</li> <li>• How the bank will be protected if the business is unable to repay the loan.</li> </ul>

Source: Authors own compilation

The bank official will in a professional manner ask the relevant questions to obtain the abovementioned information. Furthermore, the bank official must have some sense of comfort that the credit will be used for the intended purpose, for example, to generate more profit for the business, and not to be used for consumption spending (Harif *et al.*, 2011). The applicant will be advised on how to complete an application form and to provide the bank with the relevant financial information.

The application form will normally include questions pertaining to the following (Petersen, 2004; Singapore, 2007; Carter *et al.*, 2007; Krog, 2008; Harif *et al.*, 2011) (refer to Table 3-2):

Table 3-2: Application form information

<b>Business:</b>	<b>Owners/members/directors:</b>
<ul style="list-style-type: none"> <li>• Legal name of the business and any trading name.</li> <li>• Legal status.</li> <li>• Number of years in business.</li> <li>• Type of business and industry.</li> </ul>	<ul style="list-style-type: none"> <li>• Full details of owners/members/directors.</li> <li>• Whether the applicant has the legal capacity to act on behalf of the business.</li> </ul>

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<sup>1</sup> Owners may include: a sole proprietor; partners in a partnership, members of a Close Corporation (CC), directors of a Company ((PTY) LTD), and so on. For ease of reading the term “owners” will be used for this study.

<b>Business:</b>	<b>Owners/members/directors:</b>
<ul style="list-style-type: none"> <li>• Type of product or service provided.</li> <li>• Where the business trades from and for how long.</li> <li>• Number of employees.</li> <li>• Banking details of the business account or personal account if the business does not have a separate business account.</li> <li>• Business address (also whether rented/owned, home-based).</li> <li>• Contact details: telephone/email address/ website.</li> <li>• Status with regards to insolvency.</li> </ul>	<ul style="list-style-type: none"> <li>• A personal statement of assets and liabilities is to be completed by each owner.</li> <li>• Income and Expenditure Statement.</li> <li>• Status with regards to sequestration/administration/debt counseling and debt review.</li> </ul>

Source: Authors own compilation

The application for credit will require the authorized signature/signatures. Furthermore, consents may be required from the applicant such as the authorization to conduct credit bureau checks and requesting online bank statements from the applicant's bank where the cheque account is held. Should the credit application be successful, the signed contract will serve as a legal document that binds the applicant to the terms and conditions. These terms and conditions include the cost of the loan to the customer; the loan amount; the term of the loan; and the requirements for collateral (Petersen, 2004).

The bank obtains information mainly from the following sources (Kumra, Stein & Assersohn, 2006; Carter *et al.*, 2007):

- Information provided by the applicant.
- Credit bureau/trade information.
- Bank information.
- A visit by the bank representative to the business premises.

Due to the cost associated with this visit, this is not typically done in South Africa for small business lending. The purpose of the visit would be twofold; to ensure the business does exist, and to determine whether the business could potentially meet the credit policy criteria.

The information to be provided by the applicant usually includes the following: (where applicable) (Altman, Sabato & Wilson, 2010; Harif *et al.*, 2011; Lisowsky & Minnis, 2015; Minnis & Sutherland, 2017) (refer to Table 3-3):

Table 3-3: Documentation requirements

<b>Documentation requirements</b>
<ul style="list-style-type: none"><li>• Proof of identification of owners/relevant parties and proof of address – in accordance with regulatory requirements.</li><li>• Proof of registration documentation of the business.</li><li>• Annual financial statements (these are to be audited if it is a Company) (Income Statement and Balance Sheet/ Profit and Loss statement). Typically for three years.</li><li>• If the financial statements are older than six months at the time of application, the most recent management accounts must also be obtained.</li><li>• Pro-forma statements for new businesses.</li><li>• Cash flow statement.</li><li>• Bank statements for the past six months (owners and business).</li><li>• Projected cash flow statement – to review the business development and ability to pay.</li><li>• Business plan.</li><li>• Debtors age analysis.</li></ul>

Source: Authors own compilation

It is important for the banks to ensure that the information provided is coming from a reliable source, for example, from a reputable accounting firm. The banks will not accept “own” company prepared financial statements (Minnis & Sutherland, 2017).

An additional important source of financial information, apart from financial statements, is the tax returns of a business. This is valuable to a bank during the assessment process as it provides information on a business’s income and expenses and also the assets and liabilities. Furthermore, the tax return is to be submitted annually hence it could be a less costly substitute for financial statements. The downfall is that the tax return does not include cash flow statements, the balance sheets are not detailed, and the returns are not timely (Minnis & Sutherland, 2017).

From the information requirements listed above, it can be derived that this information will be available for businesses that are more sophisticated and have been in existence for some time. For an entrepreneur buying over an existing business, the information such as the financial statements can be obtained from the existing owner (Krog, 2008).

Furthermore, banks normally review the existing business accounts with overdrafts/other facilities on an annual basis (or depending on the risk grading and collateral position), even in the event that the business does not request for an increase in credit. The financial information

will have to be provided by the customer to the bank for the review. This is done to ensure that any early warning signs of any credit risk can be detected at an early stage.

For start-up businesses, which are normally defined by banks as businesses which have been in operation for less than two years, there is no reliable "track record" of profits, which makes it difficult to determine the capacity of the business to repay the loan, and hence is considered risky (Minnis & Sutherland, 2017).

### **3.6.3 Credit assessment process**

Once the information gathering process is complete, a full credit assessment will be conducted to ensure that the applicant's business activities are feasible, marketable and profitable (Rivai & Veithzal, 2006). This is normally done by a credit analyst assisting the portfolio manager. Using a combination of both qualitative and quantitative measures, the credit application will be evaluated to estimate the probability of default. The credit assessment will ultimately determine whether the applicant will be granted credit, and if so, determine the cost of credit in terms of the underwriting fees, the interest rate to be charged, and the term (Kumra *et al.*, 2006). The risk assessment in the underwriting process for an existing borrower on the bank's portfolio in comparison to a new applicant normally differs due to the differing levels of analytic detail, opportunity costs, and analytic objectives (Kumra *et al.*, 2006).

In order to ensure some guidance and uniformity for credit managers when assessing credit applications for new and existing customers, the banks typically use the 5C's of credit as a framework, as previously discussed. This criteria for assessing commercial credit applications has received a considerable amount of attention in recent years (Dlova, 2017). Some lenders develop scorecards using aspects of the 5C's of credit, combined with other variables such as the personal credit bureau reports of the owners (Berger & Udell, 2006). Credit scoring will be discussed in more detail later in the chapter. The criteria of the 5C's of credit will now be further explored.

#### **3.6.3.1 Criteria of the 5C's of credit**

##### **Character/Personal attributes of the borrower**

It is important for a bank to have significant comfort with the character and personal attributes of its prospective borrowers (Frame, Srinivasan & Woosley, 2001). Character is referred to by some scholars as the "common sense" factor that the bank looks at when considering an application for credit. Essentially it is the general impression which the bank derives of the credit applicant (Gangata & Matavire, 2013).

Not only is it important to determine the ability to repay a loan, it is equally important, if not more important, to determine as far as possible through qualitative factors such as “honesty” the applicants’ willingness to make repayments in full and on time (Harif *et al.*, 2011).

It is generally accepted that the most tightly drafted documentation and apparent abundance of security cannot guarantee the prevention of a fraudulent transaction. Mistrust is a poor foundation for any business relationship and it is therefore critical to apply all measures to make an informed opinion of the owner/s of the business. One of these measures is to assess the “character” of the individuals (Harif *et al.*, 2011).

There are lenders according to Liberti and Petersen (2018) that determine, based on a picture of the applicant, the trustworthiness of the applicant. There are studies which found that applicants who were more attractive were more likely to have credit approved (Liberti & Petersen, 2018). Todorov, Olivola, Dotsch and Mende-Siedlecki (2015) state that beautiful people are perceived to be more productive and more confident. Furthermore, a study conducted by D’angelo, Mustill and Piccolo (2018) to investigate whether the lending-decision process is affected by behavioural biases, found that women were discriminated against when the credit manager making the decision was a male, and that credit managers had greater confidence in older borrowers. The other finding was that there was a positive effect on the perception by the banks regarding the beauty of the borrower (D’Angelo *et al.*, 2018).

Character may include attributes such as an individual’s way of thinking, integrity, and stability (Abbadi & Karsh, 2013). Whilst it is difficult to identify these attributes without being trained for this during an interview, and without psychometric testing, other indicators such as the applicant’s reputation as a borrower, and financial stability based on historical information are considered (Kabir, Jahan, Chisty & Hasin, 2010). Whether the individual is conservative with personal finance and the honouring of existing credit obligations are usually strong indications of a borrower’s willingness to pay (Keown, 2013). If these are positive, should the borrower have the means to pay, it would be expected that there would be similar behaviour displayed with future credit, with regards to the willingness to pay. Lenders, therefore, look at past credit history to show how responsible an applicant will likely be in the future.

There may, however, be instances where a borrower had an incident beyond the person’s control, such as retrenchment, that resulted in a bad credit history (Niesche, 2013). Unfortunately, this would result in most instances that the application for credit would be declined (Dean & Nicholas, 2018). There are recent initiatives by Government to grant “amnesty” where past adverse information, for example, is no longer reflected after a certain

period on a person's credit history at the credit bureau. This period is normally three years or longer, depending on the type of debt (Kelly-Louw, 2015).

Quantitative methods used to determine an applicant's propensity to pay the future debt or determine the ability to repay the credit applied for are; credit reports, credit ratings, and credit scores (Karsh & Abumwais, 2018). These are provided to a large extent by credit bureaus. Credit reports contain detailed information about how much an applicant has borrowed in the past and whether the loans have been repaid on time. The reports also contain information on collection accounts, judgments, liens and bankruptcies (Karsh & Abumwais, 2018). The information is retained by the credit bureaus and reflected on an applicant's report for a required period, unless amnesty is granted, as discussed above.

The Fair Isaac Corporation (FICO) uses this information to create a credit score, which the banks can use to get a quick snapshot of creditworthiness before looking at credit reports (Berger, Cowan & Frame, 2011). Factors which are highly ranked to determine this score typically include; adverse information, delinquent accounts, total debt, and late payments. Karsh and Abumwais (2018) rank the five key factors typically used in credit bureau scores as payment history 35%, amount owed on accounts 30%, length of credit history 15%, types of credit used 10%, and new credit enquiries 10%.

Dean and Nicholas (2018) in their article state that credit scores may be predictive of health by means of assisting to understand who is more likely to develop, treat, or manage a condition. Credit scores may reflect personal characteristics, such as a person's tolerances for risky behaviours, or ability to manage complex processes, such as navigating payment schedules. For example, one study showed that individuals with higher bankruptcy risk were more likely to experience car crashes, whereas another found that financial literacy and fluid intelligence (speed and capacity for processing and responding to information) were associated with higher credit scores (Dean & Nicholas, 2018).

These above examples according to Dean and Nicholas (2018), suggest that credit scores may serve as proxies for social and economic factors, and there could be a clinical benefit to identifying key associations, such as whether patients who frequently pay bills late also struggle with medication adherence or follow-up care. Although this seems promising, there is regulation which prevents discrimination in scorecards and certain variables may not be used in credit scores such as; race, colour, religion, national origin, gender, marital status, age, and the use of public assistance (Dean & Nicholas, 2018).

There are instances where the bank will decline credit outright without any further assessment based on factors such as unethical business operations, period of existence of the business, or due to regulation/legislation. Normally lenders will look firstly at the length of time in business as banks are not keen to lend to a business that cannot demonstrate repayment ability through formal financial statements. Applicants may be turned away if the business has not been in successful operation for at least two years (Karsh & Abumwais, 2018). For some banks, it may be a requirement that the business must have been in existence for at least three years, as banks typically look at the history of three years of financial statements. Unethical business operations include examples such as the drug trade (Abedifar, Ebrahim, Molyneux & Tarazi, 2015).

Regulatory examples where an application would be declined upfront include where the person has applied for, or is under debt counselling, administration, sequestration/insolvent, below the minimum age requirement, where the necessary consent has not been obtained from the spouse in instances required by marriage law, or where consent has not been obtained to do a credit bureau check (Berger, Barrera & Klein, 2007)

The bank will look at the integrity and level of stability of the key people who are responsible for meeting the business obligations (Karsh & Abumwais, 2018). These would typically be the owners/members/partners/ directors or any other person/business that has, or is to sign surety for the business or individual applying for credit. How lenders typically determine “integrity” has been explained above, the below are variables which the banks typically use to assess the “stability” attributes. There may, however, be an overlap of variables for determining “integrity” and “stability”. Where possible the variables considered are split for an individual and the business, and typically include the following (Table 3-4) according to various authors (Olawale & Garwe, 2010; Fatoki & Asah, 2011; Gangata & Matavire, 2013; Dlova, 2017):

Table 3-4: Character/Personal attributes of the borrower

Owners	Business
<ul style="list-style-type: none"> <li>• The period at the current address.</li> <li>• Whether the residence is rented or owned.</li> <li>• Highest educational level.</li> <li>• Previous business experience.</li> <li>• Level of knowledge in the respective business industry.</li> </ul>	<ul style="list-style-type: none"> <li>• Whether the business is legal and ethical.</li> <li>• Credit history – repayment of current debt obligations on time and within the contractual payment period.</li> <li>• Conduct of existing cheque accounts. Any dishonours, returned debit orders/stop payments, and exceeding of existing limits.</li> <li>• Any records of fraud.</li> </ul>

Owners	Business
<ul style="list-style-type: none"> <li>• Credit history – repayment of current debt obligations, on time and within the contractual payment period.</li> <li>• Conduct of existing cheque accounts. Any dishonours, returned debit orders/stop payments, and exceeding of existing limits.</li> <li>• Any records of fraud.</li> </ul>	<ul style="list-style-type: none"> <li>• Size.</li> <li>• Location – rent or own premises/ home based.</li> <li>• Number of years in business.</li> <li>• The legal form of business: Sole proprietor, Partnership, Trust, Close Corporation, Company.</li> <li>• Whether the business is a; parent, subsidiary, division, or whether it has a holding company.</li> <li>• The type of industry, for example; retail, wholesale, service, manufacturing.</li> <li>• Whether the business is seasonal/non-seasonal.</li> <li>• Whether the business is local/national or international.</li> <li>• Number of employees - 'employees to sales' ratio depending on industry.</li> <li>• Capable managers in key areas such as finance and human resources.</li> <li>• Key personnel turnover.</li> <li>• Record of labour disputes/CCMA cases.</li> <li>• Whether there is a business continuity plan in place.</li> <li>• Website information.</li> <li>• Comments from references.</li> </ul>

Source: Authors own compilation

The above sums up the first of the 5C's of credit, namely "character". The remaining 5C's of credit will now be further explored. To give some context; capacity, capital, and collateral together form the basis for a quantitative financial analysis, and conditions refer to external variables which may impact the business (applicant) (Petersen, 2004).

### Capacity to repay

Under capacity, the status of the applicant is considered to ensure that the applicant has the capacity to legally borrow on behalf of the business and secondly "capacity" describes the business's ability to repay the credit applied for (Karsh & Abumwais, 2018). The latter is determined during the underwriting process where an affordability check is conducted to

determine the ability of the business to generate sufficient revenues to repay the credit amount applied for (Matsoso & Benedict, 2015).

The banks assessment of credit risk is mainly based on historical cash flows and other assets, meaning that the bank is going to need to see a sufficient track record of cash flow (income-expenses) and be convinced that the cash flow is predictable and sufficient through the course of the loan (Moti, Masinde, Mugenda & Sindani, 2012).

Dickinson (2011) defines cash flow as the cash a borrower has to pay his debt. Generally, a borrower has three sources to draw upon to repay a loan: cash flow generated from sales or income, the sale or liquidity of assets, or by funds raised by issuing debt or equity securities (Harif *et al.*, 2011). A strong cash flow by a business's normal business activities demonstrates the capacity to repay debt, and mitigates the probability of default (Anthony, 2006). Default is the failure to pay interest or principal on a credit obligation when due. Default occurs when a debtor is unable to meet the legal obligation of debt repayment (Harif *et al.*, 2011).

During the affordability assessment process, the financial statements are analyzed to determine the overall financial soundness of the business, and key ratios are calculated and compared to industry norms (Kumra *et al.*, 2006). An analysis is also done to identify any trends, for example, deterioration of any key ratios (Karsh & Abumwais, 2018). This will indicate any early warning signs of the business cash inflow deteriorating unless it is due to, for example, a seasonal issue (Minnis & Sutherland, 2017).

Emel *et al.* (2003) however, caution that whilst there are benefits of using financial statements, as these reflect the position of a business at a point in time, and on its operations over some past period, the limitations of using ratio analysis must be noted. The limitations could include: (i) many large businesses operate in a number of different industries. In such cases, it is difficult to develop a meaningful set of industry averages for comparative purposes; (ii) inflation distorts the balance sheet of a business. Moreover, recorded values are often substantially different from their "true" values; (iii) seasonal factors can distort ratio analysis; (iv) a business could apply "window dressing techniques" to make its financial statements look stronger; (v) it is difficult to generalize about whether a particular ratio is "good" or "bad"; and (vi) a business may have some ratios looking "good" and others looking "bad" making it difficult to tell whether its financial position is on balance, strong, or weak (Emel *et al.*, 2003).

Other "red flags" to look out for when determining the financial soundness of a business are; any defaults/adverse information, late payments, dishonoured cheques, returned debit orders or exceeding of overdraft limits (Niesche, 2013). These indicators fall under the "character"

categorization of the 5C's of credit and are indicative of a business experiencing financial difficulty.

The key measure to determine affordability is “cash” availability at the time the monthly payments and interest is due, for the duration of the loan. This is critical and the reason why “capacity” in general is the most important aspect of the 5C's of credit (Rivai, 2006). However, Stricheck (2000) states that credit managers view “character” as the most important factor in making any credit decision, followed by “capacity” and “collateral” when lending to small businesses. A more recent study by Abbadi and Karsh (2013), based on commercial banks in Palestine, found that using the 5C's method, banks concentrate more on collateral, capital, and capacity of the borrower, more than character and conditions.

Stricheck's (2000) view is arguably understandable considering that despite a business having the “capacity” to repay, if the applicant has no willingness to repay (based on “character”), the bank will suffer a loss.

To determine capacity, the key measure is to compare the monthly income generated by the business against the recurring debts and assessing the business' debt-to-income ratio once the monthly installments of the credit applied for are added to the existing debt. The ratio should be within the acceptable norm, where a lower ratio indicates a higher probability of repayment. The detailed cash flow forecast in the event of business expansion, or where new equipment is to be purchased, which will generate additional income, must also be taken into consideration (Harif *et al.*, 2011).

Other factors such as whether the business makes conservative or risky financial decisions and the business margin of error for the expected growth will also be considered (Gray, 2014). Furthermore, any possible “sanity” checks are conducted to try and validate the financial information provided by the applicant. This would include, for example, interrogating the bank statements and comparing the deposits received on the account to what is reflected in the income statement/cash flow statement. Whether expenses seen on the bank statements are included in the financial statements, and any fixed property is verified by means of a deeds office search.

During assessment, it is also important to determine the capacity of the business to collect the amounts owing for goods sold or services rendered. This is where the debtor's age analysis is required for a sanity check. This will also give an indication of any cash flow problems the business may experience due to late payments received from debtors. What can also be draining on a business's cash flow is the drawings by the owners/members. The sanity check

to be done here is to identify the owners/members personal expenditure from the Income and Expenditure statement completed by each individual and also doing validation checks on accounts payable from the bureau information and looking at the personal bank statements for excessive spending on entertainment, and other deductions.

The ability of the business to absorb any unforeseen shocks based on economic conditions or a bad month or two of selling is also to be considered, together with what the structure of the business debt currently looks like, for example, whether it is secured by any assets. In addition, whether it is fixed assets or assets that can be easily converted to cash (Van Wyk, 2006; Harif & Zali, 2006). The bank normally deflates the values from the given market value to a value that can be reasonably obtained in the event of a 'quick sale' situation. In addition, other factors such as the stock turnover ratio, and any obsolete stock and various other factors are looked at, depending on the type of business (Harif *et al.*, 2011).

The most critical ratios which are typically the following, are thoroughly assessed by the bank to determine affordability (Kabir, Jahan, Chisty & Hasin, 2010; Altman *et al.*, 2010; Harif *et al.*, 2011):

- Liquidity measures (the liquidity of a business is measured by its ability to meet its short-term debt obligations as they fall due).
- Activity ratios (assess the speed with which current accounts such as; inventory, debtors, and creditors are converted into cash in the business); and
- The ability of the business to repay short-term debt (which is due within 12 months).

### **Capital of the business**

Under "capacity" the means of repayment by way of cash flow was determined. This is derived mainly from the Income Statement provided for the business. For the "capital" requirements the Balance Sheet provided will be assessed to determine the capital assets of the business, the owner's equity, and retained earnings in the business (Harif *et al.*, 2011).

The owner's equity is the capital that the owners/members have invested in the business. It provides a cushion for a business in times of financial difficulty; hence a larger contribution by the owners/members indicates a lower probability of default (Brown & Moles, 2014). This also indicates that owners are serious about the business as they believe in the business (Johnson *et al.*, 2014). A ratio used by banks as an indicator to determine the capital adequacy of a business is "Owners' equity/total assets". The higher the ratio, the better (Emel *et al.*, 2003). The SMME and funding institutions survey shows that banks require businesses to have a

minimum of 30% owners contribution (depending on the applicant's risk) in order to qualify for credit (Dlova, 2017).

Retained earnings are also a positive indicator as it shows that the owners are putting back money into the business, as opposed to depleting all the profits. The business balance sheet will be assessed to determine the capital of the business. More capital indicates a higher probability that the business can stand volatility (Ray, 2010). Capital is essentially the net worth, which is the assets less liabilities. Capital assets of the business may include machinery and equipment, product inventory and fixtures, depending on the type of business.

Cash is always considered by banks as the best asset, as assets such as machinery and equipment depreciate in value and in the event of default of a borrower, the bank may be in a position to sell the assets, but at liquidation value. The banks focus is therefore on the business's cash position and cash flow (Fatoki, 2014b).

Combined with the information obtained under "capacity" the credit analyst will make an overall assessment to determine whether the business has the financial resources based on the financial statements provided to repay the existing creditors, together with the new credit amount applied for using mainly the following (Noradiva & Azlina, 2016; Karsh & Abumwais, 2018):

- Net worth (assets-liabilities).
- Working capital.
- Cash flow; and
- Key ratio calculations, such as the debt-to-equity ratio.

It is important to note that the experience and qualification of the person making this assessment are critical. The person must be in a position to analyze and interpret financial statements (Karsh & Abumwais, 2018). The issue is also that financial records are snapshots of the past, and during the credit analysis process the credit analyst is trying to make a prediction of the future based on the past results and trends of the business. The 5C's of credit assist in the overall analyses of a commercial lending application, as it guides the analyst to combine elements of the past together with any possible foreseen credit risks, to make a future prediction (Karsh & Abumwais, 2018). Any possible foreseen credit risks that may impact on the business may be, for example, local economic conditions (Moti, Masinde, Mugenda & Sindani, 2012). These would be included under "conditions" which will be further explored below.

## Condition

The conditions such as the purpose of the loan, the interest rate, and the principal amount, influences the banks desire to finance the borrower (Peprah *et al.*, 2017). The bank must also understand the broader market conditions affecting the industry, segment, market, and overall economy in which its borrowers engage in, and how these may impact on the ability of the business to meet its debt obligations (Rivai, 2006). For example, an economic downturn could have a negative impact (Keown, 2013), and a strong industry growth or economic conditions could support a business' ability to generate cash and repay debt (Erigida, 2013:25).

When an application is assessed, the credit manager will look specifically for any industry-specific or local economic conditions that may affect the business's financial situation, and its ability to service the debt applied for. For example, whether there is a growing or a going market for the business (Moti, Masinde, Mugenda & Sindani, 2012) and whether there will be an impact by the internet or advanced technology on redefining the business (Harif *et al.*, 2011).

This analysis is done to ascertain the borrower's vulnerability to happenings in the economy (Moti, Masinde, Mugenda & Sindani, 2012). Other examples include the construction industry which may be influenced by changes in Government policies on immigration, interest rates, and taxation. If the business deals with international trade, the impact of any change in the currency rates in the near future will need to be taken into consideration (Hudson & Leftwich, 2014). Further examples based on the views of various authors are included in Table 3-5 (Kabir, Jahan, Chisty & Hasin, 2010; Hudsons & Leftwich, 2014; Dlova, 2017).

Table 3-5: Condition: External or macro-economic factors that may impact the business

<b>External or macro-economic factors that may impact the business</b>
<ul style="list-style-type: none"><li>• Local/ national or international economy.</li><li>• Financial health of borrowers industry.</li><li>• Local market.</li><li>• Competition.</li><li>• Market fluctuations.</li><li>• Industry growth rate.</li><li>• Political factors.</li><li>• Legislative factors.</li><li>• Currency rates.</li></ul>

Source: Authors own compilation

It is important for the owners of a business to foresee trends in the marketplace and have a backup plan to overcome any challenges. There must be a plan for both good and bad turns in the economy (Dlova, 2017).

### **Collateral**

In addition to having a good credit history, a proven ability to generate sufficient cash flow to repay the loan, sufficient business assets, and acceptable risk conditions of the business, the bank will mostly require an owner to pledge assets or fixed property as security for the credit applied for (Minnis & Sutherland, 2017).

Collateral is the assets ceded as security to obtain credit. It is also commonly referred to as “collateral security” or “security”. This is to provide comfort to the bank in the event that the borrower is not able to repay the amount owing with the business cash flow (Keown, 2013). The word “mostly” is used but typically with commercial credit, if there is any tangible security available, the bank will take it!

If the borrower defaults, the bank would realise the collateral or sell the collateral and the proceeds would be applied towards the repayment of the debt (Minnis & Sutherland, 2017). A realistic bank value is placed on the assets which are available as collateral which allows for easy liquidation in the event that the borrower defaults (Kothari, Ramanna, & Skinner, 2010). If the owner has nothing to lose if the business fails, the owners can simply walk away from their obligations, leaving the bank to suffer the loss. Furthermore, the willingness of the business owner to offer collateral to the bank is an indication that the business owner has confidence in his/her own capabilities and the success of the business project (Berger & Udell, 2006).

The reason for taking collateral is therefore twofold, firstly to serve as a second form of income to repay the debt in the event of default by the borrower (Moti *et al.*, 2012) and secondly to ensure the commitment of the owner/s to the success of the business (Brown & Moles, 2014; Minnis & Sutherland, 2017).

However, even if 100% tangible security is offered to cover the credit amount applied for, security cannot make a bad loan a good loan. If the business itself cannot generate the cash flow required to service the debt applied for, which is clearly demonstrated in the analysis of the financial information, the application for credit should be declined (Golam *et al.*, 2010). Security should only be taken as a sense of comfort in the event of the business not being able to repay the debt as a result of unforeseen circumstances (Wilkinson, 2013).

With retail credit, the banks have moved towards unsecured lending due to the high cost of taking and managing security. However, unlike with retail lending where an applicant can provide a pay slip to prove monthly earnings, commercial lending cannot provide that comfort and relies on trained credit professionals to determine affordability based on the financial information provided (Carter *et al.*, 2007; Karsh & Abumwais, 2018).

Fixed property is a common form of collateral, where a covering bond may be taken on the property (Sharma & Kalra, 2015). Cash and other liquid assets are also important forms of collateral. Examples of primary security typically include fixed property, life insurance policies with a sizeable surrender value and investments. Secondary security would include, for example; accounts receivable, inventory, and equipment (Gray, 2014). Secondary security is not rated highly by the bank and carries less security value. It can be assumed that the bank takes cession of secondary security more as a comfort and preventative measure, for example, by taking cession of member's loans this prevents the owners from eroding the owner's equity in the business.

For a bank, it is important to obtain security where the value does not easily depreciate and which is easily liquidated. In the event that the borrower defaults on the debt obligation, the bank has some recourse to realize the security such as the policy surrender value, and apply it to the outstanding amount (Minnis & Sutherland, 2017). If there is still a balance owing, the bank usually obtains an acknowledgment of debt from the borrower for the outstanding amount, where monthly payments are agreed upon (Strahan, 1999).

If a business goes into bankruptcy, it effectively defaults on all debt with all its creditors. Creditors with loans secured by the business's assets, such as property, inventory or vehicles, may reclaim those assets in lieu of repayment. If there are any funds left over, and it is a company, for example, the company's bondholders receive a stake, followed by the shareholders which are next in line (Hatch, 1991:132).

It is standard practice for banks to obtain personal suretyships by the members/directors where the business entity (applicant) is a separate legal entity, such as a company. Without a personal suretyship by the members/directors in favour of the business, the bank will not have the right of recourse to take legal action against the members/directors in their personal capacity in the event of default by the business. The suretyship must be signed for a minimum value of the credit amount applied for. In addition, an outside party may sign surety in favour of the business. This person may be called upon by the bank to pay the outstanding amount owing in the event that the borrower defaults (Strahan, 1999).

The above provided an overview of what variables are taken into consideration when assessing a credit application from a business applicant. The results of a study conducted by Balogun *et al.* (2016) indicate that the company tax number of the business applicant, the managerial competency, specifically high education and related experience, the business plan, project value, relation with banks, and the location of the business, are important determinants predicting credit accessibility to bank credit by small businesses in the construction sector. Below the credit approval process will be considered.

#### **3.6.4 Credit approval process**

Once the application has been fully assessed, and where there is merit, the portfolio manager/bank official will forward a detailed motivation together with all the supporting documentation to a credit manager at Head Office Credit for approval (Liberti & Petersen, 2018). Most of the banks in South Africa have centralized credit which means that all credit decisions are made from a central point, usually at the Head Office.

A committee would typically only consider credit applications over a certain identified threshold amount which exceeds an individual credit manager's credit mandate (Van Wyk, 2006). In some cases, if the total value of combined group exposure for the application exceeds an individual's mandate, it may be referred to a credit manager/area manager with a higher mandate, if this exceeds the higher authorities mandate, a committee may make a decision. The committee is normally made up of a team of senior credit managers and a higher authority (Mandala *et al.*, 2012).

It is important to note that the person interviewing the business applicant to obtain the required information for credit assessment, is not the person making the credit decision (Liberti & Petersen, 2018). This is done to ensure segregation of duties and a "cold" decision to be taken by the mandated credit official. This prevents an applicant from influencing the decision and avoiding any possible "reward" to be given to the credit decision maker by the applicant (Kithinji, 2010). Banks have implemented a "Gift register" where bank officials are obliged to report any "gifts" above a determined value, (normally R50, 00) in any form received from bank customers. This alludes to the ethical behaviour of employees and is determined by the Ethics Policy of an institution (Jackson, 2000).

The credit decision taken is sent back to the portfolio manager to be relayed to the applicant. In accordance with the NCA requirements (within the ambits of the NCA), should the application be declined, the bank is required to provide the customer with the most dominant reason for the decline. Furthermore, at the request of the customer, a printed decline advice

indicating the reason must also be provided. Where an application is declined due to an adverse report received from a credit bureau, the name, address and contact details of the credit bureau must also be given to the customer (Kelly-Louw, 2015).

From the above, one can derive that the process followed for credit assessment of a small business credit application is a very detailed process, requiring a lot of time from the bank officials. The time taken equates to cost for the bank as it is very skilled people required for assessment and approval. At the same token, it is time-consuming and costly for the applicant to provide the required financial information to the bank (Minnis & Sutherland, 2017). Should the application be declined at the end of the process, without any option for the applicant being told to re-apply after meeting certain conditions, this would have been a wasted and costly process for the applicant and the bank.

The applicant also does not have an opportunity to meet with the credit decision-maker to ask questions or ask for advice on how to change things to possibly be eligible for credit at a later stage. One could imagine that this leaves the small business owner in a position of not knowing where to turn for assistance and may lead to the applicant dropping a possible viable business opportunity, more so for start-up businesses (Storey & Greene, 2010). For an existing business, depending on the purpose of the credit application and the circumstances, it may ultimately lead to the demise of the business if the credit is declined. However, this is not implying in any way that all credit applications should be approved, it is simply looking at the consequences which may result if the small business applicant is denied further credit. The bank is also careful not to worsen the current position of the business by providing more credit where it is not viable.

It is clear that credit managers are faced with a lot of responsibility. The credit managers follow the guidelines set in the bank credit policy which normally does not allow for any “grey” areas, such as taking a calculated risk where the business does not meet all the criteria, however, the credit manager may see the potential in the business (Karsh & Abumwais, 2018). This implies that the current position of limited access to credit for small businesses will not change. Credit managers are also held accountable to some extent for bad lending decisions (Carter *et al.*, 2007), which will arguably also increase the likelihood of the decision maker rather declining an application if there is some uncertainty.

The above provides a guideline of the process followed by banks to assess small business credit applications. As can be derived, the underwriting process is labour intensive, and is largely dependent on human judgment. This is costly for the bank as credit managers which make the credit decisions are expensive (Minnis & Sutherland, 2017). For any lender, cost

efficiency is a priority and the increased pressure faced by banks due to increased competition from retailers and increased regulation further squeezes the profit margins. Whilst the banks realize that there is an opportunity to provide more credit in the small business space, as there is a great demand for credit in this market, small amounts of credit cannot justify an expensive origination process (Berger & Frame, 2007).

Banks in South Africa have started automating the ratio analysis and parts of the credit analysis process, however, the final decision for commercial lending remains with a credit manager. It would seem logical to automate what is practical and keep only what cannot be automated, for example, the more complex decisions and the larger values for credit management assessment. Credit scoring provides process automation (efficiency), an improved risk measurement (quantification) and management (consistency), which ultimately leads to a reduction in cost (Shen *et al.*, 2013). Credit scoring will now be further reviewed.

### **3.7 Credit scoring**

Credit scoring models have been widely used for consumer lending for unsecured personal loans, credit cards, vehicle finance and home loans (Berger *et al.*, 2011). This has resulted in low-cost, commoditized credits that are often sold into secondary markets, yielding significant growth in consumer credit availability. However, only in the mid-1990s did financial institutions begin to create scorecards for small business credit on a widespread basis (Kaplan & Norton, 2006). This is when the largest external provider of scores; Fair, Isaac and Company, introduced its first small business model. The models are usually designed for use for credits up to \$250, 000, but many banks use them only for credits up to \$100, 000. Similar statistical techniques, such as discriminant analysis were used in lending to larger firms before this time, but they were based on business data, not the personal credit history of the owners (Saunders, 2000). The use of personal credit history may be viewed as the key innovation behind the development of the small business credit scoring technology (Berger *et al.*, 2011).

Berger *et al.* (2005) noted that the personal credit history of small business owners is highly predictive of the loan repayment prospects of the business. The personal information used in small business credit scoring (SBCS) models usually include the owner's monthly income, outstanding debt, financial assets, employment tenure, home ownership, and previous loan defaults or delinquencies.

There are however many people that do not have credit bureau scores. According to Berg *et al.* (2018), the lack of access to financial services affects around two billion working-age adults worldwide, particularly in developing countries, and is seen as one of the main drivers of

inequality. FinTech players have emerged that use digital footprints to challenge traditional banking options and develop innovative financing solutions. These FinTechs have the vision to give billions of unbanked people access to credit when credit bureau scores do not exist, thereby fostering financial inclusion and lowering inequality (Berg *et al.*, 2018).

Berg *et al.* (2018), in their study, based on 250 000 observations, analysed the information content of a digital footprint which is a trail of information that people leave online simply by accessing or registering on a website. The aim of the analysis was for predicting consumer default. Their results suggest that the digital footprint complements rather than substitutes credit bureau information and a lender that uses information from both sources (credit bureau score plus digital footprint) can make superior lending decisions compared to lenders that only access one of the two sources of information.

Yan (2018) states that due to the government's inability to provide a solution to the difficulty for small businesses to obtain finance, and the banks preferring to lend to larger businesses, Internet Finance is becoming a popular means for small businesses. Specifically the P2P net loan option, also referred to as the "everyone loan". The internet provides a network loan platform which brings investors and borrowers together. Yan (2018) recommends that considering the vast technology benefits that technological companies have over banks, that banks partner with services providers such as Internet Finance as a means to provide credit to small business.

Van der Zande (2018) adds that the financial industry is currently experiencing a transformation as there are newly formed financial organizations using enhanced technology which are challenging the current way that banks operate. Considering these upcoming potential threats, Van der Zande (2018) states that banks will need to adapt in order to remain relevant and competitive. Moreover, other than FinTech, there are major technologically advanced companies such as GAFAA (Google, Amazon, Facebook, Apple, and Alibaba) that are entering the field of financial services. Should these new financial service organisations start offering financial services on their platforms, banks will effectively be downgraded to utility providers managing the infrastructure (Van der Zande, 2018). Ditshego (2018) adds that banks will have to revisit the current culture and start thinking like digitally advanced technology companies as the threat is that FinTech could, for example, develop new products and services faster and cheaper. FinTech, on the other hand, could benefit from the banks distribution network, the banks large customer base, and the trust which the customers have in the bank. It is, therefore, foreseen that there could be collaboration, partnering and joint ventures (Van der Zande, 2018).

Several banks are adapting their processes to optimize on the technology available. An example is Swedbank in Sweden which aims to be the market leader in cost-efficiency using digitalization. Swedbank, for example, hires people with backgrounds in technology, works closely with the Information Technology department and encourages employees not familiar with technology to make use of a mentor, for example, the children of the employees who are normally more advanced regarding digital methods and technology (Van der Zande, 2018).

Part of the technical innovation, is artificial intelligence (AI) and machine learning which has already been applied in several industries, including banking. Knight (2017) describes artificial intelligence as a group of multiple technologies that provide machines with the ability to sense, enable, and act, while learning from experience and adapting over time. This ability to self-learn and adapt is also known as machine learning or reinforced learning. Swedbank is also exploring this avenue and envisage that in the near future people will be able to have real conversations with their bank accounts to receive information and advice (Van der Zande, 2018). Potential applications of AI in banks could be in the front-end during customer interface where voice recognition software can be used for customer interaction and advisory processes, and in the back-end to apply enhanced learning platforms to scan text, such as legal documents, and to generate leads. AI could also be used to drive customer segmentation of the banks' customers by integrating data and identifying weak patterns (Van der Zande, 2018). The latter may also benefit the enhancement of small business credit scoring.

Small business credit scoring is far more complex than consumer lending as it involves collecting information from various sources, not only for example from pay slips, and application and credit bureau data used for consumer lending. Small business credit scoring involves analysing consumer data about the owner/s of the business and combining it with relatively limited data about the business itself to predict future credit performance (Berger & Frame, 2007). Kaplan and Norton (2006), however, confirm that to date no significant secondary market for small business credit has emerged. It can be argued that in South Africa there is no prominent successful small business credit scoring model, and lending is ultimately based on human judgment decisions' by credit managers, as previously explained.

Based on this, it would be prudent at this point to further research how banks currently use credit scoring models; a basic review of how credit scoring works, and what variables could be applied in a credit scoring model for small business lending. Yu *et al.* (2015) note that credit scoring may be the most important tool to enhance the evaluation accuracy of credit risk of potential borrowers, stating that regression techniques and evaluation indexes of scoring methods are critical factors.

Credit scoring models used by banks can be classified into three main categories; application, behavioral, and collection models, depending on the stage of the customer credit cycle in which they are used. This could begin with prospecting of potential customers, assessing whether the customer qualifies at origination and underwriting, customer management, through to collections. The underlying technology and main principles of the credit scoring approaches used at each stage remain the same, however; the form of data used and the goals of such systems at each stage differ. The differentiator is the availability of reliable data to estimate a customer's creditworthiness, for example, the earlier the stage in the credit cycle, the fewer data will be available. This implies that the application models have a lower prediction power than the behavioral and collection models (Sabato, 2010). The different types of scoring systems and the purpose and benefits will be further explored.

### **3.7.1 Credit scoring models**

#### **Prospect scoring**

Customer acquisition is costly so the aim is to cut down on the time and cost of bringing in potential customers to the bank. This model identifies from the outset which customers are most likely to accept a given product offer (Chou *et al.*, 2000).

Once a customer accepts a product offer, the strategy of the bank is normally to maximize the potential of each customer by offering the customer suitable value-added products such as internet banking, investments, and insurance products. This not only provides more profits to the bank but also serves as a retention strategy, as it makes it more inconvenient for a customer to leave the bank to go to a competitor bank. The data used for the customer acquisition models can be from geo-demographic indicators and marketing databases (Chou *et al.*, 2000).

#### **Application scoring**

Application scoring is used at the point of origination when an applicant applies for credit such as a personal loan, vehicle finance or home loan. The system looks at the applicant's potential credit risk to select creditworthy customers. Origination was one of the first areas in the bank to use a scoring system to replace the decisions which were based solely on human judgment in the retail space. The aim is to reduce bad debt by minimizing the number of customers going into collection. This model can also include screening and identity resolution to be alerted to suspicious financial transactions that could indicate fraud or money laundering (Berger & Frame, 2007).

The data for application scoring for consumer lending is usually sourced from credit bureau reports, business databases and balance sheet statements of income/pay slips. For small business application scoring, the application form is the primary source of data. Other sources of information can include credit bureau references and the financial statements of the business such as the balance sheet, profit and loss statement, cash flow statements, and bank account statements (Berger & Frame, 2007).

### **Behaviour scoring**

Behaviour scoring is based on past customer behaviour and is used mainly to manage credit limits. The other benefit is that it can be used as a tool to optimize the earnings from existing customers by offering customers with a good credit record increased limits or other products (Thomas, 2000).

### **Collection scoring**

Collection scoring is used to reduce cost and increase efficiency by selecting the most appropriate collections strategy by segmenting, prioritizing and tracing customers (Berger & Frame, 2007). The aim is to collect as much as possible and as fast as possible. The bank may also outsource some of its book to external debt collectors or sell part of the book where it is feasible. The data used is based on past customer behaviour and credit bureau reports.

### **3.7.2 How credit scoring works**

Credit scoring uses statistical methods to look at the previous behaviour of customers to predict the potential future behaviour of customers. The aim of credit scoring is primarily to assess and quantify the probability of default at different stages in the relationship between the customer and the bank. Scoring assigns what is termed a 'default probability' to every applicant. A customer is said to be in default when a substantial proportion of the loan or the entire loan is not repaid. The Basel Committee definition of default is essentially a delinquency stage of 90 days or more. Payments in arrears, the oldest of which is 90 days or more overdue. The delinquency status must be coupled with a high likelihood that the debtor will not be in a position to repay, without giving up one or many pledged collaterals (in the case of secured lending) (Lessmann *et al.*, 2015).

When developing a scorecard the Basel II Capital Accord does not specify a specific methodology to be used, but several overriding principles. Taking into consideration the guiding principles, banks develop models to calculate the expected loss of the bank based on predictions of its components, as follows: Expected Loss = Probability of default (PD) x Loss given default (LGD) x Exposure at Default (EAD) (Lessmann *et al.*, 2015).

Behr and Güttler (2007) state that scoring models should include the same set of key financial and non-financial risk factors (characteristics) that banks normally analyze subjectively. Kumra *et al.* (2006) agree that whilst pure statistical models are very accurate, these are not appropriate for commercial lending on their own as they do not allow for what banks normally analyze subjectively as this analysis is dependent on the credit managers skill. For example, to gain an understanding of the business, its owners, its management structure, and its market.

This implies a need for tools that represent risk in a manner that: structures the credit process in a consistent manner; incorporates both subjective and quantitative information; and provides a means to store information on the nature of the borrower's business (Kumra *et al.*, 2006). A model that supports the underwriting process should, ideally, structure its analysis in a way that is similar to the way an experienced underwriter would look at a risk and assist the underwriter in gaining an understanding of the business (Kumra *et al.*, 2006). The logic is that if the risk factors make sense individually, then as a group of factors, the scorecard will be able to rank the risk of the applicant (Behr & Güttler, 2007). The credit manager must incorporate factors that are not captured by the system to ensure a relatively accurate description of the business. Psillaki *et al.* (2010) developed a novel methodological approach which included discriminate analysis and was able to corroborate previous results showing that non-financial performance factors are useful ex-ante determinants of business failure.

The different risk factors/characteristics are often referred to as "variables". The variables that are identified as being most informative are called primary predictors. They effectively predict the credit behaviour of customers. The stability of these predictors, however, must also be taken into consideration. For example, income can be predictive but could change rapidly with time, especially in a high inflation environment. The aim is to identify the combination of predictors that will provide the strongest combined predictive power and that will be most stable over time. Statistical weights are then assigned to each predictor of a new applicant, depending on how important they are seen to be, and the sum of the weights makes up the applicant's score (Kenya, 2009). Essentially the credit score represents the creditworthiness of the applicant.

The total score for an applicant can vary, for example between 1 and 50. Each score is associated with a default probability and the two are brought together in what is called a default probability. Applicants who do not score high enough (above the cut-off score) are rejected. As an example, a bank could accept all applicants that score 40 and above, and reject those that fall below 40 (Thomas, 2000).

Dinh and Kleimeier (2007) emphasize that selecting the cut-off score is probably the most important decision to make when a bank implements a credit scoring model. The setting of a cut-off score takes into account two crucial parameters that drive in opposite directions:

- The risk levels: The maximum probabilities of default the bank is willing to accept based on the risk appetite for a specific market segment; and
- Business development: The acceptance rates it wants to maintain. The amount of funds available for disbursement is also taken into consideration.

For the applications which are accepted, depending on the customer's allocated score, the system ranks (segments) applicants based on the potential credit risk. Based on the applicant's risk band, the system allocates the appropriate terms of business, such as the maximum loan amount, term of the loan, and interest rate to be charged. In addition, a consistent risk measure provides management with a numeric estimate of the impact of business decisions, allowing for an informed decision to be made on where to tighten or loosen credit policy risk criteria (Shen *et al.*, 2013).

The system can also make provision to refer applications to a credit manager for a final decision to be made in instances where it may not be a clear decision for an 'accept' or 'decline', or for larger value credit amounts. The bank may also choose to only allow the scoring model to make decisions to decline applications based on not meeting the requirements of the Credit Policy, minimum requirements, or where there is insufficient information. The applications that pass the scoring system are allocated a limit for approval by the system and these applications are then referred to a team of credit managers for approval within their discretionary credit mandates (Shen *et al.*, 2013).

### **3.7.3 Choosing an appropriate scorecard**

Credit scoring models can be qualitative as well as quantitative in nature. The qualitative technique is judgmental and subjective (Moti *et al.*, 2012). The quantitative technique is a systematic method to categorize performing or non-performing loans (Shen *et al.*, 2013).

There are three main types of credit scorecards that can be developed using only a financial institution's internal data:

#### **Judgmental scorecard**

Also referred to as rules-based systems or expert systems, judgmental scorecards structure credit policies and management risk preferences into a mathematical model that ranks

applicants according to risk. A judgmental model can be created without any historical data, so it can be applied to new segments (Bekhet & Eletter, 2014). However, Yu *et al.* (2015) notes that the expert system approach is highly dependent on subjective judgment; therefore, the evaluation results for credit risk could be biased or discriminatory compared with other quantitative methods based on historic data.

### **Statistical scorecard**

Statistical scorecards are derived from data of thousands of past applicants in the target sector. Statistical techniques vary, but some of the most popular techniques are decision trees, artificial neural networks, and logistic regression. A statistical model can be developed only for products where there is a substantial amount of historical data on both its good and problematic customers (Bekhet & Eletter, 2014).

### **Hybrid scorecard**

Hybrid scorecards are statistically derived models augmented with judgmentally weighted variables. A hybrid scorecard requires extensive historical data but provides flexibility to incorporate new risk factors related to a new product or segment (Yu *et al.*, 2015). It is further stated that Hybrid models that combine several individual model types can effectively exploit the merits of each model and address the drawbacks of others. Therefore, various hybrid models have been developed and introduced to obtain greater prediction accuracy in credit evaluation.

According to Bekhet and Eletter (2014), the choice of an appropriate scorecard is driven by the quality and quantity of data available and the strategy for the segment. If there is little or no historical data, such as when the bank is entering a completely new segment, the only option is a judgmental scorecard. When there is ample historical data, a statistical scorecard is preferable because it can quantify the probability of a “negative credit event”. If there is insufficient data for a statistical scorecard or if the bank has developed a reasonably predictive scorecard but would like to incorporate additional factors related to a new target customer sector, a hybrid scorecard is recommended (Jayagopal, 2004). Moreover, the results of a study conducted by Yu *et al.* (2015) suggest that various hybrid approaches have been developed and have become an increasingly potential tool in evaluating credit scores.

The evolutionary techniques of credit scoring are summarized below (Yu *et al.*, 2015:16):

“With respect to credit scoring, the main goal of various models is to minimize evaluation errors; therefore, various evolutionary optimization techniques can be introduced into AI forecasting models to enhance evaluation accuracy. For example, Desai *et al.* (1997) utilized

genetic algorithms (GA) in an ANN forecasting model for individual credit, and the results showed that the GA-based techniques performed somewhat better than the other methods. In addition to GA, genetic programming (GP) has also been applied. For example, Ong *et al.* (2005) used genetic programming (GP) for individual credit and concluded that GP is superior to benchmarks such as neural networks, decision trees, rough sets, and logistic regression. Huang *et al.* (2006) proposed two-stage genetic programming (2SGP) to manage individual credit scoring problems by incorporating the advantages of if-then rules and the discriminant function. The author found that 2SGP provides superior accuracy compared to other models”.

More recently Metawa *et al.* (2017) proposed an intelligent model based on Genetic Algorithm (GA) to organize bank lending decisions in a highly competing environment with credit crunch constraint.

#### **3.7.4 Validation of scoring models**

Models must be tested for accuracy and reviewed for relevancy. Testing can be performed using data from historical cases (sometimes called “back-testing”), hypothetical cases, or on new applicants in a pilot testing phase. In many cases, some combination of the three approaches is used (Shen *et al.*, 2013; Bekhet & Eletter, 2014).

It is also possible to test a card’s weighting by making up common customer profiles and testing to see if the “good” customers pass and the “undesirable” customers fail. Testing can also be done on data captured from new applicants in a pilot-testing phase, although this approach requires additional time (Altman & Sabato, 2007).

The above provides a general idea on how banks apply credit scoring models. Considering that the focus of the study is on small business lending, possible variables that can be used in the design of a small business credit scoring model will now be further explored.

#### **3.7.5 Small business credit scorecard: variables**

For commercial lending, a combination of qualitative judgment and quantitative measures to evaluate the creditworthiness of an applicant is recommended by Abdou *et al.* (2007). The reason for this is that small business lending decisions are more complex than for retail lending. Credit managers consider a wider range of factors for small business lending, such as the financial capacity of the business to repay the loan, the willingness of the owners to repay the loan, any collateral to be pledged, and the specific terms and conditions of the loan contract. At the same time, the bank does not want the credit manager to spend hours

analyzing small businesses' financial statements to underwrite a small value loan. This is not cost effective and there is an opportunity cost for the credit manager to rather spend this time on larger loan values where the bank receives larger returns.

According to Berger *et al.* (2011), the most appropriate way to underwrite a large book of small-business loans is with a simple scorecard that evaluates a mix of financial and non-financial factors where the financial factors can be taken as independent variables. The findings of a study conducted by Altman *et al.* (2010) confirms that by including non-financial variables as predictors of failure of a small business significantly improves a prediction model's accuracy. This finding is significant considering the limited or lack of financial information by many small businesses. Banks also incorporate macro-economic variables to accommodate the changing circumstances of a borrower (Bellotti & Crook, 2009). Furthermore, it is important that the scorecard is customized to the specific local conditions of the country and the bank (Jayagopal, 2004).

Banks usually have minimum lending criteria, which is the first point of assessment. If the applicant does not meet the minimum criteria at this point, the application is declined without any further assessment. The criteria may include the following (Frame *et al.*, 2001):

- Acceptable value loan to collateral value < 70%.
- Annual turnover 3 times loan value.
- Borrower years in business at least 1 year.
- Current Ratio > 0.5; and
- Total Assets > €100,000.

Using the 5C's of credit, the following variables can be included:

### **Character**

Under this section, data is collected on the business and the owners by accessing credit or public record information (Credit bureau). Examples of the data collected for the business and the owner/s is listed in Table 3-6, followed by a description of the information obtained from the credit bureaus (Bari & Cheema, 2005; Karsh & Abumwais, 2018):

Table 3-6: Character – Variables.

Owners/Members/Directors:	Business:
<ul style="list-style-type: none"> <li>• Personal credit history.</li> <li>• Credit rating.</li> <li>• The residential status of the owner (own or rent place of dwelling).</li> <li>• Soft skills: ambition and drive, innovativeness, communication skills, decision-making abilities.</li> <li>• Intellectual capital.</li> <li>• Level of education.</li> <li>• Experience in the same industry.</li> <li>• Experience in a different industry.</li> <li>• Administrative abilities.</li> <li>• Technical and operational abilities.</li> </ul>	<ul style="list-style-type: none"> <li>• Age of the enterprise (time since the company was created/has been operational).</li> <li>• Industry sector.</li> <li>• Size of the business.</li> <li>• Type of legal entity.</li> <li>• Ownership structure.</li> <li>• Growth prospects.</li> <li>• Years with the bank.</li> <li>• Turnover.</li> <li>• Credit history.</li> <li>• Number of missed payments.</li> <li>• Credit rating.</li> </ul>

Source: Authors own compilation

#### Public record information (credit bureau):

The four consumer credit bureaus in South Africa; TransUnion ITC, Experian, CompuScan, and XDS collect credit information when credit data on consumers exist. Information is reported by banks and providers of retail credit, where retail credit accounts constitute approximately 90% of trade line data in South African files (Turner *et al.*, 2008).

The commercial credit reporting market is dominated by two bureaus: KreditInform and TransUnion ITC. Each bureau reports company profiles on more than two million businesses. Many of these are historical data. The two bureaus also each have credit reports on approximately 500 000 to 600 000 businesses. One of the bureaus reports 280 000 credit-active businesses in these files, while the other reports 600 000, or combined between 10% and 21% of the estimated number of active businesses in South Africa (Turner *et al.*, 2008).

The credit bureau information shows the business's payment performance history with other lenders and suppliers. According to Berger and Frame (2007), research has shown that in very small and newly established businesses, the future credit performance of the business is strongly reflected by the past credit performance of its owners. This is also true for existing businesses, where Samreen and Zaidi (2012) confirm that the most important factor to predict future default is the credit history of the business. Based on this, for existing businesses where

the credit performance information is available, the business credit history can be combined with the owner’s credit information which could add significant value to the credit risk assessment (Gupton, 2005). The business demographic information and the owners and management information which can be considered in a scorecard are included below.

As previously identified, the information can be obtained from bank application forms, bank statements and also by asking the owners to complete a specifically designed questionnaire to obtain information on the non-tangible characteristics of the owners. Furthermore, the bank official interviewing the business owner and visiting the business can rate the owners and management of the business in certain aspects to be included in a scorecard to contribute towards the final score of the applicant. Information can also be sourced by interviewing the key personnel of the business (applicant), customers of the business, speaking to members of the neighboring businesses, and information provided by suppliers of the applicant (Harif *et al.*, 2011). Chen and Cheng (2013) confirm that by including the qualitative data (soft information) this significantly improves the power of default prediction models, which improves the estimation of expected loan loss.

### Capacity

Under capacity, the financial data is obtained to determine the businesses liquidity position and profitability. The financial data includes the current assets, current liabilities, total assets and liabilities, working capital, revenue, profit and net worth (Berger & Frame, 2007). The projected earning potential of the business is usually assessed and rated by the credit analyst to include in the scorecard based on the guidelines provided in Table 3-7 below.

Table 3-7: Projected earning potential

<b>Guidelines: Projected earning potential</b>
<ul style="list-style-type: none"> <li>• Cash flow projection is accurate and realistic.</li> <li>• Forecasted earnings can meet the loan payments.</li> <li>• Future expansion can be financed through the projected earnings.</li> <li>• The expected growth rate is realistic.</li> </ul>

Source: Karsh & Abumwais (2018)

For existing businesses which can provide financial statements, the following ratios can be calculated by the system and compared to industry norms. The financial ratios in Table 3-8 below were selected due to usage, appeal to researchers, and general acceptability and prediction power according to various authors (Farrell *et al.*, 2011; Harif *et al.*, 2011; Samreen & Zaidi, 2012):

Table 3-8: Financial ratios

<b>FINANCIAL RATIOS</b>
<b>Liquidity ratios</b>
<ul style="list-style-type: none"> <li>• Current Ratio: Total current assets / Total current liabilities.</li> <li>• Quick Ratio: (Current Assets - Inventory) / Current liabilities.</li> <li>• Working Capital to Total Assets Ratio: (Net Working Capital / Net Total Assets) x 100.</li> </ul>
<b>Profitability ratios</b>
<ul style="list-style-type: none"> <li>• Gross Profit Margin: Gross income / Sales.</li> <li>• Operating Income Margin: Operating income / Sales.</li> <li>• Net Profit Margin: Net Income / Sales.</li> <li>• Retained earnings / Total assets.</li> <li>• Earnings before interest and taxes / Total assets.</li> <li>• Return on Assets (ROA): Net Income / Total assets.</li> <li>• Return on Equity (ROE): Net Income / Shareholder's Equity.</li> <li>• Sales growth (in the past 2 years): (Current Year's sales - Last Year's sales) / (Last Year's sales) * 100.</li> </ul>
<b>Financial leverage ratios</b>
<ul style="list-style-type: none"> <li>• Debt to Equity Ratio: Total Debt / Total Equity.</li> <li>• Total Debt to Assets: Total Debt / Total Assets.</li> </ul>
<b>Coverage ratios</b>
<ul style="list-style-type: none"> <li>• Interest Coverage Ratio: EBIT / Interest.</li> <li>• Debt Service Coverage Ratio: (Net Income + Finance Cost. + Depreciation) / (Repayments of long term loans + Finance Cost).</li> <li>• Debt leverage: Total Liabilities / EBITDA.</li> </ul>
<b>Activity/efficiency ratios</b>
<ul style="list-style-type: none"> <li>• Receivable turnover: Days Sales / (Accounts Receivable/365).</li> <li>• Day's sales in inventory: Inventory / (Cost of goods sold/365).</li> <li>• Payable turnover: Days Sales / (Accounts Payable/365).</li> <li>• Asset turnover ratio: Net sales / Average total assets.</li> <li>• Loan size as % of Sales.</li> <li>• Estimated annual sales of the business. The 'sales to employee' ratio would indicate whether there is insufficient staffing capacity, or overstaffing, depending on the type of business.</li> </ul>

<b>FINANCIAL RATIOS</b>
<b>Market ratios</b>
<ul style="list-style-type: none"> <li>• Earnings Per Share (EPS): <math>\text{Net Income} / \text{number of shares outstanding}</math>.</li> <li>• Price Earnings (PE): <math>\text{Ratio Market price per share} / \text{EPS}</math>.</li> </ul>
<b>Solvency ratios</b>
<ul style="list-style-type: none"> <li>• Market debt ratio: <math>\text{Total liabilities} / \text{Total liabilities} + \text{Market value of equity}</math>.</li> </ul>

Source: Authors own compilation.

The above provides an insight into the ratios which can be used to determine the creditworthiness of a small business. Samreen and Zaidi (2012) went one step further and based on questionnaires and interviews with credit managers and using statistical methods such as factor analysis, determined which ratios/variables can be considered more important and less important when determining the creditworthiness of a potential borrower. These are reflected in Table 3-9.

Table 3-9: Most important and least important predictors of default

<b>Most important predictors of default</b>	<b>Least important predictors of default</b>
<ul style="list-style-type: none"> <li>• Credit rating.</li> <li>• Credit history.</li> <li>• Current ratio.</li> <li>• Quick ratio.</li> <li>• Operating income margin.</li> <li>• Gross profit margin.</li> <li>• Net margin.</li> <li>• Return on assets (ROA).</li> <li>• Return on equity (ROE).</li> </ul>	<ul style="list-style-type: none"> <li>• Dividend per share ratio.</li> <li>• Market to book ratio.</li> <li>• Fixed asset turnover.</li> <li>• Capitalization ratio.</li> <li>• Current asset turnover.</li> <li>• Book value per share.</li> <li>• Dividend payout ratio.</li> <li>• Total asset turnover.</li> </ul>

Source: Samreen & Zaidi (2012)

The above provided an insight on the ratios that can be considered under “Capacity”, below the variables to be considered under the remaining 5C’s of credit will be reviewed.

### **Capital**

Table 3-10: Capital – Variables

<b>Capital – Variables</b>
<ul style="list-style-type: none"> <li>• Owner’s contribution to financing.</li> </ul>

<b>Capital – Variables</b>
<ul style="list-style-type: none"> <li>• Average bank account turnover/Turnover from Income Statement.</li> <li>• Average bank account balance.</li> <li>• Debt-Equity Ratio: Long-term debt/Owners equity.</li> </ul>

Source: Brown & Moles (2014)

### **Collateral**

Table 3-11: Collateral – Variables

<b>Collateral – Variables</b>
<ul style="list-style-type: none"> <li>• Loan to value ratio.</li> <li>• Sufficient collateral is offered.</li> <li>• Type of collateral.</li> <li>• Any additional guarantees.</li> <li>• The proportion of the business financed by the owner/manager.</li> </ul>

Source: Golam *et al.*, (2010)

### **Conditions**

The variables to be considered under 'conditions,' are included in Table 3-12.

Table 3-12: Conditions – Variables

<b>Conditions – Variables</b>
<ul style="list-style-type: none"> <li>• Type of finance, amount applied for, and term.</li> <li>• Sector risk – the current health of the sector.</li> <li>• Key buyer/supplier dependencies.</li> <li>• Strength of competition.</li> <li>• The market for this product/service is developed/growing or undeveloped/stagnant.</li> <li>• The existing competition who supply a similar product/service is: plentiful/limited.</li> <li>• Suppliers are: closely situated and plentiful.</li> <li>• The distribution system for the product/service is clearly defined.</li> <li>• Nature of product/service is marketable or undetermined.</li> <li>• The general economic trend at the time is conducive to the product/service marketability.</li> </ul>

Source: Mandala *et al.*, (2012)

It is important to note that for determining the conditions which may impact on a business requires experts to accurately derive and weigh each variable appropriately (Hahm & Lee,

2011). The scorecard for commercial lending is arguably far more complex than for consumer lending considering all the variables to be considered. An example of variables used for consumer lending is listed in Table 3-13 (Hahm & Lee, 2011; Shen *et al.*, 2013; Annappindi, 2014; Karsh & Abumwais, 2018):

Table 3-13: Variables: Individual lending credit scoring model

<b>Variables: Individual lending credit scoring model</b>
<ul style="list-style-type: none"> <li>• Applicants' age.</li> <li>• Gender: male/female.</li> <li>• Marital status.</li> <li>• Total monthly income.</li> <li>• Employer: applicant works in a credible company or not.</li> <li>• Guarantor: the existence of an alternative source of repayment if required.</li> <li>• The highest level of education, education discipline/concentration, year attained, educational institution.</li> <li>• Residency: years at current address, own/rent status.</li> <li>• Loan amount.</li> <li>• Loan purpose: car, housing, personal commitments, education, marriage, and so on.</li> <li>• Period with current employer.</li> <li>• Job experience with the current employer.</li> <li>• Resident/non – resident.</li> <li>• Duration since the first opening of a credit account.</li> <li>• Duration since the most recent opening of a credit account.</li> <li>• The total amount of bank loans.</li> <li>• No. of banks borrowed from (recent 2 years).</li> <li>• No. of credit guarantees.</li> <li>• No. of arrears and delinquencies.</li> <li>• Duration since the most recent arrear.</li> <li>• No. of days in the longest arrear.</li> <li>• Highest amount in current arrears.</li> <li>• No. of days in the longest arrear within recent 2 years.</li> <li>• No. of current loan arrears.</li> <li>• No. of credit inquiries.</li> <li>• Date of the most recent credit enquiry.</li> <li>• No. of loans.</li> </ul>

#### Variables: Individual lending credit scoring model

- No. of days since credit card opening.
- Utilization rate in bank loan commitment.
- Amount of the largest loan.
- Utilization rate in card loan commitment (preceding 12 months).
- Debt payment ratio (total debt/total income).
- Debt ratio (debt/available debt).
- Duration of credit.

Source: Authors own compilation

It is important to note that in South Africa, the NCA regulation does not allow for any unfair discrimination in the scorecards. Irrespective of what type of model, it is clear that it is not a simple procedure to develop a model. Sufficient and quality data is needed, together with the expert knowledge to implement. Other than continuous testing, it is also important to apply the most relevant variables. It is also important to custom make models for a relevant bank. According to Beck *et al.* (2008) a 'cut and paste' of a competitors credit scoring model will not work. The motivation is that a powerful scoring model is highly personalized to a given bank – it should take into account the organizations' tacit knowledge, brand perception, customer base, product lines, and history.

Due to the specialist nature of this field, it can be assumed that there must be many challenges faced by the banks to grant credit to small businesses (Beck *et al.*, 2008). This aspect will be further explored.

### 3.8 Challenges for banks

Before delving into what the bankers perceive as challenges, it is important to look at worldwide macro-economic factors that influence access to credit to small businesses by banks. One that is widely known is the impact of the Great Recession.

#### 3.8.1 Impact of the recession on small business lending

According to Duygan-Bump *et al.* (2015), the great recession (global financial and economic crisis during 2008) and the ensuing credit crunch severely restricted the ability of well-run small businesses to gain access to capital. The impact is that even in the current economic environment, successful businesses that would otherwise have access to credit are being turned away because banks are fearful of making any loans to small businesses.

Wiersch and Scott (2013) agree that small business lending has dropped substantially since the recession. While the crisis may not have impacted the South African banking sector as deeply as in the United States of America (USA) and Europe, banks in South Africa experienced a drop in earnings and some stress. However, according to Job (2013), the Minister of Economic Development, Ebrahim Patel stated that the tighter lending criteria adopted by mainstream lenders in South Africa in the wake of the recession had a negative impact on SMMEs and an overall reduction in credit extension over a period. For example, growth in credit extension during 2011 was the lowest in over 50 years (Job, 2013). It was a concern by policymakers that since the recession businesses are not getting the credit needed. Different views have emerged about the reasons for the scarcity of small business credit since the recession. Bankers say that the main reason small business lending is lower now than before the great recession is that demand has fallen. Bankers say the problem rests with small business owners and regulators. Banks argue that there is a drop in business expansion due to the drop in demand for products and services which reduces the demand for credit (Wiersch & Scott, 2013).

An analysis of data from the Federal Reserve Survey of Consumer Finances revealed that the income of the typical household headed by a self-employed person declined by 19% (in real terms) between 2007 and 2010 (Wiersch & Shane, 2013). Similarly, Census Bureau figures indicated that the typical self-employed household saw a 17% drop in real earnings over a similar period. Effectively lower earnings and sales mean that fewer small businesses are seeking to grow. Reduced small business growth translates into subdued loan demand. In support of this, the National Federation of Independent Businesses (NFIB) reported that businesses who borrowed once every three months fell from 35% to 29% between June 2007 and June 2013 (Wiersch & Shane, 2013).

On the other hand, the Wells Fargo/Gallup Small Business Index survey, in the second quarter of 2007, reported that 13% of small business owners expected that credit would be difficult to get in the next 12 months. By the second quarter of 2013, the figure had increased to 36%. By contrast, 58% of small business owners said credit would be easy to get during the next 12 months when asked in 2007, compared to 24 % six years later (Mills & McCarthy, 2014). Based on this, it can be argued that the drop in demand could also be influenced by the perception of the small business owners that credit may not be readily available (Wiersch & Shane, 2013).

In addition to this, the banks advise that the regulators are compelling the banks to tighten lending standards which are adding to the reason for the decline in credit to small businesses.

Tighter credit policies reduce the number of creditworthy small business owners (Wiersch & Shane, 2013).

According to the latest Wells Fargo/Gallup Small Business Index, 65% of small business owners said their cash flow was "good" in the second quarter of 2007, compared to only 48% in the second quarter of 2013 (Wiersch & Shane, 2013). The Federal Reserve's Survey of Small Business Finances also indicated that small business credit scores are lower now than before the Great Recession.

To make matters worse, the decline in value of both commercial and residential properties since the end of the housing boom has made it difficult for businesses to meet bank collateral requirements according to the banks. Small business owners, in turn, say the problem rests with bankers and regulators. Bankers for increasing collateral requirements and reducing the focus on small business credit markets, and regulators for making loans more difficult to obtain (Wiersch & Shane, 2013).

While bankers, small business owners, and regulators all point to different sources for the drop in small business credit, Wiersch and Shane (2013) state that a careful analysis of the data suggests that a multitude of factors explain this decline in credit, however, these factors must not be seen as the sole cause of the decline in small business credit. The results revealed that fewer small businesses are interested in borrowing than in past years, and at the same time, small business financials have remained weak, reducing small business loan approval rates. In addition, collateral values stayed low, as real estate prices declined, limiting the amount that small business owners can borrow.

Furthermore, increased regulatory scrutiny has caused banks to tighten lending standards, lowering the number of creditworthy borrowers. Finally, shifts in the banking industry also had an impact. Bank consolidation reduced the number of banks focusing on the small business sector, and small business lending has become relatively less profitable than other types of lending, reducing bankers' interest in the small business credit market (Cornett *et al.*, 2011).

Considering these varying factors impacting on the decline in small business credit, Wiersch and Shane (2013) propose that all the possible multiple factors affecting small business credit must be researched and taken into consideration. In order to further research the challenges for small business credit, the 5C's of credit framework will be used as a guideline. The most common challenges faced by credit managers when assessing credit applications for small businesses will now be further explored.

### 3.8.2 Challenges for credit managers when assessing small business credit applications

The challenges faced by credit managers based on the views of various publications/authors (Ahmad & Seet, 2009; Buma *et al.*, 2010:35; USAID, 2010; Harif *et al.*, 2011) are summarized and categorized under the headings of the framework of the 5C's of credit for consistency in Table 3-14:

Table 3-14: Challenges for credit managers when assessing small business credit applications

<b>Character (owners)</b>
<ul style="list-style-type: none"> <li>• Lack of knowledge in working capital management.</li> <li>• Lack of knowledge in accounting.</li> <li>• Insufficient experience in the current field of business.</li> <li>• Insufficient management skills to ensure the viability of the business.</li> <li>• Owner operates the business on his/her own.</li> <li>• Inability to explain financial problems professionally.</li> </ul>
<b>Capacity</b>
<ul style="list-style-type: none"> <li>• Insufficient or incomplete information on the credit application given to the bank.</li> <li>• No formal financial statements or proof of income.</li> <li>• Opaque and unaudited financial statements.</li> <li>• None or limited credit histories with commercial banks.</li> <li>• No proper business plan.</li> <li>• A high debt-to-equity ratio.</li> <li>• Over indebtedness.</li> <li>• No other source of income to support the application.</li> </ul>
<b>Condition</b>
<ul style="list-style-type: none"> <li>• There is no way of knowing that the funds will be applied for the purpose that the credit was granted.</li> <li>• Macro-economic factors: competition; macro instability; high interest rates; exchange rate risk.</li> </ul>
<b>Capital</b>
<ul style="list-style-type: none"> <li>• Insufficient personal financial contribution as compared to the loan requested.</li> </ul>

### Collateral

- Lack of adequate collateral (in the form of immovable property or valuable movables) that banks require as security in the event of default.

Source: Authors own compilation

According to Buma *et al.* (2010:35) banks are not equipped with the necessary skills to assist entrepreneurs, and do not have a well-defined measure of small business risk. One could ask the question then, on how it can be improved if it is not measured. Furthermore, uncertainty when considering a small business credit application for approval could lead to the bank requesting more information on the business in the hope of providing more comfort on the likelihood of the repayment of the credit amount applied for. However, as identified above, it can be particularly challenging to collect information about small businesses, more so for start-ups, due to unavailable/unreliable financial information and limited/no credit history (Berger & Udell, 2005).

This position creates uncertainty for the bank on the credit risk of an applicant as the lack of credible information makes it difficult for the bank to determine the competence and commitment of the entrepreneur and the prospects for the business (Parker, 2002).

Furthermore, the applicant (small business) will always have a better understanding of their actual financial position, the detail of the investment project, and the intention to pay back the debt, than the bank. This results in information asymmetry as the small business has the higher ranking exclusive information (asymmetric information), leaving the credit managers to make decisions based on imperfect information (Maziku, 2012).

According to Bergh *et al.* (2018), information asymmetry takes place when one side to the lending transaction has more and/or better-detailed information than the other side. Asymmetric information hence creates problems for the bank before concluding a credit transaction (adverse selection) and after the transaction has been closed (moral hazard) (Berndt & Gupta, 2009).

Adverse selection occurs as it is difficult for credit managers to differentiate between high-risk and low-risk borrowers due to the lack of credible information to base decisions on (Stiglitz & Weiss, 1981). Due to this uncertainty, banks normally charge higher interest rates to small businesses overall to compensate for the increased risk due to the inability to determine which applicants to grant credit to. The low-risk borrowers are hence penalized at the expense of the high-risk borrowers (Maziku, 2012). Moreover, the high interest rates discourage low-risk small businesses from applying for credit and encourage the more risky businesses to apply for

more credit. As the businesses know their financial position more than the bank, the riskier businesses are normally aware that based on their high-risk profile they should be paying higher interest rates (Beck *et al.*, 2018). Consequently, the banks normally end up with a high-risk small business credit portfolio (Berndt & Gupta, 2009).

Effectively adverse selection occurs when bad credit risks (businesses which have poor investment channels and high interest risks) become more probable to acquire credit than good credit risks (businesses with better investment opportunities and less inherent risks) (Mason & Stark, 2004).

Moral hazard occurs after the credit has been disbursed to the borrower and it arises in situations when the borrower, for example, breaches the credit agreement covenants by applying the funds in immoral projects. Information asymmetry once again in this instance resulted in moral hazard due to the bank's lack of knowledge of the borrower's activities. Moral hazard also occurs due to the high cost to the bank to enforce the covenants of the credit agreement, which gives the borrower more leeway to invest in high risk and immoral projects (Berndt & Gupta, 2009).

Furthermore, loan cost is one of the most critical risk dimensions for banks. If the loan cost is high relative to the potential interest revenue to be earned, it may not be worthwhile for the bank to grant that specific loan. Small business loans are considered less profitable than the larger loans as they are considered by banks to be more banker-time intensive, are more difficult to automate, have higher costs to underwrite and service, and are more difficult to securitize and collect on (Minnis & Sutherland, 2017).

As most loan costs are fixed, the net profit on small business loans relative to the size of the loan is lower than that for larger businesses which can spread the fixed costs over more Rand value. The transaction cost per Rand lent is therefore much higher for small loans than for larger loans (Turner *et al.*, 2008).

The limited information on customers further drives up the cost of collections. Moreover, the bank may not be able to collect at all where the defaulting customer cannot be found or traced. Another aspect to consider is the increased competition faced by banks as there are many large retailers which now provide credit, making the pool of customers smaller for banks. In order to optimize more on profits, banks are moving toward bigger, more profitable loans with a result of a decline in small business loans (Minnis & Sutherland, 2017).

Considering that banks do not have a well-defined measure of small business risk, it appears a size bias causes both higher rates and more covenants to be levied against the smaller

businesses (Turner *et al.*, 2008). It is a concern that small businesses may be paying interest rate premiums that are not fully warranted by extra risk (Jones, 2005:46). The other challenge identified by Kim *et al.* (2006) is that banks are not well placed to cater to the needs of start-ups and small businesses.

Turner *et al.* (2008) state that countries are beginning to use non-financial payment data such as utility bills and telecom payments when standard credit information is unavailable. However, such information is rarely collected in South Africa. Turner *et al.* (2008) argue that collecting more trade credit data from the informal sector could greatly expand access to credit for small businesses.

The above provided a background on the challenges faced by credit managers when assessing small business credit applications. One could derive that the challenges mentioned above could be similar to the reasons for the decline of small business credit applications. The reasons for the decline of small business applications will be further explored.

### 3.9 Reasons for the decline of credit applications

The prominent reasons for the decline of small business applications are summarized in Table 3-15 based on the feedback provided by credit managers during various studies conducted and reported on by various authors (Krog, 2008; Fatoki & Odeyemi, 2010; Harif *et al.*, 2011; Cameron & Hoque, 2016):

Table 3-15: Prominent reasons for the decline of small business credit applications

<b>Prominent reasons for the decline of small business credit applications</b>
<ul style="list-style-type: none"> <li>• Lack of passion by the owner for the business.</li> <li>• Owner lacks business management and financial skills.</li> <li>• Insufficient experience by owners in the business industry.</li> <li>• Poor management.</li> <li>• Poor financial statements.</li> <li>• Poor business plans.</li> <li>• Unsatisfactory conduct of current account.</li> <li>• Lack of repayment ability.</li> <li>• Unsatisfactory history on an existing or previous loan.</li> <li>• Unsatisfactory history on a government obligation, such as taxes.</li> <li>• Unsatisfactory debt repayment history/blacklisted.</li> <li>• Business activity not eligible.</li> </ul>

<b>Prominent reasons for the decline of small business credit applications</b>
<ul style="list-style-type: none"><li>• Refusal or unable to pledge collateral.</li><li>• Outstanding judgments.</li><li>• High-risk industry.</li></ul>



Source: Authors own compilation

### **3.10 Conclusion**

Based on the objectives of this chapter, the focus was first to gauge how banks typically grant credit to small businesses. From the literature review, the steps followed from customer (small business) application for credit, to when the credit decision is made were covered in detail.

During the assessment process, the banks follow the traditional 5C's of credit lending principles to provide guidance to the credit managers, and to ensure some form of uniformity. It was concluded that the credit application requirements are plenty and complex, and the assessment process is very technical and requires vast experience and skill by the credit manager.

The second objective of this chapter was to identify the challenges faced by banks when lending to small businesses. Considering the literature review, it appears that not only the South African banks but banks globally experience challenges when lending to small businesses. Furthermore, the challenges identified are very similar.

Some of the prominent challenges identified were that it is difficult to do a proper credit risk assessment due to the limited or unreliable financial information available for small businesses, and insufficient credit history, more so for start-ups. The owners of the business also lacked certain competencies which were considered a requirement to operate a business such as financial management skills, and experience in the industry in which the business operates. This position creates uncertainty for the bank on the credit risk of an applicant as the lack of credible information makes it difficult for the bank to determine the competence and commitment of the owner, and the prospects for the business. The other prominent challenge was the lack of available collateral security.

## **CHAPTER 4:**

# **INFLUENCE OF REGULATION AND GOVERNMENT INITIATIVES ON SMALL BUSINESS LENDING**

### **4.1 Introduction**

The focus of this chapter is to gain an understanding of the Government influence on small business lending, specifically through regulation and government initiatives aimed at small business lending. Considering the limitations of this study due to limited time and resources, it would not be practical to cover all the Government initiatives which may influence small business lending, either via government interventions or due to legislation. The focus of this study will, therefore, be on the legislation and government intervention which arguably according to the 80/20 principle may have the biggest influence on access to credit for small businesses in South Africa. Based on this argument, the Khula Credit Guarantee Scheme and the National Credit Act (NCA) will be further researched and form the basis for this chapter.

### **4.2 Evolution of government initiatives in support of SMMEs**

The government in South Africa has been very active in putting programmes in place in support of SMMEs in South Africa. Specifically, after South Africa's first democratic election in 1994, a number of Government institutions were established to provide support to small businesses in South Africa. In 1995, the White Paper on the promotion of SMMEs was developed. It emphasized the government's need to create a conducive environment for SMME access to information, procurement opportunities, markets, business infrastructure, and credit. However, Berry *et al.* (2002) stated that the Paper seldom addressed the needs of SMMEs and this resulted in increased unemployment and poor economic growth.

Due to increased pressure by government to review its SMME Policy, the Department of Trade and Industry (DTI) released the Integrated Small Enterprise Development Strategy (DTI, 2008:26). The strategies focus is on increasing the supply of financial and non-financial support services; creating a demand for small enterprise products and services' and reducing small business regulatory constraints.

Several institutions have since been established. These include, amongst others, the following institutions (The DTI, 2008; Molapo, Mears & Viljoen, 2008:28; GEM, 2014; SEDA, 2016):

- Umsobomvu Youth Fund (now the National Youth Development Agency (NYDA)) was formed with the purpose of assisting young South Africans between the ages of 14 and 35 years to start businesses and to finance existing businesses.
- Ntsika Enterprise Promotion Agency (now incorporated into the Small Business Development Agency (SEDA)). The aim of SEDA is to execute the National Small Business Strategy. In addition, to design and implement a standard and common national delivery network for small enterprise development, and integrate government-funded small enterprise support agencies across all tiers of government.
- The Small Enterprise Finance Agency (SEFA) was merged with the South African Microfinance Apex Fund (SAMAF) and Khula Enterprise Finance Limited, to cater for small businesses requiring funding up to a limit of R3 million. SEFA offers bridging finance, revolving loans, term loans, asset finance and funds for working capital needs.
- The Department of Science and Technology established the Technology and Innovation Agency (TIA) in order to enable and support technological innovation, as well as to enhance the global competitiveness of South African businesses.
- The National Empowerment Fund (NEF) was founded with the intention of offering financial and non-financial support to black empowered businesses; and
- Other Department of Trade and Industry (DTI) Institutions and the Provincial Desks.

Literature, however, alludes that the above initiatives by the government aimed at creating an enabling environment for SMME access to credit have not been effective in achieving their intended results (Van Scheers & Radipere, 2008; Ayandibu & Houghton, 2017). Some of the major deficiencies of the Government programmes aimed at SMME development according to various authors are summarised in Table 4-1 (Monkman 2003:4; Van Scheers & Radipere, 2008; Gstraunthaler & Cramer, 2012; Ayandibu & Houghton, 2017):

Table 4-1: Government programme challenges

<b>GOVERNMENT PROGRAMME CHALLENGES</b>
<ul style="list-style-type: none"> <li>• There are gaps between what the businesses' needs are and the types of services offered by the Government.</li> <li>• Programmes do not develop entrepreneurial culture.</li> <li>• There is a tendency to focus on potentially viable businesses.</li> <li>• There is a tendency to serve larger and medium businesses more than smaller ones.</li> </ul>

- There is a low usage of the Department of Trade and Industry and Agency Programmes.
- There are cumbersome administration procedures.
- There is no “after support”.

Source: Authors own compilation

Beck *et al.* (2005) emphasize that the impact of Government interventions on small business lending cannot be underestimated, especially since the 2008 Global financial crises. If one considers the spike in the number of defaults of the bank’s credit portfolio, and considering that the minimum capital requirements are a regulation that banks must abide by, this is directly influenced by the number of defaults expected by banks. According to Beck *et al.* (2005), country studies found that capital requirements can bias against small business lending, as small business loans are considered riskier than loans for large businesses.

Furthermore, the government has put in place legislation which financial institutions must adhere to before they are able to approve a credit application. Such legislation includes, amongst others; the Financial Advisory Intermediary Service Act (FAIS); Code of Banking Practice; Know your customer (KYC); Exchange Control for foreign national and non-residents; the Financial Intelligence Centre (FIC) Act, 2001; and the National Credit Act (NCA). The FIC Act requires institutions to educate their employees to identify suspicious transactions and money laundering, and to report it to the Financial Intelligence Centre (FIC) (Van Wyk, 2006; Krog, 2008). The NCA has had a major influence on credit lending overall in South Africa. The NCA will now be further explored.

In order to identify the influence of the NCA on small business lending, it is important to begin with an understanding of the NCA and why and how it came about. The literature study will, therefore, go back into the history of legislation governing lending practices to banks to obtain the background.

### **4.3 History of microfinance regulation**

Since the late 1960s, the regulatory framework for the microfinance sector was provided by the Usury Act and two exemptions to the Act introduced in 1992 and 1999. The Usury Act introduced in 1968 prescribed interest rate ceilings for loans, irrespective of the purpose. It was an offense to charge interest in excess of the stipulated ceiling. The aim of the statute was to protect individuals from credit providers that charged excessive interest rates (Aregbeshola, 2014). For larger financial institutions this posed a challenge in that the maximum interest rate cap did not allow for profitable lending of smaller loans, considering the transaction costs for the banks to provide smaller loans (Buma *et al.*, 2010:36).

It was previously argued in the previous chapter that it costs the same, if not more, for a bank to provide a small loan than a larger loan, where the revenue earned is far higher on a larger size loan (Turner *et al.*, 2008). The effect of this interest rate cap inhibited the provision of small loans by banks, as banks did not have any incentive to do so. As a result, the Minister in 1992 granted an exemption to the interest limitation set in terms of the Usury Act. The exemption applied to microloans defined (at that stage), as loans of less than R6000 granted for periods shorter than 36 months (Buma *et al.*, 2010:36). Effectively this meant that credit providers could charge unlimited interest for loans less than R6000 (Chakabva, 2015).

The intention was to promote the access of loans to small businesses that could not provide collateral security. Micro-loans are generally perceived as high-risk credit agreements, but the high rate of interest which could be charged would encourage lending, as the risk is reduced for the credit provider (Turner *et al.*, 2008). This exemption to the interest limitation was, however, not limited to loans for business development as intended. For example, loans could be used for any purpose such as consumption spending and purchasing of furniture. As a result, furniture retailers and the micro-lending industry dominated the market, lending mainly to salaried workers (Chakabva, 2015). This, however, defeated the objective of SMME development.

This situation was exacerbated when the state granted credit providers with access codes to allow credit providers to deduct installments directly from the salaries of government employees, and at a later stage from large private sector employees' salaries (James, 2012). This assisted to reduce the risk of lending and reduced the collection costs, and as a result, there was a boost in unsecured lending to salaried workers (Buma *et al.*, 2010:38). This, in turn, created controversy, resulting in the exemption ceiling on loans raised to R10 000 in 1999, but with conditions (Chakabva, 2015).

To ensure compliance, the Microfinance Regulatory Council (MFRC) was appointed as the regulatory body. This appointment resulted in the formalization of the microfinance industry in South Africa (Mashigo, 2012:34). Credit providers providing microloans had to register with the MFRC and comply with its rules (Buma *et al.*, 2010:38). In addition, it had to maintain the National Loans Register, the purpose of which was to record all transactions by micro-lenders. At this stage, there was broad consensus that the focus of regulating microcredit had shifted from SMME promotion to the protection of borrowers from credit lenders exploitative practices, such as the over-extension of credit and illegal collection methods (Goodwin-Groen & Kelly-Louw, 2006).

The focus therefore arguably changed from SMME development to the protection of borrowers. It is during this period that Government then introduced Khula Enterprise Finance Limited. The objective of Khula was to provide wholesale credit to financial institutions that would on-lend this money exclusively to SMMEs. The Khula Credit Guarantee Scheme offered to the banks will be elaborated on further in the Chapter.

The commercial banks' reaction to the exemption was to be initially reluctant to enter the microloan market, but gradually changed policies, and either opened separate microloan divisions or entered partnerships with, and acquired shares in existing commercial micro-lenders. Since then the major banks have disbursed loans worth billions of Rand through micro-loan divisions or subsidiaries, but the majority of these loans have been advanced to low-income salaried workers for consumption purposes (James, 2012).

The general consensus is that the exemptions made microloans more lucrative and increased consumption purpose microlending, but did not significantly increase access to credit for SMMEs (Coetzee, 2009; Buma *et al.*, 2010:40). While a number of Non-Governmental Organizations (NGOs) entered into the industry to provide microloans to small businesses under the exemptions, the NGOs constituted a tiny part of the industry. Loans were restricted to below R10, 000 in order to benefit from the exemption and achieve full cost recovery by charging higher interest rates. This limit on loan size did not allow for the growth of businesses at the critical stages where working capital was required to expand the business. In the period 2004 to 2005, only 4% of the R17 billion worth of microloans disbursed had been used to finance small businesses (Buma *et al.*, 2010:40).

Regulating the sector and providing a platform for the development of SMMEs was the objective, however, it became increasingly evident to policy makers and stakeholders in the 1990s that a new regulatory framework was needed. Governments' response was the National Credit Act (NCA) which was promulgated during 2005 and came into effect on the 1st June 2006 (Krog, 2008). The Act was enacted to address the social and economic inadequacies perpetuated by the apartheid regime, especially through imbalances in the process of awarding credit to consumers and the costs attached thereto (James, 2012).

#### **4.4 The National Credit Act**

The National Credit Act (NCA) will now be further explored. It is important to note that although the objective is to determine the influence of the NCA on small business lending, it is difficult to isolate only those sections which pertain to small business lending. A holistic view is to be

explored in order to determine the areas which may influence specifically small business lending.

#### **4.4.1 Definition of the NCA**

The Government Gazette (2006:2) defines the National Credit Act as promoting a fair and non-discriminatory marketplace for access to consumer credit and for that purpose to provide for the general regulation of consumer credit and improved standards for consumer information; to promote black economic empowerment and ownership within the consumer credit industry; to prohibit certain unfair credit and credit-marketing practices; to promote responsible credit granting and use and for that purpose to prohibit reckless credit granting; to provide for debt re-organisation in cases of over-indebtedness; to regulate credit information; to provide for registration of credit bureau, credit providers and debt counselling services; to establish national norms and standards relating to consumer credit; to establish the National Credit Regulator and the National Consumer Tribunal; to repeal the Usury Act, 1968, and the Credit Agreements Act, 1980; and to provide for related incidental matters. Debt counselors assist consumers in servicing their debts. This is a preliminary step before asking a court to enforce repayment of loans (StovinBradford & Shevel, 2007:15).

One of the prominent aims of the NCA is to promote a fair and non-discriminatory marketplace when applying for credit. The Act does this by granting every person the right to apply for credit (S 60 (1), National Credit Act, 2005), and that credit may only be refused on reasonable commercial grounds (S 60 (2), National Credit Act, 2005). The Act does not establish a right to require a credit provider to enter into a credit agreement, but merely that no discrimination takes place in the provision of credit (S 60 (3), National Credit Act, 2005). This prohibition on discrimination must, according to the Act, be read with the objects and purport of the Constitution (S 9 (3) of Constitution of the Republic of South Africa, 1996, which prohibits discrimination based upon 'race, gender, sex, pregnancy, marital status, ethnic or social origin, colour, sexual orientation, age, disability, religion, conscience, belief, culture, language and birth'), and with the provisions of the Promotion of Equality and Prevention of Unfair Discrimination Act. The relevant provisions are contained in Chapter 2 of the Act (Chapter 2, Promotion of Equality and Prevention of Unfair Discrimination Act, 2000, which deals with the 'Prevention, Prohibition and Elimination of Unfair Discrimination, Hate Speech and Harassment', and within Chapter 2, by s 6, which is a 'Prevention and general prohibition of unfair discrimination'; s 7, which is a 'Prohibition of unfair discrimination on ground of race'; s 8, which is a 'Prohibition of unfair discrimination on ground of gender'; s 9, which is a 'Prohibition of unfair discrimination on ground of disability'; s 11, which is a 'Prohibition of

harassment'; and s 12, which is a 'Prohibition of dissemination and publication of unfair discriminatory information that unfairly discriminates') (Schmulow, 2016).

These prohibitions against unfair and discriminatory treatment under s 61 (1) (National Credit Act, 2005) extend to and include: assessing the consumer's credit worthiness S (1)(a); acceding to an application for credit S (1)(b); any aspect of the costs involved S (1)(c); any of the terms or conditions S (1)(d); assessing or requiring compliance with any aspect of a credit agreement S (1)(e); exercising any of the credit provider's rights S (1)(f); 'determining whether to continue, enforce, seek judgment in respect of, or terminate a credit agreement' S (1)(g); or reporting any consumer's record, S (1)(h) (Schmulow, 2016).

#### **4.4.2 Who needs to register with the NCA**

The NCA regulates all Credit Providers, Debt Counsellors, Credit Bureaus, Payment Distribution Agents (PDAs) and Alternative Dispute Resolution Agents (ADRs) (Krog, 2008). Credit providers include banks, micro-lenders, retailers such as clothing and furniture stores, vehicle financiers, and all businesses, companies, close corporations and individuals who do business on credit, provide loans or charge interest on overdue accounts (Kelly-Louw, 2007). Prior to the 2016 amendments to the NCA, if a credit provider entered into 100 or more credit agreements or if the debt owed to the credit provider exceeded R500,000 the credit provider had to register with the National Credit Regulator (Kelly-Louw, 2007).

This was, however, amended by means of the Government Notice 513 in Government Gazette 39981 dated 11 May 2016, which now requires every person who enters into a qualifying credit transaction, to register as a credit provider regardless of the size of their debtor's book (this, however, excludes incidental credit providers). If a credit provider fails to register, the implications may be severe. In *Visagie NO and Others v Erwee NO and Another* the court declared the agreement null and void. The result is that credit agreements entered into with that credit provider will be unlawful and monies paid by the consumer to the credit provider should be refunded with interest (Section 40(4)). All registered credit providers must comply with the reporting requirements set out in the NCA (Section 52 (4) (f)) (Raath, 2018).

#### **4.4.3 Credit transactions regulated by the NCA**

The Act applies to all written credit agreements between parties dealing at arm's length and concluded within the Republic. The NCA regulates the following types of credit agreements (Section 8-9): Mortgage agreements; credit facilities like store cards, bank overdrafts, credit cards, garage cards; personal loans; instalment sales; lease of movable property; pawn and discount transactions; developmental credit; incidental credit and credit guarantees

(suretyships) (Kelly-Louw, 2007). Automatic increases in facilities will no longer be allowed (Chipeta & Mbululu, 2012).

In addition, the National Credit Amendment Act (NCAA) introduced affordability assessment regulations with an aim of assisting credit providers to effectively assess the consumer's ability to repay credit and to also protect consumers from reckless lending. These regulations require credit providers to verify consumers' income before granting credit. With the limitations of this study, all the exceptions or exemptions cannot be covered however it is important to note the exemptions which are deemed more relevant considering my research topic. The most relevant exclusion is where the consumer is a juristic person/company whose annual turnover or net asset value at the time that the agreement is concluded is over R1 million (Turner *et al.*, 2008).

According to Raath (2018), the NCA has an extended definition of "juristic person"; it includes partnerships, associations and a trust with three or more individual trustees or if a trustee is itself a juristic person. Some credit agreements with juristic persons as consumers are fully exempt from the NCA (due to the R1 million threshold or because they are large agreements), whilst others are subject to the Act (below the R1 million threshold and not a large agreement).

A non-juristic person according to Raath (2018) is; an individual (sole proprietor), a trust with one or two natural persons as trustees, and a stokvel who are, in principle, fully subject to the NCA provisions relating to affordability assessments, over-indebtedness and reckless lending [note s78 and Regulation 23A(2) for a few exemptions not relevant here].

What is unclear from the above; is where a company applies for an overdraft facility and at the time the turnover and/or asset value is  $\leq$  R1 million, the NCA will apply. If the company however applies for an increase in the overdraft facility at a later stage, and at this point the turnover is now, for example, in excess of R1 million, based on the interpretation it would seem that the NCA now no longer applies, even though the NCA did apply at the time when the first overdraft facility amount was granted. This could create some confusion for banks from an interpretation and implementation perspective. However, according to Raath (2018) a credit agreement with a juristic person as consumer, irrespective of whether the agreement is fully exempt from or subject to the NCA, is always specifically exempt from the NCA provisions relating to affordability assessments, over indebtedness and reckless lending [s6]. One could then question what the aim of the distinction is for the split for juristic persons, considering all the exemptions, all it seems to create is complexity in understanding the Act.

Other than from a bank's perspective, small business owners should also have an in-depth understanding of the Act, as some businesses may need to comply with the Act depending on whether the business charges its customers fees, charges, or interest for late payment in the event of incidental agreements (Coetzee, 2009).

With the introduction of the NCA in June 2006, there was a large focus on large credit providers registering with the National Credit Regulator and ensuring compliance with the NCA. There was however very little, if any, attention given to small and medium businesses on the impact of the NCA on the daily operations of the business. The onus was left to the business owners to educate themselves. One would question whether business owners are even aware of the implications of the NCA on their daily business operations. Some business owners may have the incorrect perception that as long as the business does not give credit, and that all debtor accounts are payable within 30 days, that the NCA does not apply to their business (Van Heerden & Boraine, 2015).

Where the business operations involve the delivery of goods and/or services and the customer's payment is deferred, usually, for thirty days, these transactions are potentially credit transactions or incidental credit agreements, which are both regulated by the NCA (Coetzee, 2009). There is however exemptions, for example, where shareholder loans are automatically exempt from the NCA, but employee loans are not. Depending on the volume and collective value of any employee loans, the business may need to register as a credit provider, even if the business is not in the business of providing credit to customers (Coetzee, 2009).

More prominently the NCA implication is where the customer does not pay the business immediately or is invoiced on a month-to-month bases. For example, when an account is tendered for payment for goods and/or service, that has been provided by the business to the customer once-off, or over a period of time, and one or both of the following conditions apply: if the account is not paid in full before a certain date an extra charge, fee or interest is added to the account; and/or; where two prices are quoted, a lower price if the account is paid before a certain date, and a higher price if the account is paid thereafter (Van Heerden & Boraine, 2015). In terms of Section 5(2) of the NCA, these types of agreements are considered to only come into existence 20 business days after the business has first levied the extra charge, fee or interest to the customer's account. Furthermore, if the business obtains an acknowledgment of debt, it may also fall within the ambits of the NCA depending on certain requirements, and if there are fees/charges and/or interest payable (Section 8(4)(f)) (Van Heerden & Boraine, 2015).

It must, however, be noted that the NCA has certain exemptions in place to protect businesses where stipulated, for example, an Incidental Credit Agreement is, amongst others, exempted from certain provisions in the Act, for example, reckless lending (Van Heerden, 2011:658).

#### **4.4.4 Rights and duties of consumers**

The primary focus of the NCA is to protect natural persons from exploitation by credit providers; hence it is very focused on the rights of the consumer (Krog, 2008). The consumer's rights will be elaborated on below.

##### **4.4.4.1 Consumer's rights**

Consumer rights entail the following: the right to apply for credit; the right not to be discriminated against when applying for credit; the provision of information regarding the credit agreement must now include disclosure on all credit pricing information, such as fees, interest rates, and all other credit-related charges; consumers are entitled to receive prescribed documents before they enter into a credit agreement. This includes a quote and pre-agreement in plain and understandable language; in the event that an application for credit is declined the consumer may request reasons for such rejection; the right to access and challenge information held by the credit bureaus; consumers are entitled to be informed of the risks of the proposed credit agreement, as well as their rights and obligations in terms of this agreement; marketing information can only be communicated to a consumer in those circumstances where they have selected this option and the provider of such information is obliged to keep a record of the consumer's choice in this regard; the right to receive periodic statements; the right to the removal of adverse consumer credit information; and consumers will have access to a complaints resolution process, including the Banking Services Ombudsman, the Consumer Tribunal and the National Credit Regulator (First, 2007; Stoop, 2009; Kelly-Louw, 2014).

The above provides a brief on the rights of the consumer; however, the consumer also has certain duties when applying for credit. The duties of the consumer are elaborated on below.

##### **4.4.4.2 Duties of consumers**

The duties of consumers entail the following: to answer all questions truthfully; to provide authentic documentation; to truthfully disclose all financial obligations; to disclose the location of goods; and to inform credit providers of a change of address (Kelly-Louw, 2014).

The above covered a brief on the sections of the NCA which apply to the rights and duties of the consumer during the credit application process. Below the sections of the NCA relating to the rights and duties of credit providers will be explored.

#### **4.4.5 Rights and duties of Credit providers**

Registered credit providers are required to comply with a number of requirements however the most noteworthy is the duty to prevent the granting of reckless credit, making certain disclosures and complying with the reporting requirements set out in the NCA. Documents should be submitted in terms of Sections 62 – 68 (Migiro, 2017). The prevention of reckless lending is further discussed below.

##### **4.4.5.1 The duty to avoid reckless lending of credit**

On 1 June 2007, the NCA introduced Sections 79, 80 and 81.

Before a credit agreement is concluded, a credit provider has to take reasonable steps to assess: the proposed borrower's (i) general understanding of the proposed credit, (ii) debt repayment history under credit agreements, (iii) existing financial means, prospects and obligations; and if the credit is for commercial purposes, whether there is a reasonable basis to conclude that it may prove to be successful [s81]. "Financial means, prospects and obligations" include; if there is a commercial purpose for the credit, the reasonably estimated future revenue flow from that business [s78]. A credit provider could determine its own evaluative mechanisms to make an assessment, provided it was fair and objective [s82] (Raath, 2018).

Although there was a clear duty to ensure that a borrower could afford credit, the legal requirements lacked specific prescriptive detail and allowed credit providers a discretion to determine and use future income. On 13 September 2015 the Affordability regulations were introduced which prescribed detail for affordability assessments. Amongst other things, a credit provider had to take specific, practical steps to validate gross income.

#### **Evaluation of existing financial means and prospects**

Credit providers are obliged to take practical steps to assess a consumer's discretionary income to determine whether they have the financial means and prospects to pay the proposed credit instalments. Regulation 12 of the affordability assessment regulations require the following from credit providers when conducting an affordability assessment (refer to Table 4-2):

Table 4-2: Affordability assessment requirements

<b>AFFORDABILITY ASSESSMENT REQUIREMENTS</b>
<ul style="list-style-type: none"> <li>• Calculate the consumers' discretionary income.</li> <li>• Take into account all monthly debt repayment obligations in terms of credit agreements reflected on the consumer's credit profile held by a registered credit bureau.</li> <li>• Take into account maintenance obligations and other necessary expenses.</li> <li>• Where a credit agreement is entered into on a substitutionary basis in order to settle off one or more existing credit agreements, a credit provider must: record that the credit being applied for is to replace other existing credit agreements; take practical steps to ensure that such credit is properly used for such purposes.</li> </ul>

Source: NCA, (Regulation 12)

Discretionary income refers to gross income less statutory deductions (such as income tax, Unemployment Insurance Fund (UIF), and maintenance payments) less necessary expenses, less all other financial commitments/obligations as disclosed by the consumer. Necessary expenses include minimum living expenses, excluding monthly debt repayment obligations in terms of credit agreements.

In order to deter for the personal expenses from being understated, the Affordability Regulations introduced the minimum living expense norms table which serves as a guide for calculating consumers living expenses. This table is based on the gross monthly income of the consumer. In instances where the consumer's declared minimum personal expenses are lower than those in the NCAA, the credit provider should request the consumer to complete a Customer Declaration questionnaire provided in the National Credit Amendment Act.

Credit providers must take practical steps to validate gross income by obtaining the required documentation as listed in Table 4-3 (Regulation 4 of the affordability assessment regulations):

Table 4-3: Proof of income requirements

<b>CONSUMER TYPE</b>	<b>REQUIREMENTS</b>
Consumers who receive a salary from an employer	<ul style="list-style-type: none"> <li>• 3 latest pay slips, or</li> <li>• 3 latest bank statements (showing 3 salary deposits).</li> </ul>
Consumers who do not receive a salary	<ul style="list-style-type: none"> <li>• 3 latest proof of income documents, or</li> <li>• 3 latest bank statements.</li> </ul>
Consumers who are self-employed	<ul style="list-style-type: none"> <li>• 3 latest bank statements, or</li> <li>• Latest financial statements.</li> </ul>

Source: NCA, Regulation 23A (4)

Where the consumers monthly gross income shows material variance (significant change in amount), the average gross income over the period of not less than three pay periods preceding the credit application must be used.

If a credit provider fails to conduct an assessment as required by s81 (2) [s 80(1) (a)] it could be regarded as reckless lending, because the credit provider would have failed to comply with the prescribed validation requirements. Without prescribed validation, a credit provider should not grant credit. A credit provider's evaluative mechanisms for assessment purposes must result in a fair and objective assessment and also be consistent with the Affordability regulations (including the validation requirements) [s82(1)] (Raath, 2018).

It is important at this point to provide a distinction between "predatory lending" and "reckless lending". Schmulow (2016), provides a simple distinction between the two, explaining that reckless lending ignores a consumer's circumstances, whereas predatory lending actively preys upon a consumer's circumstances. Although not considered as predatory lending, "payday lending" is the closest example to predatory lending as it displays predatory characteristics.

To the extent that Schmulow (2016) explains that the predatory payday lending practices in South Africa were so egregious that they triggered civil unrest, which arguably led to the 'Marikana massacre' on 16 August 2012. According to Bond (2013), the background to this was that mine employees of Lonmin's mine were obtaining too much credit from the local micro lenders and as a result were caught in a spiralling debt trap and were requesting microcredit in advance of payday. According to Bond (2013) the employer refused to back down which angered the employees, resulting in the unfortunate event.

From the information in Table 4-3, the only requirement stipulated for businesses which fall under the ambits of the NCA, is that the applicant must provide either three latest bank statements or the latest financial statements as proof of income. An inference can therefore be made that a business must be in existence for a minimum period of three months in order to apply for credit.

### **The outcome of the affordability assessment (Reg. 16 &19)**

If the applicant is successful, the credit agreement is concluded. Unsuccessful applicants must be provided with the dominant reason for the decline and if the applicant requires it, the credit provider must provide the customer with a printed decline advice indicating the reason. Where an application is declined due to an adverse report received from a credit bureau, the name,

address and contact details of the credit bureau must also be given to the applicant (Migiro, 2017).

A consumer who is aggrieved by the outcome of the affordability assessment may at any time lodge a complaint with the credit provider for dispute resolution. If the consumer is not satisfied with the response of the credit provider, the consumer can lodge a complaint with the Ombud. Credit providers must attempt to resolve the complaint within 14 business days after receiving notification of the complaint. If the grievance is not addressed within 14 business days, the consumer can approach the NCR. If the NCR issues a notice of non-referral in response to the complaint, the consumer may refer the matter directly to the National Consumer Tribunal (Migiro, 2017).

#### **4.4.5.2 Credit Agreement**

##### **The existence of the Credit Agreement**

The NCA covers the following under this section; the cost of credit, changes, deferrals, and waivers, address for serving notice, the disclosure of the location of goods, substitution of goods, issuing statements, altering the credit agreement, debt enforcement, debt review and debt resolution.

According to Buma *et al.* (2010:38), one of the major motivators for the introduction of the NCA was the failure of credit providers to supply consumers with the proper information regarding the true cost of credit. For example, a consumer who purchased a R5000 lounge suite on credit with a repayment period of 24 months could end up paying R32, 000 for the lounge suite due to fees and the exorbitantly high interest rates that could be charged. This led to the exploitation of poor customers who could not afford to pay cash for goods.

Consumers were also not informed about costs such as administration fees, insurance costs, and delivery charges, all of which were added to the initial purchase price. In many instances, consumers had to apply for new loans to pay existing loans and were soon caught in a spiraling debt trap.

In accordance with the NCA, consumers must also be informed of the difference between the cash price and the total amount consumers will pay if the goods are purchased on credit. By making this comparison, the intention is to encourage savings to rather purchase for cash (Buma *et al.*, 2010:38).

The regulations have since allowed for the disclosure of the credit cost multiple which should be disclosed in the pre-agreement statement and quotation. Table 4-4 summarizes the costs and fees to be disclosed in the credit agreement (Section 93 and Regulations 29, 30 and 31):

Table 4-4: Costs and fees to disclose in a credit agreement

<b>COSTS AND FEES TO DISCLOSE IN A CREDIT AGREEMENT</b>
<ul style="list-style-type: none"> <li>• Principle debt.</li> <li>• Deferred amount.</li> <li>• Proposed distribution of costs.</li> <li>• Cash price for goods or services.</li> <li>• Initiation fee.</li> <li>• Service fees.</li> <li>• Interest rate.</li> <li>• Credit insurance costs.</li> <li>• Default administration charges.</li> <li>• Collection costs.</li> </ul>

Source: NCA (Section 93 and Regulations 29, 30 and 31)

### **Repayment information to be included in the credit agreement**

Other than the cost and fees, the NCA stipulates the repayment information to be included in the credit agreement. This is summarised in Table 4-5 (Section 93 and Regulations 29, 30 and 31):

Table 4-5: Repayment information to be included in the credit agreement

<b>REPAYMENT INFORMATION TO BE INCLUDED IN THE CREDIT AGREEMENT</b>
<ul style="list-style-type: none"> <li>• The number of repayments.</li> <li>• The frequency of repayments.</li> <li>• When the first repayment is due.</li> <li>• If all repayment amounts are not equal, how they will differ.</li> <li>• The total amount of all repayments.</li> <li>• The term of duration of the agreement.</li> </ul>

Source: NCA (Section 93 and Regulations 29, 30 & 31)

What is also important to note under this section is that the NCA regulates the way in which accounts can be collected and the specific rights, duties, and obligations of the parties to such

an agreement. For example, credit providers may not commence legal proceedings before they have issued a written notice to their debtors meeting all of the prescribed requirements set out in the Act (Section 129). So threatening a bad debtor with legal action prematurely could have negative consequences to the credit provider. The implications are that some businesses try and find ways to avoid the requirements of the NCA. For example, some businesses will rather forfeit interest when collecting on unpaid accounts, in order to avoid the requirements of the NCA (Migiro, 2017).

The next step in the consumer credit lifecycle is the termination of the credit agreement which will be discussed below.

### **Termination of the credit agreement**

A credit agreement can be terminated by either the consumer or the credit provider. This section covers mainly the following areas; settling a credit agreement, rescinding a credit agreement, rescinding a lease or installment sale agreement, surrendering of goods, making early payments, and the credit provider's right to terminate and the prescription of debt.

What is important to note under this section is that no penalty fees may be charged for the early settlement of small and intermediate agreements. If the consumer would like to terminate a large credit agreement (over R250, 000) or a mortgage agreement, the settlement amount may include an early settlement charge which is not allowed to be more than three months interest. If the consumer provides notice of his/her intention to settle early, it will reduce the three-month interest early charge by the notice period (Section 125) (Migiro, 2017).

The above provided a brief on the prominent areas of the NCA throughout the credit lifecycle. Below the influence of the NCA on credit providers will be summarized.

#### **4.4.6 Influence of the NCA**

Credit providers have various views on the influence of the NCA. A prominent view is that the NCA has intensified competition, resulting in some small loan lenders merging with or acquiring competitors to expand on loan book size (Ntingi, 2008:1). Under the new legislation, unregistered lenders are not allowed to extend credit. While small informal lenders are said to be disappearing, big listed micro-lenders like Capitec bank seem to be thriving. A general view is that the influence of the NCA has effectively resulted in a changing model, consolidation, and an increase in the cost of credit (Ntingi, 2008:1). These will be discussed below.

## **Changing model**

Prior to the NCA, small informal lenders could charge any interest rate on loans. Post-NCA, there is reduced interest rates and therefore reduced profit margins. This coupled with the aggressive price undercutting by larger competitors questions the future of the smaller informal lenders. The big listed micro-lenders have greater access to cheap capital allowing for the provision of loans at lower interest rates (Ntingi, 2008:1).

According to Riaan Stassen, the CEO of Capitec Bank, there is speculation that the NCA has leveled the playing field as more small informal lenders are leaving the market, and larger institutions are entering the micro-lending space. The reason for this is the inability to cope with the NCA and competition in the market. Wessel Smit, Head of the legal department at Blue Financial Services, adds that other reasons for small lenders leaving the industry are due to the lack of access to affordable capital (Ntingi, 2008:1).

On the other hand, Gabriel Davel, former chief executive of the National Credit Regulator (NCR), stated that there is no clear evidence that the number of micro-lenders in the market has shrunk due to heightened competition. Some have closed; however, new players have also come to the market. Official figures show that there were 2100 micro-lenders registered with the NCR during 2009, compared with 2000 lenders that were registered with the NCR's predecessor, the Microfinance Regulatory Council (Migiro, 2017).

## **Consolidation**

Another implication of the NCA is the consolidation of the microlending market, and as a result, there has been a reduction in credit provided. The NCA also drove the Loan Sharks or *Mashonisas* out of the market (Ntingi, 2008:2).

Examples of the consolidation process were African bank which acquired furniture retailer and credit provider Ellerines for R10 billion. Furthermore, Blue Financial Services, which has extensive operations across the African Continent, acquired rival micro-lender, Future Finance, thereby boosting it's earning from South Africa (Ntingi, 2008:1).

It can be argued that whilst the NCA may have created opportunities for some large micro-lenders, also driving out dubious practices by Loan Sharks, there are surely also pitfalls. One of these pitfalls is the increase in the cost of credit for credit providers, which will be elaborated on below.

### **Increase in the cost of credit**

Ntingi (2009) states that the cost of credit may increase as a result of the additional cost incurred due to the requirement of providing extra information, and conducting more detailed affordability assessments. Previously the onus was on the customer to ensure that he/she was fully informed concerning the finer details of loan agreements, as well as the rights in the event of a dispute. Under the NCA, the emphasis has shifted to the credit provider to ensure that customers are fully informed of their rights and all the relevant information, as determined by the law.

Loan documentation must now make all required information comprehensible to the consumer, from providing pre-agreement quotes with five-day validity, to how debt and interest payments will be calculated. In addition, credit providers may no longer use 'fine print', all documents must be legible. In the past, while consumers were able to shop around for the best rate, not all credit providers, however, supplied the same level of information. As a result, it became difficult to compare credit products. The new system allows consumers to make accurate comparisons (Ntingi, 2009).

### **Credit constraints and productivity**

Miller (2013), states that interest rate caps intensifies the already existing problem banks face of adverse selection as it prevents the bank from price discriminating. Effectively it reduces the provision of credit as the more risky businesses which previously obtained credit at a higher cost, will no longer qualify for credit. The World Bank found that credit constraints may reduce profit margins by up to 13.6% per annum (Miller, 2013). In addition, the interest rate caps will result in less credit for the lower end of the market considering that microfinance institutions charge higher interest rates, as they pay a higher cost of funds to on-lend to small businesses (Miller, 2013). Mphahlele (2015) concurs that by capping interest rates and fees, loans to smaller and higher-risk consumers may have been discouraged, inhibiting access to credit by those consumers. Despite this limitation to microfinance institutions, there is still a steep growth reflected in the unsecured lending market which will be elaborated on below.

### **Steep growth in the unsecured lending market**

Although the NCA has achieved many positive milestones in protecting the consumer, Aregbeshola (2014) argues that it has not been able to prevent opportunistic behaviour on the part of the lenders. This is based on the steep growth in the unsecured lending market. As a way of circumventing the provisions against opportunistic lending in the capital market, especially asset-backed finance such as home loans, the four leading banks in the country diversified into the lower credit stream of the market (Bloomberg, 2012; Mittner, 2013). This is

reflected in the data which shows a steep growth in unsecured loans of 53% between 2010 and 2011. Moreover, the data shows that ¾ of unsecured loans consist of loans more than R15, 000 and more than 60% of the loan value goes to low-middle income earners (people earning less than R10, 000 per month). The most worrying aspect of the growth in unsecured loans is that the funds are used for immediate consumption in most of the cases, and also to service or repay existing debt (The National Treasury, 2011; Mittner, 2013; Aregbeshola, 2014).

It is also important to note that according to Raath (2018) there are individuals who benefit from developmental credit when qualifying, for example, for educational loans or low income housing. Developmental credit is financing for a specific prescribed purpose (one of which is for the development of a small business) but otherwise applies in principle to any type of borrower, any type of credit agreement for any amount [s10]. For the prescribed purpose “*development of a small business*”, “small business” is defined in the NCA with reference to the National Small Enterprise Act (102 of 1996) and, therefore, may only be granted to those small businesses that qualify.

A “small enterprise” is defined as a separate and distinct business entity, predominant in certain economic sectors mentioned in a schedule and classified as a micro, very small, small, or medium enterprise according to criteria in the schedule [s1]. Since this definition limits the meaning of “small enterprise” to a separate and distinct business entity, it legally limits developmental credit to qualifying companies and close corporations. In general legal terms these are the only legal entities with separate legal personality and qualify, therefore, as separate and distinct business entities. The effect of this is that a sole proprietor, partnership, association, stokvel or (any) business trust (all relevant in the small business market but which are not “separate and distinct business entities”) do not qualify for NCA developmental credit, as these do not meet the definition criteria of a “small business” (Raath, 2018).

The above covered an overview of the NCA and the influence on small business lending. Whilst the initial intention may have been to regulate the sector and provide a platform for the development of SMMEs, the benefit of the development of SMMEs is not evident.

Whilst the protection of borrowers is clear from the above literature, the downside is that there is less access to credit, as it appears that the granting of credit has become more cumbersome and expensive for credit providers since the implementation of the NCA. Overall, access to credit remains persistently inadequate (Raath, 2018).

Turner *et al.* (2008) notes that the NCA has a profound effect on the SMME lending market overall in South Africa. This is considering that the majority of the smaller businesses are sole proprietors which mainly use consumer loans to finance their business. Based on this assumption, the NCA's reckless lending provision may restrict credit to sole proprietors despite the exemptions for small businesses (Turner *et al.*, 2008).

The above summarizes the influence of the NCA on credit lending in South Africa.

## **4.5 Khula Credit Guarantee Scheme**

The influence of the Khula Credit Guarantee Scheme on small business lending will now be explored, also reviewing Credit Guarantee Schemes from abroad to gain a broader perspective.

### **4.5.1 Overview**

The Khula Credit Guarantee Scheme was introduced by Government in 1996 with the aim to encourage and assist banks to more readily provide credit to SMMEs. However, as previously established, after the 2008 Global financial crisis, the number of defaults increased and banks were no longer interested in utilizing Khula (Okeke-Uzodike *et al.*, 2018).

SEFA since took over the Khula Guarantee Scheme and is attempting to re-ignite the interest of banks to utilize the Credit Guarantee to increase the availability of finance to small businesses. For the purpose of my study, it is important to understand how the Credit Guarantee Scheme works, then determine what the challenges or hindrances could be from the banks perspective when utilizing the Credit Guarantee Scheme. The history of the Khula Credit Guarantee Scheme practices will be delved into, and where possible compared to International practices to gain a broader perspective of Credit Guarantee Schemes.

### **4.5.2 The aim of the Credit Guarantee Scheme (CGS)**

Guarantees are a worldwide phenomenon as a study revealed that approximately 85% of countries of the Organisation for Economic Co-operation and Development had at least one Credit Guarantee Scheme (CGS). The study showed that by 1995, the largest and best-established guarantee schemes were almost all in developed countries, including Canada, Japan, the United Kingdom, some other EU countries, and the United States (Beck *et al.*, 2008b).

The purpose of Credit Guarantee Schemes is to assist banks in lending to SMMEs by overcoming the problem of lack of collateral. Credit Guarantee Schemes as previously

indicated, work on the principle that a reliable guarantor guarantees that in the event of default, it will stand in for the outstanding debt. These schemes are normally designed to alleviate the constraints SMMEs face in seeking access to credit, by sharing the risk of default with banks on an agreed ratio. Should the borrower default, the guarantor is called upon by the lender on the terms of a legal contract that specifies how the lender (in this case the bank) can recover the funds (Gstraunthaler & Cramer, 2012).

### **4.5.3 Categorization of Guarantees**

Credit guarantee schemes can be categorized as follows, according to who acts as guarantor, operates and controls it: Government programmes; Donor or non-governmental organization programmes; Mutual guarantee organizations set up by a group of SMMEs, and Independent Credit Guarantee Schemes with separate legal status funded by investors and/or donors (Beck *et al.*, 2008b).

It is important to note that the South African Khula Credit Guarantee Scheme is owned, operated, and controlled by the Government.

### **4.5.4 Models of Credit Guarantee Schemes**

There are three types, or models of Credit Guarantee Schemes in terms of how guarantees are issued. These three models will be discussed below.

#### **4.5.4.1 Individual-retail-selective model**

Under this model, guarantees are extended on a case-by-case basis and two possible methods of issuing guarantees can be distinguished. First, the borrower approaches a potential lender, who reviews the project and makes the loan dependent on a guarantee. Either the lender or the borrower will then apply for a guarantee from the scheme. Second, the guarantor can issue an advance guarantee approval to the borrower, who can use it to negotiate a loan contract with the lender. A direct relationship between the guarantor and the borrower exists because the guarantor investigates every loan application and selects which ones to guarantee. This reduces the probability of moral hazard on the part of the lender, thereby lowering default costs and ensuring that guaranteed borrowers are indeed the targeted ones. Moral hazard may exist where banks may not be motivated to supervise loans as expected, or to chase the collection of repayments as banks traditionally would, considering that the majority of the loan value is covered by a guarantee. The South African Khula Credit Guarantee scheme can be classified under this model.

Originally the banks and Khula agreed on a risk-sharing ratio of 40 (Bank): 60 (Khula), but due to unpaid claims and complaints by the banks of the high risk involved, the agreement was re-negotiated and the application form redesigned in order to encourage banks to participate more actively in the scheme. In terms of the new agreement, Khula accepts between 70% and 90% of the risk, depending on the value of the facilities covered. If the bank wants to cover a bigger facility, the risk covered by Khula may go down to 50%, but there were none of these special requests. The bank's share is thus less than the ideal benchmark of between 30 and 40% which is the norm for banks abroad which apply this model (Nigrini & Schoombee, 2002). Fundes International is an example abroad applying this model (Malhotra *et al.*, 2007).

#### **4.5.4.2 Portfolio model**

Under the Portfolio model, the guarantor provides a guarantee that automatically covers all loans made by the lender within certain criteria (such as loan size and borrowers' assets) up to an overall portfolio amount. As there is no direct contact between the guarantor and the borrower, this approach enables a considerable expansion of activity by reducing time-consuming and cost-intensive screening procedures. However, the economies of scale are achieved at the cost of higher default rates and less additionality compared with the individual-retail selective model (Malhotra *et al.*, 2007). Additionality can be measured in terms of loans that would have otherwise been declined by the bank if it was not for the Credit Guarantee. Examples of this model are the Fondo Nacional de Garantias (FNG) in Colombia and the Small Business Administration in the United States (Bogan, 2012).

Malhotra *et al.* (2007) highlight that according to the Inter-American Development Bank, both the individual-retail-selective model and the portfolio model have proved to be ineffective in increasing lending to SMMEs due to insufficient interest on the part of banks resulting from the high transaction costs involved. Furthermore, the perceived high risks and the inability of Credit Guarantee Schemes to cover costs under such arrangements also contribute to the ineffectiveness of these models. The Intermediary-wholesale model is a potentially viable alternative. This model is described below.

#### **4.5.4.3 Intermediary-wholesale model**

Under the Intermediary-wholesale model, the guarantor typically guarantees a loan or a line of credit from a local bank to a nonbank microfinance institution. What makes this model attractive to lending banks is that they do not need to employ resources and new lending methodologies to reach the unfamiliar SMME sector. ACCION International's Global Bridge

Fund and Women's World Banking have followed this model. ACCION International is one of the most respected nongovernmental organizations in microfinance (Bogan, 2012).

ACCION created the Latin America Bridge Fund in 1984. The fund acts as collateral for irrevocable standby letters of credit issued by a U.S. bank (currently CitiBank) in U.S. dollars and guarantees 10 to 90% of credit provided by local commercial banks to ACCION's affiliate microfinance programmes. Since its inception, the fund has collateralized more than US\$70 million of letters of credit for 23 ACCION microfinance institutions in 12 Latin American countries, including Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Mexico, Paraguay, and Peru. The fund has worked with 45 local commercial banks in these countries. The average loan term given to micro-entrepreneurs by ACCION affiliates is six months with an average loan size of US\$500 (Bogan, 2012).

From the above information, it can be argued that the Individual-retail-selective model is also not as effective abroad, similar to the South African situation, as this is the same model applied by the South African Government Khula Credit Guarantee Scheme. The challenges for the banks may be similar abroad to the South African banks when utilizing a Guarantee Scheme based on this model.

#### **4.5.5 Challenges**

##### **4.5.5.1 Guarantee Scheme**

The challenges faced by the Guarantee Scheme is that banks might transfer all loans which are perceived as risky to the guarantee scheme, even if the bank is able to obtain adequate collateral. This does not contribute to reducing the problem of high loan (operation and administration) costs, which is a prominent reason for the reluctance of commercial banks to lend to small businesses. If a large enough revenue stream is not established to spread costs over a great number of operations, high administration costs will consume the capital of the guarantee fund (Gstraunthaler & Cramer, 2012).

##### **4.5.5.2 The banks**

The challenges faced by South African banks which have utilized the Khula Credit Guarantee Scheme can be summarized as follows (Nigrini & Schoombee, 2002; Mago & Toro, 2013; Okeke-Uzodike *et al.*, 2018):

- Fear that settlement of claims will involve considerable delays and costly administration.

- A strained relationship as Khula often promotes its services directly to entrepreneurs rather than to the banks. This creates certain expectations among entrepreneurs about the possibilities of the guarantee scheme, but banks must still meet the criteria set by Khula. The result often is friction between the SMMEs, banks, and Khula.
- If the annual premium is not paid to Khula, the guarantee lapses. This places administration pressure on the banks, as the bank will not recover the money owing by the borrower if the borrower forfeits.
- Banks are generally unhappy with the way in which Khula calculates the indemnity fee. By not taking into account the value of the security offered by the customer, Khula's fee is seen to be excessive. If collateral does exist, the banks must take it, place a value on it, and deduct it from the loan value (unsecured exposure) in the event of a claim. The potential risk for banks is then the unsecured portion of the loan, plus the unrealised collateral value, as the collateral may not yield its full value in the case of a forced sale.
- Banks also incur costs to assess loan applications. There is apparently no consensus internationally on who should take responsibility for this function. The 3% guarantee fee that Khula charges appear high in relation to international experience and the way in which the fee is calculated is also of the utmost concern to the banks, who feel that it results in an excessive fee.
- In the event that the bank submits a claim, and Khula is of the opinion that the bank has misreported any information on the customer, Khula may disregard the banks claim or charge the bank a penalty fee. Some banks feel that there is not enough transparency in this process and that it could lead to them suffering unnecessary losses. Gstraunthaler and Cramer (2012) provide examples in Malaysia and Nigeria where claims were rejected on the grounds of technicalities; and
- It is a requirement for banks to take judgment before being able to claim from the Guarantee Scheme in the event of default of the borrower. The collection costs to take judgment is very high for banks. Furthermore, if any funds are collected from the borrower at any point in the collections process, the funds are to be apportioned between Khula and the bank.

The above highlights an array of problems with the Khula Credit Guarantee Scheme. Furthermore, the FinMark Trust Survey conducted during 2009 emphasized that the Khula programme did not prove to reach the poorer market. Mthimkulu and Aziakpono (2012) noted that Khula failed to meet its mandate as the scheme largely benefited white-owned large businesses than its intended black SMME clientele. Ligthelm and Cant (2003), and Rogerson

(2006) concur that Government support in South Africa mostly neglects the large group of informal enterprises, adding that overall the growth in the small business economy does not necessarily reflect the success or impact of government support programmes.

Thurlow and Wobst (2004) and Rogerson (2007) add that the services provided by Khula do not take into consideration the unique nature of small businesses in South Africa. Moreover, a study by Mago and Toro (2013) revealed that Khula failed to encourage commercial banks to lend to SMMEs as the level of utilization of the credit guarantee scheme was far below expectations. The other concern is that micro-entrepreneurs are unaware of the existence of the Guarantee Scheme (Berry *et al.*, 2002). The Finmark Trust study revealed that only 2% of the business owners were aware of the Guarantee Scheme (Porteous, 2007). According to Job (2013:1), the Khula Credit Guarantee Scheme in totality never topped 800 guarantees since its launch in 1996 and credit by banks has been on the decline. This does not compare well with emerging market peers such as Chile, Malaysia, India, and Brazil which lends out thousands of loans a year using credit guarantees (Job, 2013:1).

SEFA as mentioned previously since took over the Khula Guarantee Scheme. Based on the above challenges, SEFA migrated into different avenues. SEFA continues to use the channels used by Khula, that is; banks and financial institutions which on-lend to small businesses, but since added a third channel, that of direct lending, through direct lending products. The aim is to achieve a national branch network providing the new products (Job, 2013:1). Migro (2005:3) however states that this is a major concern for the success of the Khula Credit Guarantee Scheme considering that the major channel for the Guarantee Scheme is Banks. Migro (2005:3) emphasizes the importance of banks as a channel saying that once the initial start-up phase of a business has been completed, banks are the most important providers of the financial means in the early growth phase, as previously identified in Chapter 2.

The other avenue which SEFA diversified to is changing from the Individual-retail-selective model to the Portfolio model. The challenges for banks, however, remains the same with regards to the collections cost as it is still a requirement for the banks to take full judgment and distribute all funds collected from the borrower equally between the bank and SEFA. Furthermore, the challenges of the high transaction costs, not having control over the process, and the uncertainty that the claim will not be paid still remain. Moreover, as highlighted by Malhotra *et al.* (2007) above, both the Individual-retail-selective model and the Portfolio model were not effective abroad due to the lack of interest by the banks due to the high cost.

## 4.6 Conclusion

Based on the literature review, a deduction can be made that the NCA has made a positive impact in certain areas. These prominent areas are the prevention of reckless lending and unfair pricing in South Africa. The NCA has also to a large extent driven out bad practices by “Loan Sharks”. It was also highlighted that the NCA may have created more opportunities for some large micro-lenders. The focus of micro-lenders is, however, on salaried individuals and not on the self-employed.

Considering that the intention of the Government was seemingly to regulate the sector and provide a platform for the development of SMMEs, it can be argued that whilst the regulation of the sector has shown some success, it is based more on the individual consumer, and not for SMME development. Even with the implementation of the Khula Guarantee Scheme, this showed very little evidence of promoting the development and growth of specifically small businesses.

The Individual retail selective model was used by the Khula Credit Guarantee Scheme, and more recently also started to offer the Portfolio model to banks. However, according to literature, the Inter-American Development Bank reported that both the Individual and Portfolio model has proven to be ineffective in increasing lending to SMMEs due to the high transaction cost to the bank. As a result of the low take-up rates by banks, the Khula Credit Guarantee Scheme did not achieve its objectives as intended.

## **CHAPTER 5:**

### **RESEARCH METHODOLOGY AND EMPIRICAL RESULTS**

#### **5.1 Introduction**

During the previous chapters, the research methodology was based on an extensive review of relevant theoretical and empirical literature on various aspects related to access to credit for small businesses. The literature review sources included mainly journal articles, books and to some extent published and unpublished thesis and dissertations, as well as websites.

This chapter provides the methodology followed, and the results of the empirical study are presented. Empirical research is defined as research based on experimentation or observation to collect data (Gill & Johnson, 2010:71). The empirical study was approached from the perspective of a formal research design through the definition of the study population, the incorporation of suitable measuring instruments, and reliable techniques for data analysis as stipulated in Cooper and Schindler (2008).

#### **5.2 Research paradigm**

The term paradigm originates from the Greek word "*paradeigma*" which means pattern. According to Lincoln (1994), a research paradigm is composed of three components namely ontology, epistemology and methodology. The three concepts provide a framework that serves as a blueprint for the entire research process (Antwi & Hamza, 2015). Bhattacharjee (2012) define ontology as people's assumptions of how they see the world. Guba and Lincoln (1994) define epistemology as the nature of the relationship between the researcher and what can be known. It is concerned with the nature and forms of knowledge.

Guba and Lincoln (1994) explain that four paradigms are normally used by researchers, namely positivism, post-positivism, critical reality, and constructivism paradigms. The positivist paradigm is based on the premise that reality is objectively given and is measurable using methods that are objective, quantifiable and independent of the researcher (Antwi & Hamza, 2015).

The positivist research paradigm is underpinned by quantitative, experimental and manipulative methodology (Antwi & Hamza, 2015). In a quantitative methodology, questions or hypothesis are stated in propositional form and subjected to an empirical test to verify them (Guba & Lincoln, 1994). The post-positivism paradigm has similar ontological, epistemological

and methodological beliefs as those of positivism. The difference is that post-positivism is principled on critical realism ontology. The critical theory paradigm is based on the belief that reality is composed of a researcher's subjective view of the external world and hence reality is socially constructed (Bhattacharjee, 2012). Constructivism, similar to the critical theory paradigm, is based on transactional and subjectivist epistemology and the methodology is hermeneutical and dialectical. The methodology is directed at understanding the phenomenon from an individual perspective. This involves investigating interaction among individuals as well as the historical and cultural contexts which people inhabit (Creswell, 2009).

### **5.3 Research methodology**

Methodology is a research strategy that translates ontological and epistemological principles into guidelines that show how research is to be conducted (Bhattacharjee, 2012). According to Guba and Lincoln (1994), methodology asks the question "how can the researcher find out what he/she believes can be known?". Methodology focuses on the best means for gaining knowledge about the world (Lincoln & Denzin, 2003).

A methodology provides the user with a framework for selecting the means to analyze, order, and exchange information about an issue (Hofstee, 2006). The options are to either choose a quantitative or qualitative method, or a combination of both. But what does it imply and what is the difference between quantitative and qualitative research? Hancock and Algozzine (2016) explain that while characteristics from both these approaches can be applied in a single study, the principles and activities of these respective approaches allow researchers to plan and conduct their research in very different ways.

Most fundamentally, quantitative researchers use numbers, normally in the form of statistics, to explain phenomena (Nardi, 2018). Although there have been many attempts by scholars to provide a generally accepted definition of qualitative research, Holliday's (2007) description of qualitative research is appealing as it is easy to understand. Holliday explains that qualitative research is what people do in everyday life. People normally have to solve problems about how to behave with other people in a wide range of settings. To do this it is important to not only study how others behave but also how the researcher should behave towards them. Schutz (1970) characterizes natural research as activities occurring when a 'stranger' approaches a social group which he or she wishes to join or deal with. It might entail taking up a new job or dealing with car mechanics for the first time and having to learn new rules or behaviour. This involves analyzing behaviour and language, working out how and when to be formal or informal, learning new technical terms, specialist terms or phrases, what constitutes

humour, when to be serious and when not, attitudes, values, and relative status (Holliday, 2007).

A decision was taken to follow a combined research approach of both quantitative and qualitative analysis to obtain the data required for this study, as explained earlier in Chapter 1. The larger part is quantitative analysis, with a smaller contribution of qualitative analysis. There were two measuring instruments and techniques used to obtain information as two empirical studies were conducted. These will be referred to as Empirical Study (A) and Empirical Study (B). Empirical Study (A) comprised of a mixed method of both quantitative and qualitative analysis, and Empirical Study (B) was based only on quantitative analysis.

## **5.4 Empirical Study A**

The description and the results of Empirical Study A are presented below.

### **5.4.1 Research Design**

According to Bhattacharjee (2012), a survey is a research method involving the use of standardized questionnaires or interviews to collect data about people and their preferences, thoughts, and behaviours in a systematic manner. Bhattacharjee (2012) notes that in a survey research, all respondents are given questions worded and demonstrated in the same order and the response alternatives (scales) are the same. A standardized, or structured questionnaire also provides an inexpensive and time efficient method to gather data from a potentially large number of respondents (Zohrabi, 2013:255).

A self-administered, structured questionnaire was used as the research instrument to collect data for the survey. The design of the questionnaire was guided by the literature review concept of the 5C's of credit, namely; capacity, capital, condition, collateral, and character, and also focused on the challenges in small business lending, with the aim to obtain insight to a more practical credit policy for small business lending.

The questionnaire (refer to Addendum A) comprised of 112 items and included mainly close-ended questions but also open-ended questions where more in-depth information was considered necessary. According to Harris and Brown (2010:1), quantitative data is obtained through closed-ended questions and qualitative data through open-ended questions. Rubin and Babbie (2008a) describe closed-ended questions as survey questions in which the respondent is asked to select an answer from among a list provided by the researcher. These are popular in survey research because they provide a greater uniformity of responses and are more easily processed than open-ended questions. Open-ended questions are questions

for which the respondent is asked to provide his or her own answers. In-depth, qualitative interviewing relies almost exclusively on open-ended questions (Rubin & Babbie, 2008a).

The questionnaire's closed-ended questions provided information that the participants were asked to rate using a four-point Likert scale, where; 1 = strongly agree, 2 = agree, 3 = disagree, and 4 = strongly disagree. The open-ended questions covered certain categories where more elaboration was considered appropriate, allowing participants to provide input and ideas. The questionnaire was split into four sections as follows:

### **Section 1: Banks existing proposition for small businesses**

The aim of this section was to determine the participants view on the current small business proposition and practices applied by banks when lending to small businesses.

### **Section 2: Credit Policy for small business lending**

This section covered the views on an appropriate credit policy for small business lending, based on the opinion of the participants on what methodology could be applied to reduce the credit risk to the bank, and by doing so, allow more access to credit for small businesses.

### **Section 3: Regulation: National Credit Act (NCA)**

This section covered specifically how the NCA Regulation may influence small business lending.

### **Section 4: Government Khula Credit Guarantee Scheme**

This section covered the Khula Credit Guarantee Scheme aimed at promoting the growth of access to finance for SMMEs in South Africa.

#### **5.4.2 Research population and sample size**

The population for a research study is that category (usually people) about whom conclusions are made (Rubin & Babbie, 2008b). However, due to cost and time, one is never practically able to research all of the target population and neither is it possible to make every possible observation of the participants. As a result, information will more often be collected in terms of a sample which is chosen to represent the population. Furthermore, the choice of the population to be sampled is greatly affected by the accessible database (Rubin & Babbie, 2008b).

According to Ary, Jacobs, Irvine and Walker (2018), a sample is a subgroup of a population selected to partake in the research. Lenth (2001) define stratified sampling as a way of making sure that a particular class or groups of people are represented in the sampling exercise. The target population (sampling frame) for the study was banking participants and also participants from the accounting and auditing firms. On a smaller scale, employees from the Small Enterprise Finance Agency (SEFA) were invited to participate, as SEFA took over the Khula Credit Guarantee Scheme as mentioned previously, and also provide direct lending to SMMEs. The accounting sector was included in order to gain a broader perspective on the topic, as opposed to only obtaining the view of the banking sector. The rationale behind this is that accountants have interaction with small business owners to some extent, for example, when drafting the financial statements for businesses. It could also be assumed that the accountants also get to know of the challenges experienced by business owners during the interactions with the business owners.

From a banking perspective, the aim was to target the banking employees which may consult with the business owners to obtain the required information for credit assessment (they are not credit managers). The other part of the banking population was the credit managers which make the credit decision. As previously identified during the literature review, the credit managers normally do not have any personal interaction with the small business applicants.

Participants from the following institutions participated in the study: the Big 5 banks, African bank, Rand Merchant bank, Investec, Small Enterprise Finance Agency (SEFA), the South African Institute of Chartered Accountants (SAICA), and the South African Institute of Business Accountants (SAIBA). The study was conducted during 2016.

The results were positive with 323 “usable” questionnaires received. According to Tabachnick and Fidell’s (2007:613), as rule of thumb, it is comforting to have at least 300 respondents for a factor analysis.

The total of 323 were made up of the following, per research population category: Lenders 89 (27.6%); Non-lenders 161 (49.8%); Accountants in practice 73 (22.6%). The credit managers at SEFA who participated in the questionnaire, should have marked “Government” as the “Department”, and would fall under the “Lenders” category. It is arguably understandable that the volume of “Lenders” in the banks will be far less than the “Non-lenders” as there is a relatively small number of credit managers (lenders) at the banks which make decisions for commercial lending. Furthermore at SEFA there would only be a very limited number of credit managers (less than 10) as at the point of distributing the questionnaire, SEFA had only started to venture into direct lending.

To obtain the information to form the categories “Lenders”, “Non-lenders” and “Accountants in practice” the demographic characteristics in Figure 5-5 “Department” were utilized. Although these were the only three sub groups that were formed for data analysis and reporting, the other socio-demographic information was obtained to provide an aggregate profile of the population and more specifically the diversity of the individuals.

The participant demographic data is presented in Figures 5-1 to 5-6.

Figure 5-1 reflects the gender data of the research participants.

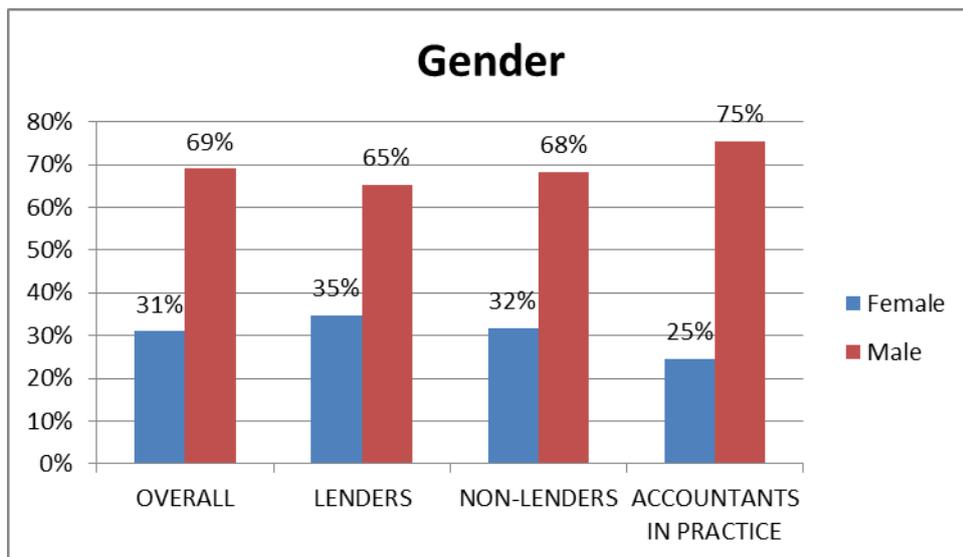


Figure 5-1: Gender

Figure 5-2 reflects the average age of the research participants.

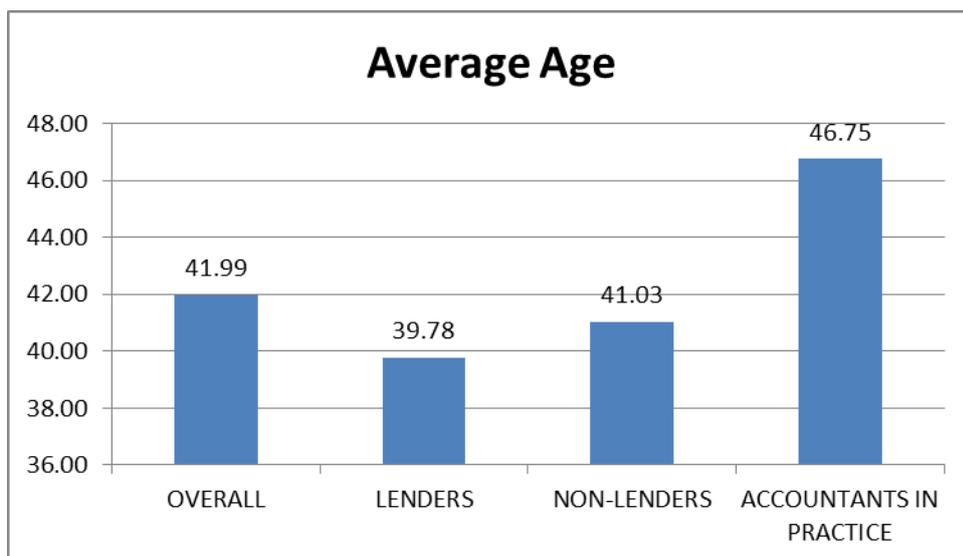


Figure 5-2: Average age

Figure 5-3 reflects the average number of years that the research participants have been in their current position at the workplace.

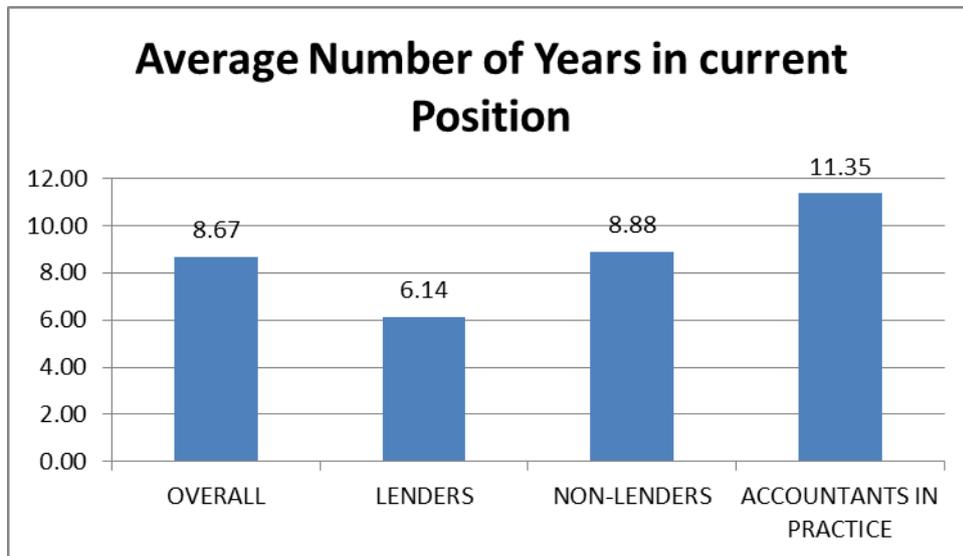


Figure 5-3: Average number of years in current position

Figure 5-4 reflects the highest qualification of the research participants.

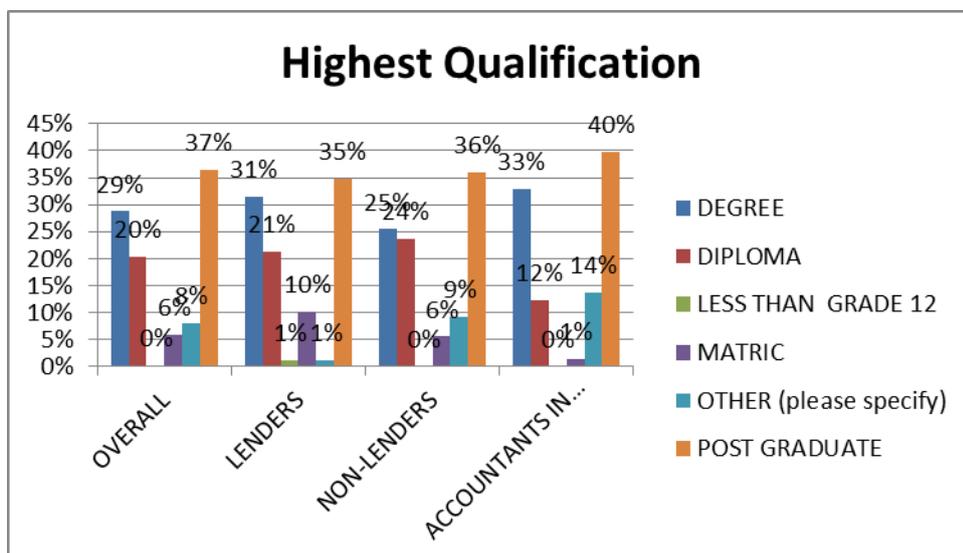


Figure 5-4: Highest Qualification

Figure 5-5 reflects the department at work of the research participants.

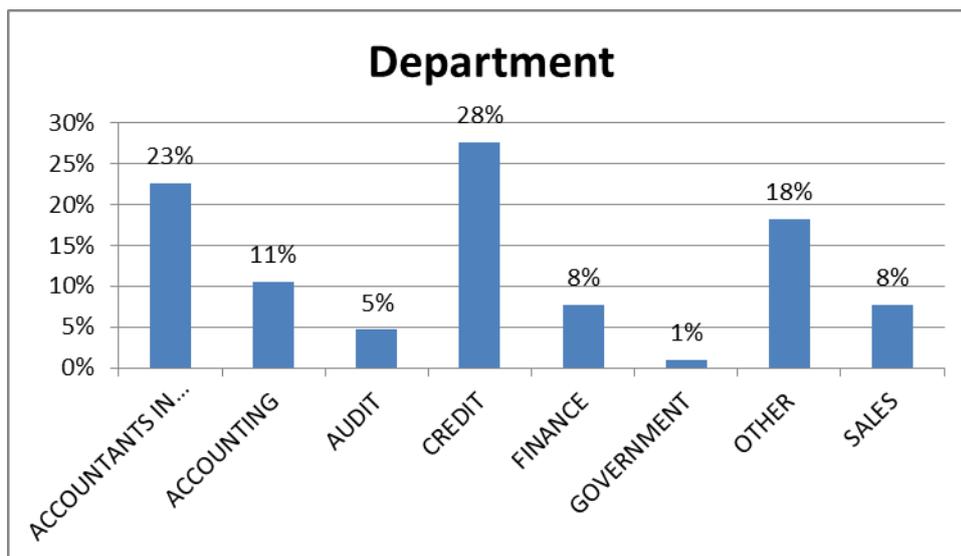


Figure 5-5: Department

Figure 5-6 reflects the division at work of the research participants.

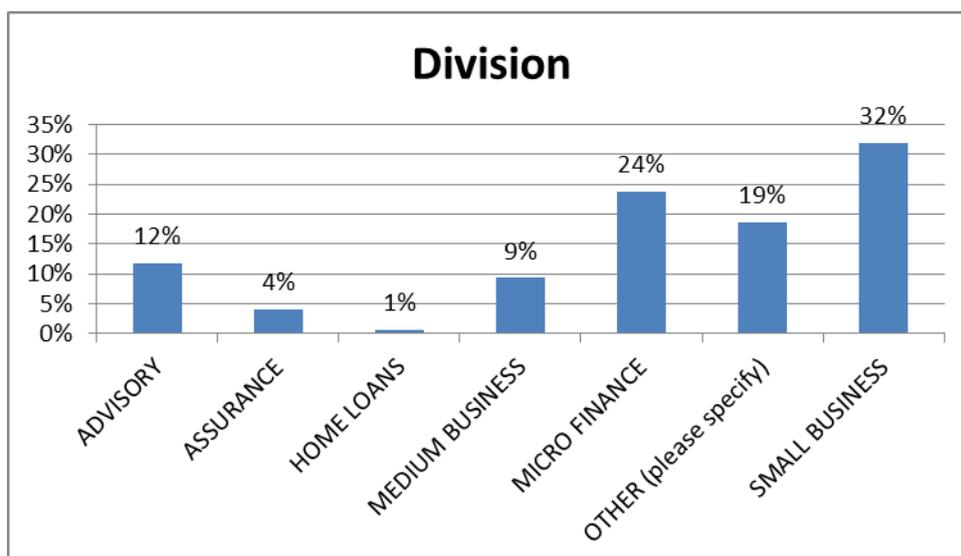


Figure 5-6: Division

### 5.4.3 Ethical considerations

In order to obtain the information, a senior person in the banks and at SEFA was identified in order to obtain the required consent from the relevant department in order to distribute the questionnaire to the population described above. Furthermore, where required, consent was obtained from the relevant banks' and SEFA's compliance department. From the accounting

perspective, a senior person at the Institute of Chartered Accountants and the Chief Executive Officer (CEO) of SAIBA was approached in order to distribute the questionnaire to the accountants to participate.

All ethical standards for this research were observed, and confidentiality was maintained by keeping the data confidential and not revealing the respondents' identities, or from which institution responses stemmed from when reporting on the data for the study. The respondents were informed about the purpose of the study and the procedures that would be used to collect the data. Participation was voluntary.

#### **5.4.4 Data analysis**

The Statistical Consultation Services at the North-West University were consulted to conduct the analysis of the quantitative “closed-ended” questions in order to ensure reliability. The results of the closed-ended questions were entered into a statistical programme, where IBM Statistical Package for Social Sciences (SPSS) Statistics Version 23 was used to analyze the data, and excel was used to draw the graphs. SPSS Inc. (2017). IBM SPSS Statistics Version 24, Release 23.0.0, Copyright© IBM Corporation and its licensors. <http://www-01.ibm.com/software/analytics/spss/>.

The results were presented in graph format. For each “closed-ended” question, there are four graphs to reflect the results for each question. The first graph will reflect the overall results of all the participants, the second graph the results only for the category of participants “lenders”, the third graph will reflect only the results of the category of participants “non-lenders”, and the fourth graph will reflect the results for the category of participants “accountants in practice”. The logic for including these different categories in the sample population was explained above.

The reason for showing the results per category is that it would be interesting to see the point of view from the various lenses of the groups of participants. For example, it is sometimes said that credit managers walk around with “blinkers” on, implying that they are not innovative and only apply “tick box” lending. Furthermore, accountants interview customers from a different end of the scale, not from a credit lending or banking perspective, hence the views may be different. Similarly the ‘non-lenders’ at the bank may also see things from a different lens, as some of these employees are customer facing and interview the customers, however, they do not have credit mandates to grant credit.

The open-ended question responses were cleaned, edited, and coded using vivo coding. Vivo coding is a form of qualitative data analysis that places emphasis on the actual spoken words of the participants (Grbich, 2007).

Charmaz (2001) describes coding as the “critical link” between data collection and their explanation of meaning. Saldaña (2015:16) defines a code in qualitative inquiry as “most often a word or short phrase that symbolically assigns a summative, salient, essence-capturing, and/or evocative attribute for a portion of language-based or visual data.”

Owen (2014) notes that coding is not a precise science as it is based on the interpretation of the coder. The aim of the coder is to find repetitive patterns of action and consistencies within the data. When looking for patterns in order to categorize data, certain data may be grouped as they have something in common, not because they are exactly alike. Coding, therefore, allows for the organization and grouping of similarly coded data into categories or “families” because they share some characteristic – the beginning of a pattern (Owen, 2014).

Through the lens of a constructivist, using descriptive and evaluative coding the ‘open-ended’ question results were categorized into codes that shared similarities, threading them into groups that logically and intuitively fitted together. Lincoln and Guba (1985) explain that the coder uses classification reasoning and tacit and intuitive senses to determine which data “looks alike” and “feels alike” in order to group the data together. The final number of major themes or concepts should be held to a minimum to keep the analysis coherent, but there is no standardized or magic number to achieve (Saldaña, 2015). Based on this, headings were identified for each category (theme), and in support of the heading, a summary of the data in support of this is listed below each category. It is important to note that based on this methodology followed, it was not deemed necessary to list how many respondents responded under each category. Furthermore, from a qualitative perspective, every contribution, in this instance recommendation, is considered as relevant, as it is based on the “opinion” of one or more of the respondents. The data validity and reliability of the questionnaire follows.

#### **5.4.5 Data validity and reliability**

All the items in the research instrument were subjected to a factor analytical procedure to determine which items should be used in summated scales to calculate the relevant scores. The factor analytical procedure revealed that the items measuring success loaded into 11 different categories. These categories were named; Credit product offering for small businesses, Shortcomings of the Khula Guarantee Scheme in enhancing credit extension, The bank’s Credit Policy differentiates for small business needs, Primary proof of income for

small business lending, Additional/supporting proof of income for small business lending, Challenges associated with lending to small businesses, Credit risks associated with lending to small businesses, Micro-economic factors: Financial, Micro economic factors: Strategy, Macro-economic factors, Financial ratios/key measures, Alternative financing methods.

The Kaiser-Meyer-Olkin (KMO) is a measure of how suited the data is for factor analysis hence this method was used to test the sample adequacy. The test measures sampling adequacy for each variable in the model and for the complete model. The statistic is a measure of the proportion of variance among variables that might be common variance. For the KMO, the value can vary between 0 and 1, where the values closer to 1 is better, and 0.6 is the suggested minimum (Cerny & Kaiser, 1977).

The Bartlett's Test of Sphericity is the test for the null hypothesis that the correlation matrix has an identity matrix. This would mean that the correlation between the variables is zero. For factor analysis, however, we need some relationship between the variables and therefore the result of the Bartlett's test must be significant, in other words we want to reject the null hypothesis (Cerny & Kaiser, 1977).

The statistical analysis of the data included an assessment of the internal reliability of the measuring instrument. This included the calculation of the Cronbach Alpha coefficients, which is a measure of the internal homogeneity or consistency of a set of variables, therefore, it shows the extent to which the same set of respondents responded in a consistent manner to similar variables/questions. Higher values are always preferred over lower ones. Reliability coefficients less than 0.50 are deemed to be unacceptable, and those above 0.70 are preferable (Nunally, 1978:226).

An example of the analysis is provided below.

Questions A1 to A3 (Refer to Addendum A: Questionnaire) was analyzed using Principal component exploratory factor analyses with Oblimin rotation, to explore the underlying factors. One factor was obtained from these questions and was named Credit product offering for small businesses (refer to Table 5-1).

Table 5-1 Factor: Credit product offering for small businesses

<b>KMO</b>	<b>Bartlett's Test (p-value)</b>	<b>% Variance explained</b>	<b>Cronbach's alpha</b>
0.732	0.000	77.49%	0.854

The KMO and Bartlett's test for this Factor analysis was 0.732 (should be above 0.5) and 0.000 (should be smaller than 0.05) respectively, indicating that a factor analysis can be done. The Percentage variance explained was 77.49%. From the Component matrix (Table 5-2) it is seen that all of the questions loaded above 0.3 on one factor, thus one factor was formed. The reliability for these questions was 0.854 (Cronbach's Alpha).

Table 5-2 Component Matrix

	Component
	Credit product offering for small businesses
The banks:   A3 Provide suitable credit products to meet the needs of small businesses.	.892
The banks:   A2 Provide clear lending criteria requirements to small business owners.	.877
The banks:   A1 Understand the needs of small businesses.	.872

In order to determine the validity and internal consistency of the data, a confirmatory factor analysis was conducted on the hypothesized factors (9 factors). The results for each factor can be found in Table 5-3. The first factor in Table 5-3 (Credit product offering for small businesses) was used as an example above, in order to provide an explanation on how to read the data provided in the table. A description of the questions which form the components 1 and 2 for "Loan assessment: "Acceptable proof of income" and "Loan assessment: Micro-economic factors" can be found in Table 5-4.

Table 5-3: Factor analysis

Factor	KMO	Bartlett's Test (p-value)	% Variance explained	Cronbach's alpha
Credit product offering for small businesses	0.732	<0.0001	77.49%	0.854
Khula Credit Guarantee Scheme: Challenges for banks	0.553	<0.0001	71.89%	0.71
Bank Credit Policy	0.638	<0.0001	70%	0.78
Challenges for banks	0.782	<0.0001	50.90%	0.714
Acceptable proof of income	0.789	<0.0001	63.63%	0.853 Component 1
				0.817 Component 2
Loan assessment: Micro-economic factors	0.858	<0.0001	62.63%	0.874 Component 1
				0.832 Component 2
Loan assessment: Macro-economic factors	0.866	<0.0001	71.79%	0.901
Financial ratios/Key matrix	0.832	<0.0001	71.23%	0.898
Alternative sources of finance	0.642	<0.0001	58.04%	0.623

With reference to Table 5-3, the lowest observed Cronbach Alpha value is 0.62 which is still deemed acceptable, and the other values are all above 0.70; hence the measuring instrument can thus be regarded as reliable.

Table 5-4: Description of the questions which form the components 1 and 2 for “Loan assessment: Micro-economic factors” and “Acceptable proof of income”

<b>LOAN ASSESSMENT: MICRO-ECONOMIC FACTORS</b>	
<b>Component 1</b>	<b>Component 2</b>
<ul style="list-style-type: none"> <li>The financial strength of the owners (by obtaining a statement of assets and liabilities of each owner/member/director).</li> </ul>	<ul style="list-style-type: none"> <li>Viability of business idea (demonstrated in a business plan).</li> </ul>
<ul style="list-style-type: none"> <li>Owner's financial contribution to the business.</li> </ul>	<ul style="list-style-type: none"> <li>Realistic envisaged growth.</li> </ul>
<ul style="list-style-type: none"> <li>Clear credit bureau report of owners/members/directors.</li> </ul>	<ul style="list-style-type: none"> <li>Projections are in line with past performance.</li> </ul>
<ul style="list-style-type: none"> <li>Clear credit bureau of the business.</li> </ul>	<ul style="list-style-type: none"> <li>Business experience of the owners/members/directors.</li> </ul>
<ul style="list-style-type: none"> <li>Owners/members/directors personal credit history with the bank.</li> </ul>	<ul style="list-style-type: none"> <li>Qualifications of owners/members/directors.</li> </ul>
<ul style="list-style-type: none"> <li>Business credit history with the bank.</li> </ul>	
<b>ACCEPTABLE PROOF OF INCOME</b>	
<b>Component 1</b>	<b>Component 2</b>
<ul style="list-style-type: none"> <li>Financial Statements and/or Management accounts.</li> </ul>	<ul style="list-style-type: none"> <li>Sales invoices.</li> </ul>

• Cash flow statement.	• Purchase receipts.
• Projected cash flow statement.	• Income tax return (owner/s).
• Personal (owner/s) account bank statements.	• Income tax return (business).
• Business account bank statements.	
• Proof of contract.	

The key outcome from the information provided in Table 5-4 above is that the mentioned factors can be formed and used in further analysis. Table 5-5 presents the descriptive statistics with an example of how to read the content of the table.

Table 5-5: Descriptive statistics for factors

	<b>N</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>Std. Deviation</b>
Credit Product Offering for SB's	323	1.00	4.00	2.5134	.80479
Credit Policy SB needs	320	1.00	4.00	2.2344	.72685
Credit Risk in lending to SB's	319	1.00	4.00	1.9224	.57638
Shortcomings of Khula	71	1.00	3.33	1.9491	.58049
Proof of Income	295	1.00	4.00	1.7153	.63717
Additional Proof of Income	295	1.00	4.00	2.0686	.74755
Micro-economic factors: Financial	255	1.00	4.00	1.8359	.62238
Micro-economic factors: Strategy	255	1.00	4.00	1.6729	.55940
Macro-economic factors	255	1.00	4.00	1.6894	.60847
Financial ratios/Key measures	240	1.00	4.00	1.6233	.56223
Alternative Finance Methods	218	1.00	3.67	1.9159	.59488
Challenges in Lending to SB's	320	1.00	4.00	2.1813	.61038
Valid N (listwise)	72				

With reference to Table 5-5, Credit product offering for small businesses had the highest mean of 2.51, whereas the Financial ratios/Key measures had the lowest mean of 1.62. This means the respondents tended to disagree with the questions in Credit product offering for small businesses and they agreed the most with the questions in Financial ratios/Key measures.

The Correlations Matrix is presented in Table 5-6 below.

Table 5-6 Correlations Matrix

	Credit Product Offering	Credit Policy needs	Credit Risk Lending SB	Shortcomings Khula	Proof of Income	Add Proof Income	Micro: Financial	Micro: Strategy	Macro	Financial ratios	Alternative Finance Methods	Challenges Lending SB
Credit Product Offering	1.000	.280**	-.027	-.055	.048	-.003	.136*	.015	-.007	.071	-.128	-.172**
Credit Policy needs	.280**	1.000	.213**	.166	.071	.080	.041	.031	.108	.094	.039	.100
Credit Risk Lending SB	-.027	.213**	1.000	.122	.229**	.217**	.227**	.294**	.372**	.277**	.171*	.368**
Shortcomings Khula	-.055	.166	.122	1.000	.191	.151	.303**	.178	.177	.276*	-.023	-.172
Proof of Income	.048	.071	.229**	.191	1.000	.592**	.417**	.465**	.479**	.466**	.264**	.206**
Add Proof Income	-.003	.080	.217**	.151	.592**	1.000	.292**	.292**	.394**	.299**	.180**	.134*
Micro: Financial	.136*	.041	.227**	.303**	.417**	.292**	1.000	.520**	.529**	.464**	.171*	-.055
Micro: Strategy	.015	.031	.294**	.178	.465**	.292**	.520**	1.000	.652**	.459**	.215**	.073
Macro-Economic	-.007	.108	.372**	.177	.479**	.394**	.529**	.652**	1.000	.582**	.337**	.149*
Financial ratios	.071	.094	.277**	.276*	.466**	.299**	.464**	.459**	.582**	1.000	.326**	.048
Alternative Finance Methods	-.128	.039	.171*	-.023	.264**	.180**	.171*	.215**	.337**	.326**	1.000	.259**
Challenges Lending SB	-.172**	.100	.368**	-.172	.206**	.134*	-.055	.073	.149*	.048	.259**	1.000

With reference to Table 5-6, all the variables marked with an asterisk (\*\*) must be considered as they are significantly related to the comparing variable. For example, with reference to the value in the second row (.280\*\*) one can derive the following: there was a positive medium relationship of 0.28 between Credit Product offering and Credit Policy needs, meaning that the more the participants agreed with Credit Product offering, the more they agreed with Credit Policy needs.

There is only one negative correlation (-.172\*\*), which is between the Challenges in small business lending and the Credit Product offering. The reason for this may be that the challenges for small business lending is not so much the product offering to small businesses but the challenges are more related to other reasons. Judging from Table 5-6, the challenges for small business lending are more associated with proof of income, where proof of income is not readily available from the small business segment as they mainly lack formal financial statements.

Furthermore, the more the participants agreed with macro-economic factors to be considered when assessing small business applications, the more they agreed with the challenges in small business lending, which highlights that macro-economic factors such as the current economic environment in South Africa could also negatively impact on small businesses. There is also a correlation between alternative finance methods and challenges in small business lending which may be an alternative financing solution considering the challenges identified.

What is also prominent from Table 5-6, is the correlation between micro (firm-based) factors, macro-economic factors, financial ratios, challenges, and credit risk. This signifies that firm-based factors, macro-economic factors, financial ratios, and the challenges have a significant impact on the credit risk in small business lending.

In addition, there is a prominent correlation between firm-based and macro-economic factors, financial ratios, alternative finance methods, credit risk and proof of income, or additional proof of income types.

Below the results of the Anova test is provided.

Table 5-7 Anova Test

	Lenders			Non-lenders			Accountants in practice			Effect Size		
	N	Mean	Std	N	Mean	Std	N	Mean	Std	Lenders with Non-Lenders	Lenders with Accountants in practice	Non-Lenders with Accountants in practice
Credit Prod Off SB	89	2.34	0.79	161	2.52	0.79	73	2.71	0.80	.22	.46	.24
Credit Policy SB needs	89	2.28	0.69	159	2.24	0.72	72	2.17	0.80	.06	.14	.09
Credit Risk Lending SB	89	1.89	0.52	159	1.93	0.59	71	1.95	0.62	.06	.10	.05
Shortcomings Khula	29	1.86	0.59	30	2.00	0.53	13	2.03	0.69	.23	.24	.04
Proof of Income	84	1.69	0.57	146	1.70	0.64	65	1.78	0.71	.00	.13	.12
Add Proof Income	84	2.07	0.73	146	1.95	0.73	65	2.32	0.76	.17	.32	.48
Micro: Financial	80	1.73	0.62	124	1.88	0.61	51	1.91	0.65	.24	.27	.04
Micro: Strategy	80	1.70	0.57	124	1.67	0.56	51	1.64	0.54	.04	.10	.07
Macro-economic	80	1.73	0.57	124	1.64	0.61	51	1.75	0.66	.15	.04	.17
Financial ratios	78	1.56	0.51	114	1.65	0.58	48	1.66	0.62	.15	.16	.01
Alternative Finance Methods	76	2.02	0.53	100	1.93	0.63	42	1.69	0.56	.14	.59	.38
Challenges Lending	89	2.41	0.54	159	2.12	0.64	72	2.05	0.57	.46	.63	.11

Analysis of Variance (ANOVA) is a statistical method used to test differences between two or more means (Gamst, Meyers & Guarino, 2018). With reference to Table 5-7, the effect sizes larger than 0.45 (which signifies a practical significant difference) (Gamst *et al.*, 2018) are reported on below.

- There was a medium effect size of 0.46 between the Lenders and Accountants in practice for Credit Product offering. This means the Lenders and Accountants in practice had a practical significant difference in their response when answering questions. Accountants in practice agreed more with the questions in Credit Product offering than the Lenders with means 2.71 and 2.34 respectively.
- There was a medium effect size of 0.59 between the Lenders and Accountants in practice for “alternative finance methods”. The Lenders agreed more with the questions in “alternative finance methods” than the Accountants in practice with means 2.02 and 1.69 respectively.
- There was a medium effect size of 0.63 between the Lenders and Accountants in practice for challenges in lending to small businesses. The Lenders agreed more with the questions in challenges in lending to small businesses than the Accountants in practice with means 2.41 and 2.05 respectively.
- There was a medium effect size of 0.48 between the Non-lenders and Accountants in practice for “additional acceptable proof of income”. Accountants in practice agreed

more with the questions in “additional acceptable proof of income” than the Non-lenders with means 2.32 and 1.95 respectively.

- There was a medium effect size of 0.46 between the Lenders and Non-lenders for “challenges in small business lending”. The Lenders agreed more with the questions in “challenges in small business lending” than the Non-lenders with means 2.41 and 2.12 respectively. This may be attributable to the fact that the Lenders have first-hand experience in the challenges to lend to small businesses, as the Lenders are credit grantors which assess small business credit applications on a daily basis.

#### **5.4.6 Questionnaire results**

In the preceding section, the statistics around the determination of constructs and the statistical significance based on the agreement or disagreement of the listed “constructs” were discussed. In the sections to follow, responses to the questionnaire are discussed based on descriptive statistics. In addition, and very specifically, the results of the qualitative part of the study is addressed.

##### **5.4.6.1 Section 1: Banks existing proposition for small businesses**

The questionnaire began with three structured questions based on the bank's proposition to small businesses as per Figure 5-7. In order to provide clarity, there are four graphs for each “closed-ended” category of questions. The first graph will provide the “Overall” total responses of all the participants, the second graph will provide the responses of only the “Lenders”, the third graph the responses of only the “Non-lenders”, and the fourth graph the responses of only the “Accountants in practice”.

For example, in Figure 5-7, there are three questions/statements: (1) The banks understand the needs of small businesses; (2) The banks provide clear lending criteria requirements to small business owners; (3) The banks provide suitable credit products to meet the needs of small businesses. The participants were asked to select from the following options: Strongly agree; Agree; Disagree; Strongly disagree. Figure 5-7 provides the results of the “Overall” participants, namely; Lenders, Non-lenders and Accountants in practice. Figure 5-8 provides the results for the Lenders, Figure 5-9 provides the results for the Non-Lenders, and Figure 5-10 provides the results for the Accountants in practice. Following the fourth graph for each category of questions, commentary is provided on what is presented in the graphs.

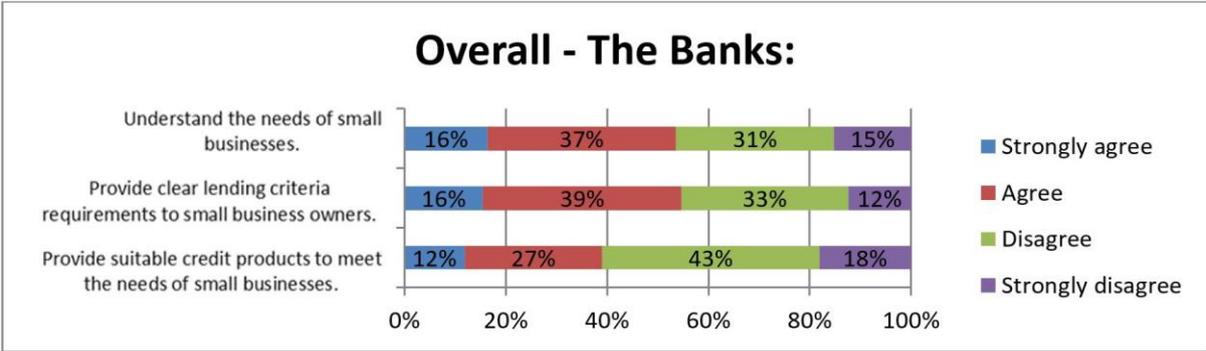


Figure 5-7: Overall: Banks proposition to small businesses

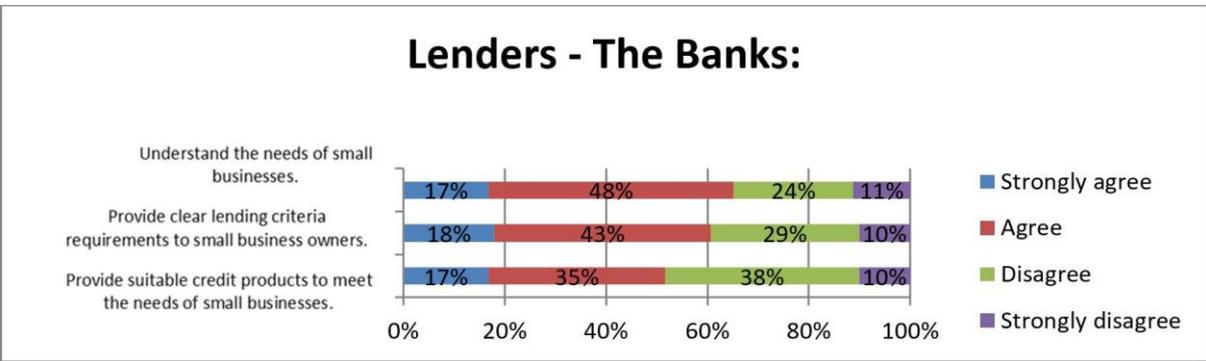


Figure 5-8: Lenders: Banks proposition to small businesses

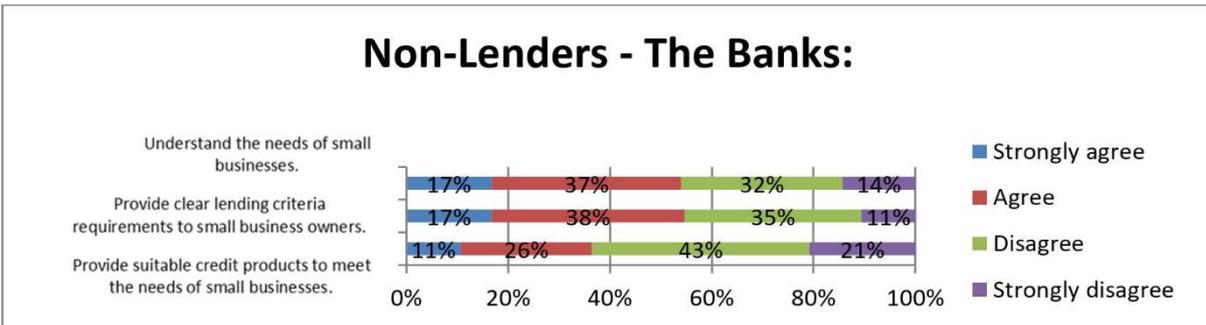


Figure 5-9: Non-lenders: Banks proposition to small businesses

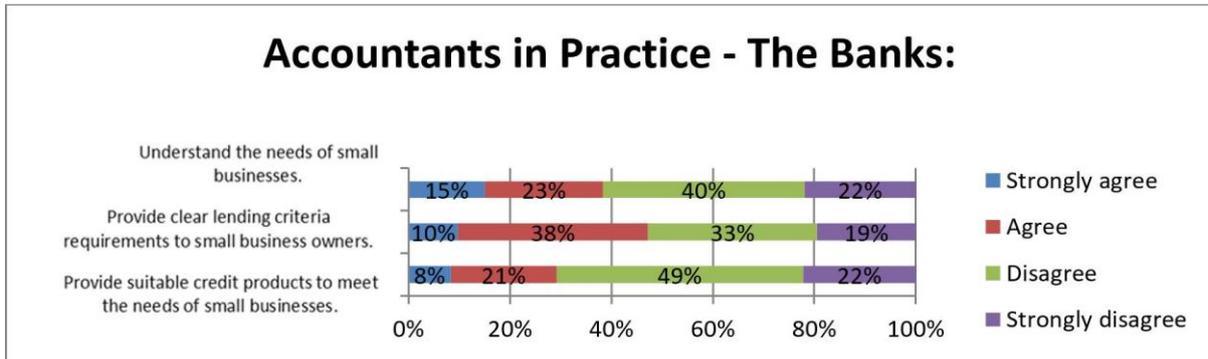


Figure 5-10: Accountants in practice: Banks proposition to small businesses

The overall figures above highlight that although banks understand the needs of small businesses, and provide clear lending criteria, the banks do not provide suitable products to meet the needs of the small businesses. Specifically, the accountants in practice (71%) and the non-lenders (64%) seem to feel that the banks do not provide suitable credit products to meet the needs of small businesses.

The participants were then asked structured questions on the Credit Policy of the banks with regards to small business lending. The results follow in Figures 5-11 – 5-14.

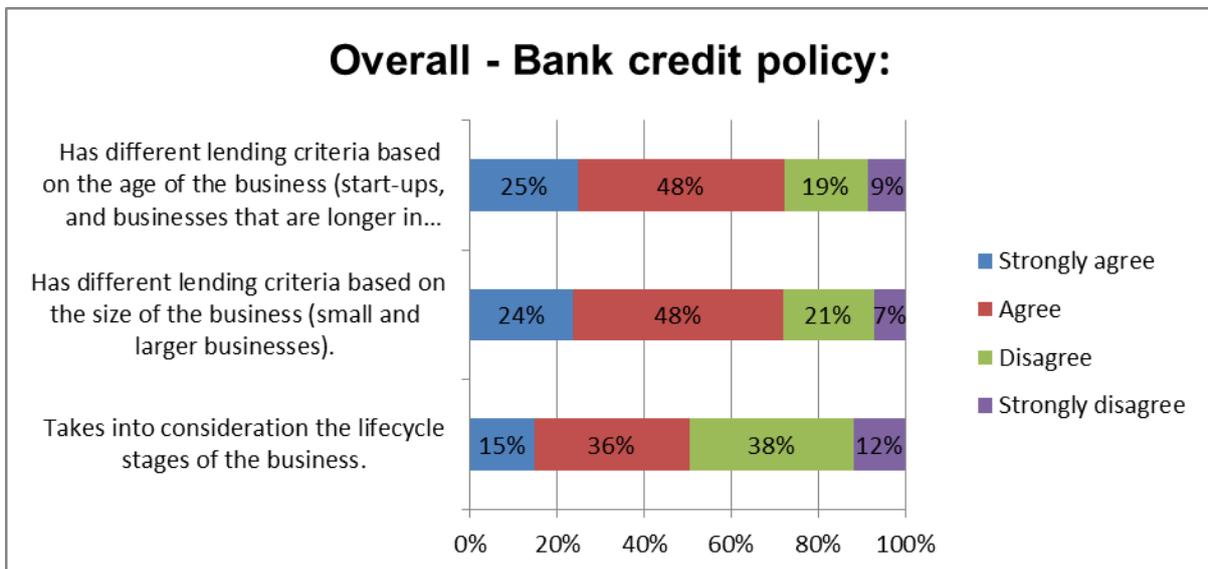


Figure 5-11: Overall: Bank Credit Policy

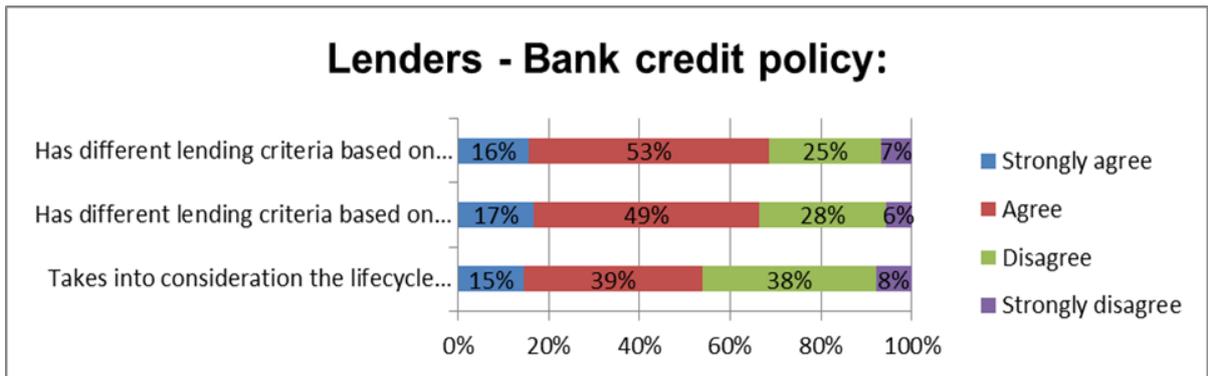


Figure 5-12: Lenders: Bank Credit Policy

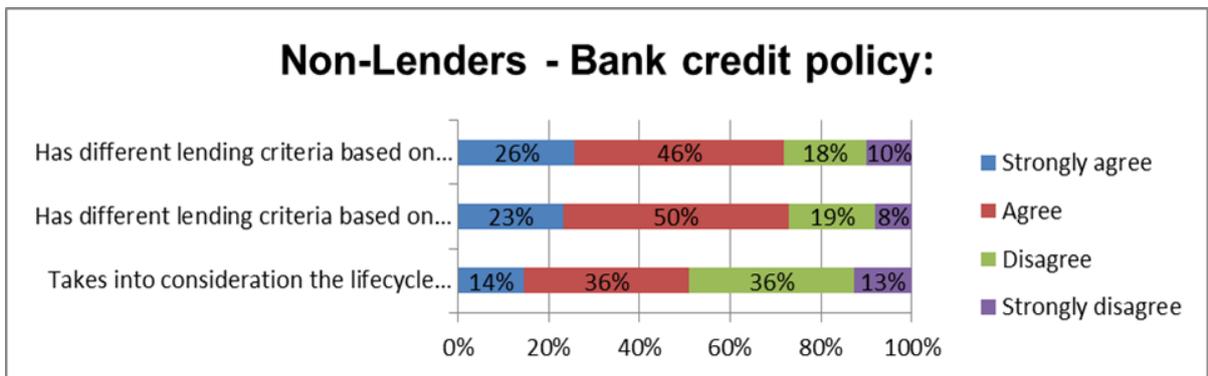


Figure 5-13: Non-lenders: Bank Credit Policy

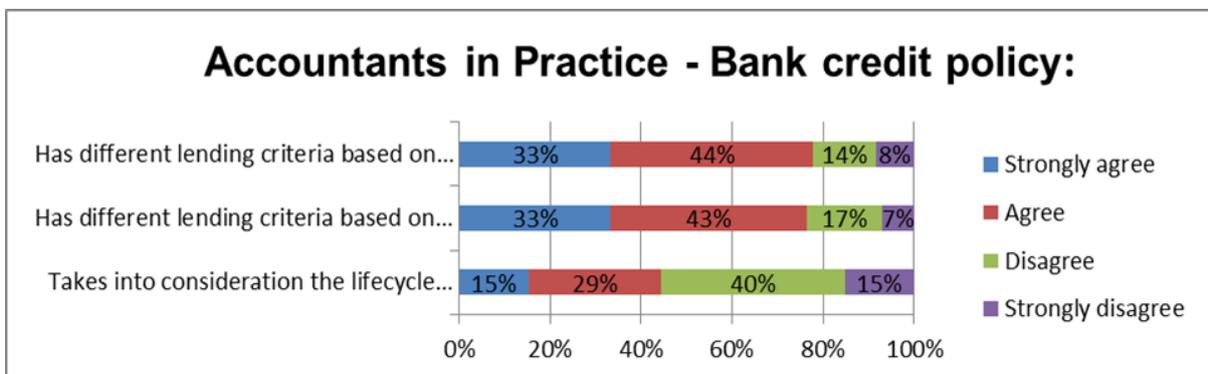


Figure 5-14: Accountants in practice: Bank Credit Policy

Overall the participants agreed that banks do have different lending criteria based on the age of the business (start-ups and businesses that are longer in existence) and size of a business, and the banks do take into consideration the lifecycle stages of a business. The accountants in practice, however, did not seem to agree that the banks take into consideration the lifecycle stages of the business as only 44% agreed to this statement.

The participants were then asked to identify the challenges when providing credit to small businesses, based on the options provided.

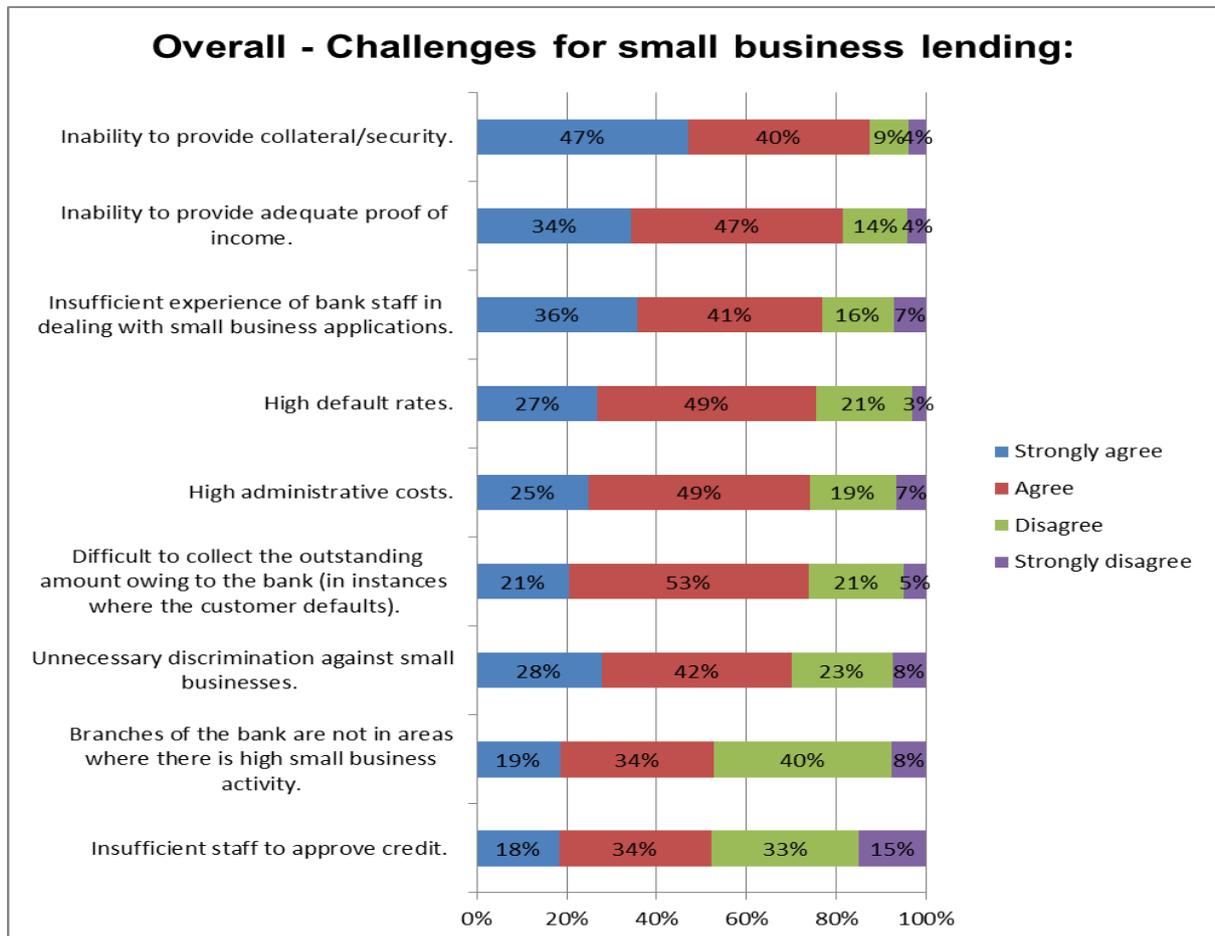


Figure 5-15: Overall: Challenges for small business lending

## Lenders - Challenges for small business lending:

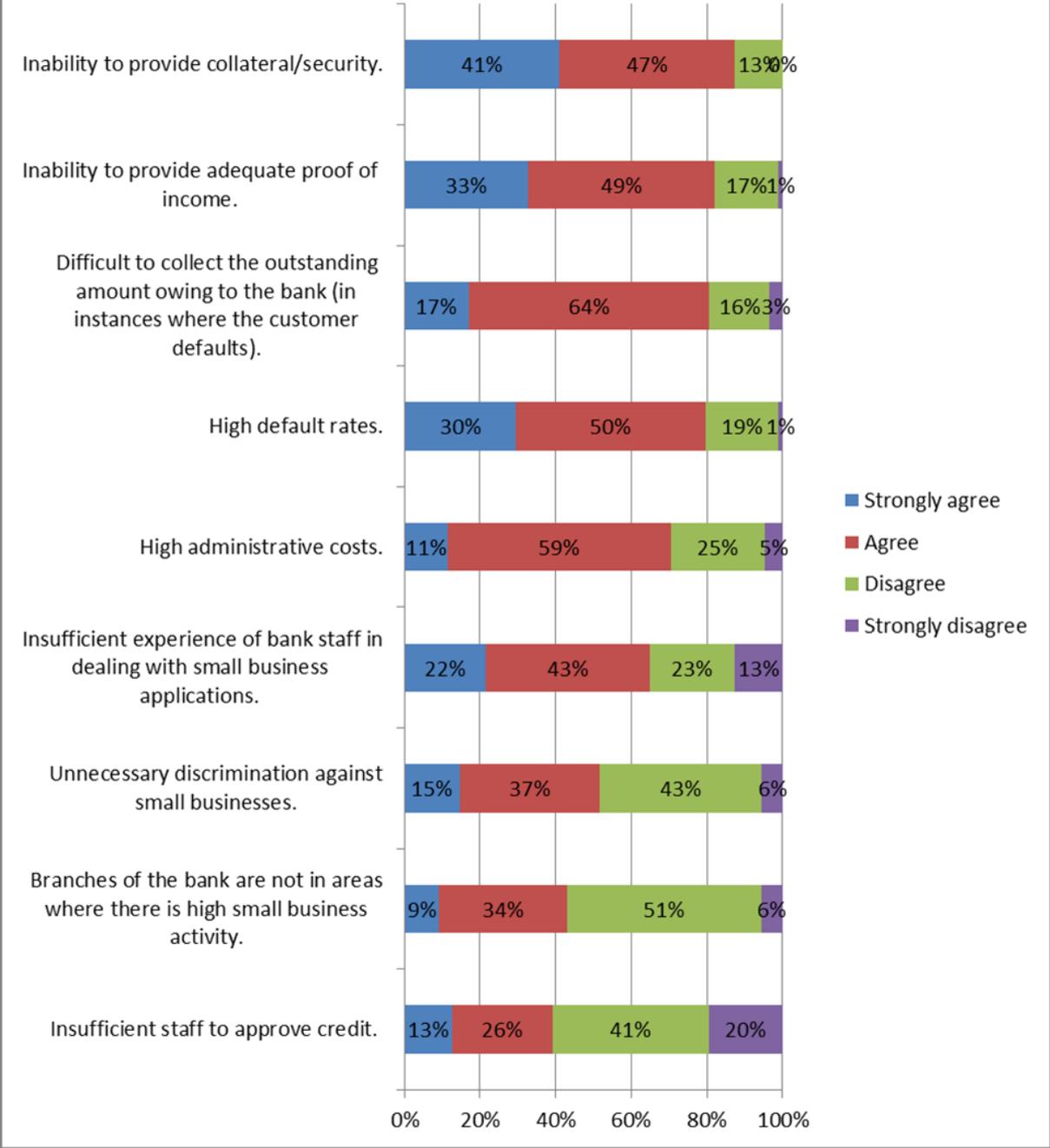


Figure 5-16: Lenders: Challenges for small business lending

## Non-Lenders - Challenges for small business lending:

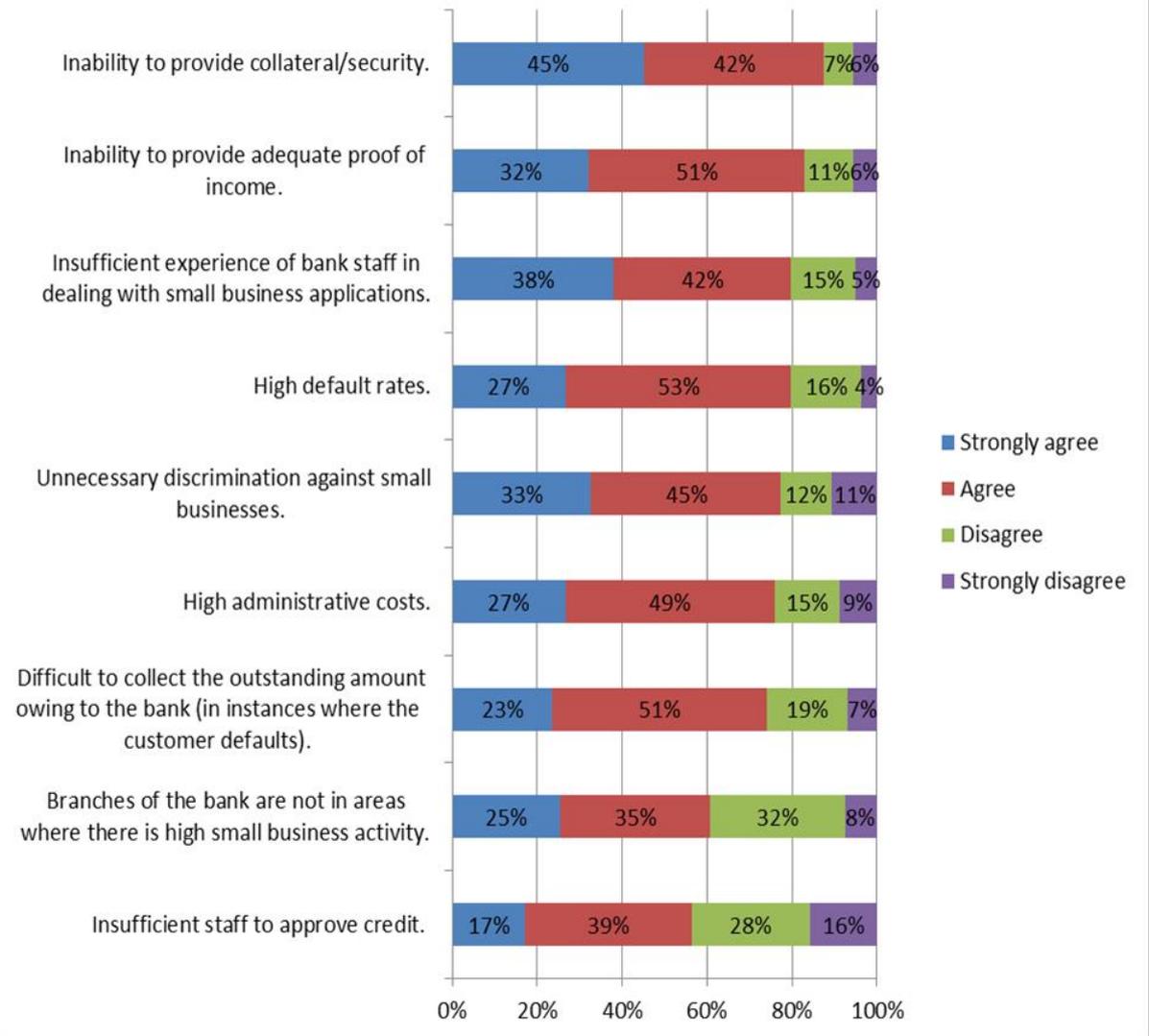


Figure 5-17: Non-lenders: Challenges for small business lending

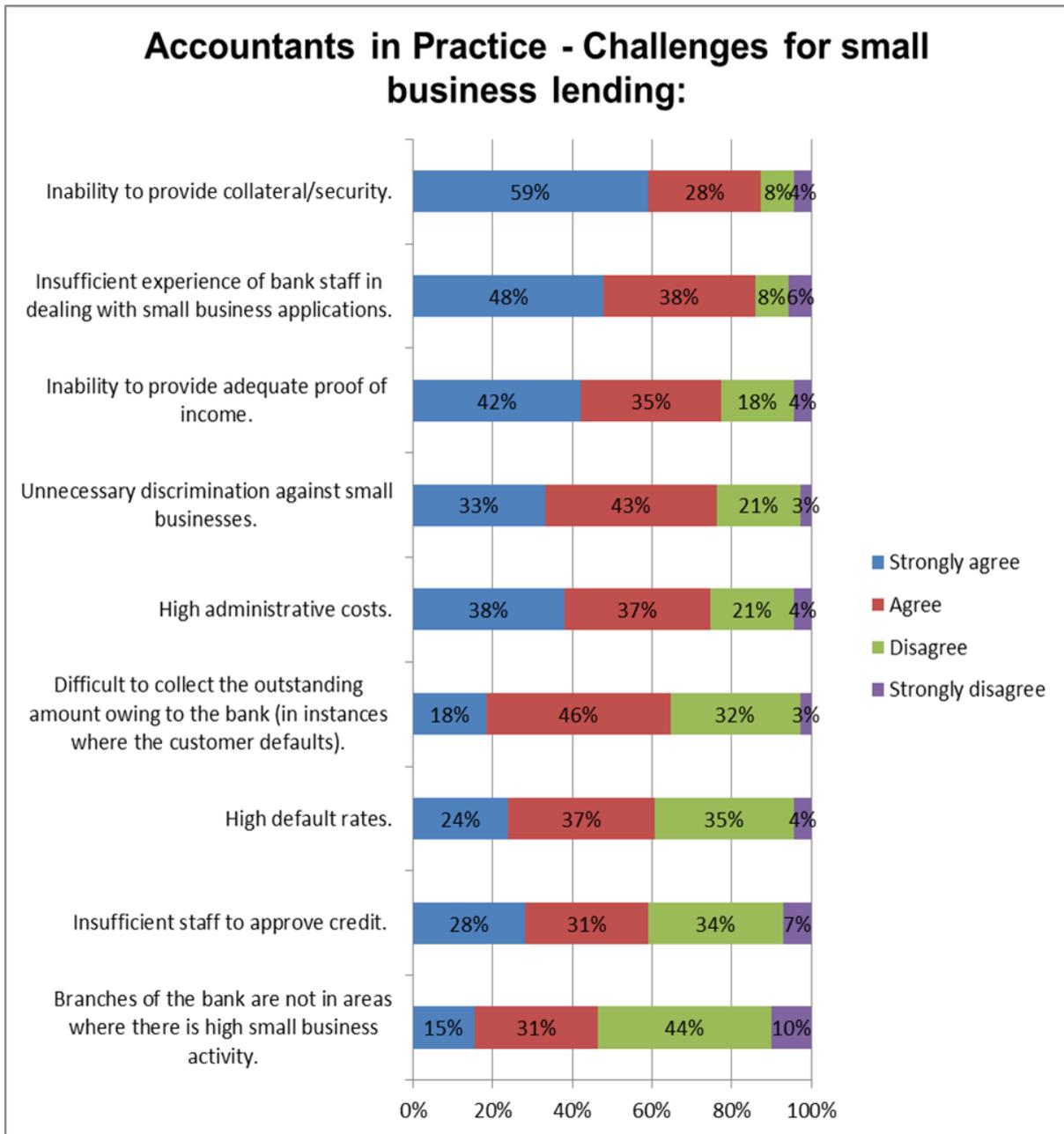


Figure 5-18: Accountants in practice: Challenges for small business lending

The above results emphasize the importance of collateral security, as overall, the inability to provide collateral security was rated as the highest challenge when lending to small businesses. Both the inability to provide collateral and proof of income were identified during the literature review as significant challenges for small business lending. What was also highlighted from the above figures is that it is not so much that there is insufficient staff to service the small business customers (as this was provided as an option), but more that the staff is not experienced to deal with small business applications. The latter seems to be more the view of the accountants in practice and the non-lenders, who also seemed to have the view that there is unnecessary discrimination against small businesses.

Other than the challenges provided for the participants to choose from, an open-ended question was posed to the participants asking what other challenges are faced when lending to small businesses. The results are presented in the two Tables. Table 5-8 reflects the challenges credit managers face when assessing small business credit applications based on the 5C's of credit. Table 5-9 reflects challenges other than from a credit evaluation perspective.

Table 5-8: Challenges from a credit evaluation perspective when assessing small business applications (5C's of credit)

<b>CHARACTER (INCLUDING PERSONAL ATTRIBUTES)</b>
<ul style="list-style-type: none"> <li>• Insufficient qualifications/education of owners, specifically in financial literacy.</li> <li>• No/insufficient business/entrepreneurial experience.</li> <li>• No/insufficient credit history on the business.</li> <li>• Poor (bad) credit record of the business/owner's.</li> <li>• Difficult to measure the dedication/confidence and passion of the owner to succeed.</li> </ul>
<b>CAPACITY</b>
<ul style="list-style-type: none"> <li>• Business plans are inadequate: Insufficient market research and there is no clear business strategy on how the expected sales will be achieved.</li> <li>• Lack of or poor quality financial statements.</li> <li>• Difficult to differentiate between personal and business assets/income and expenses. Utilize one account for both personal and business, or operate in cash to a large extent.</li> <li>• Lack of or poor cash flow forecasts.</li> </ul>
<b>CONDITION</b>
<ul style="list-style-type: none"> <li>• Unable to ensure that the funds are used for the purpose for which they were sought.</li> <li>• Macro-economic conditions: Increase in static expenses due to power and fuel increases; load shedding by Eskom.</li> <li>• Crime; Tender fraud; Black economic empowerment (BEE) requirements by suppliers; Regulation.</li> </ul>
<b>CAPITAL</b>
<ul style="list-style-type: none"> <li>• Insufficient personal liability of members/directors.</li> <li>• Insufficient consequence for default.</li> </ul>
<b>COLLATERAL</b>
<ul style="list-style-type: none"> <li>• Cannot meet collateral security requirements. Specifically tangible securities such as investments, fixed property, and surrender value on policies.</li> </ul>

Table 5-9: Other challenges

<b>INSUFFICIENT RISK APPETITE FOR SMALL BUSINESS LENDING</b>
<ul style="list-style-type: none"> <li>• Banks require the same return on equity (ROE) from small businesses as they would from large businesses.</li> <li>• The challenge is to find a mechanism to lend to small businesses at a high enough ROE to compensate for the increased risk, but also make it attractive to the small business owner.</li> <li>• Not considered “profitable enough” to lend to small businesses.</li> <li>• The high cost of qualified staff to do a risk assessment on smaller value loans.</li> <li>• The expected return may not justify this type of structure to support relationship-based lending services to small businesses.</li> <li>• Too labour intensive for the income generated and the high default rates of loans.</li> <li>• Start-ups and businesses that are not well established are considered high risk, and banks are not willing to lend to these businesses.</li> <li>• When banks “price for risk”, the interest rate charged is deemed too high and as a result, the business owner will even forego what could have been a profitable investment, for the sake of not having to pay the interest involved.</li> </ul>
<b>LACK KNOWLEDGE ON SMALL BUSINESSES</b>
<ul style="list-style-type: none"> <li>• Banks don’t understand the small business sector.</li> <li>• It is a challenge for banks to find suitable employees to service small business customers.</li> <li>• Banks lack the ability to match the employee profile to the relevant small business.</li> <li>• Banks will only be able to assist start-up businesses if the banks themselves understand the nature of start-up businesses. It is extremely difficult for people who have not started their own businesses to have the knowledge and experience to assist a start-up business.</li> <li>• Banks apply one Credit Policy for all.</li> <li>• The products offered by banks do not clearly meet the requirements of small businesses.</li> </ul>

The questionnaire then allowed the participants to provide suggestions on how banks can overcome the challenges which were identified by the participants in the previous question. The results are listed in Table 5-10.

Table 5-10: Suggestions to overcome the challenges of small business lending

<b>BANKS MUST PRIORITISE THE IMPORTANCE OF ENTERPRISE BUSINESS</b>
<ul style="list-style-type: none"> <li>• The bank's social responsibility should not be limited to Corporate Social Investment (CSI) projects but ensuring that the communities they operate within have various sustainable businesses that contributes to job creation which in turn will increase the Bank's customer base.</li> <li>• Banks should forgo some margin in order to invest in the growth of small businesses.</li> </ul>

### **GAIN AN IN-DEPTH UNDERSTANDING OF SMALL BUSINESSES**

- Understand the needs, challenges, and risks.
- Incubate: Understand through experience and learning – have a hands-on approach to research and development. A flexible mandate should be allocated to operate within.
- Conduct research and arrange for focus groups.
- Engage with: business accelerators, incubators, start-up forums and groups, Chambers.
- Have an outsourced arrangement with industry experts to understand the economics of some industries. Develop these proposals in partnership with Government and DFI's.
- Visit small businesses.

### **BE MORE CUSTOMER FOCUSED**

- Employ the right staff who will actually have a passion for assisting small businesses to develop and grow.
- Focus on creating long-standing relationships: provide a conducive and supportive environment for small business lending, this should be along the entire value chain - even at school and post-school training.
- Banks should be seen as partners to the small businesses, rather than a customer who will be charged for services being rendered to them in the form of bank charges and other related costs.
- Simplify paperwork, store it electronically and do not request this information each time a customer walks into the bank with a request - be it of a borrowing, investing, or even a fiduciary reason.
- Provide tailor-made credit packages to meet the needs for small businesses catering to a specific industry/sector.
- Provide mentorship and support services to small business owners.

### **APPLY EVALUATION METHODS SUITABLE FOR SMALL BUSINESSES**

- Develop a risk assessment model relevant to small businesses.
- Draft a Credit Policy specific to small businesses.
- Allow for applicants to have contact with decision makers and vice versa.
- Allow for the detailed business plan to be presented by the business owner but be supported by the accredited accountant.

### **PROVIDE CONSTANT AFTER SUPPORT AND MONITORING**

#### **TRAINING PROGRAMMES TO BE ARRANGED WITH GOVERNMENT TO PROVIDE THE FOLLOWING (paid by Government):**

##### **Financial**

##### **Basic accounting/bookkeeping/financial management training:**

- Building a good credit record.
- To recognize the difference between sales (turnover) and profit.
- Mark-up percentage on the sale of goods to ensure profitability.
- Cash flow budgets, personal overspending, stock control, debtor book collection.

- To compile and manage accounting records.
- Taxation and VAT issues.

**On a more advanced level:**

- Drafting of business plans/budgets/forecasts/projections.
- Cash flow management, costing, record keeping, cash management, cash flow planning, ratio analysis, credit risk, financials.

**Non-financial**

**Basic skills to manage the business:**

- Identify target market/how to get customers/market a business.
- Daily operations management of a business.
- HR management.
- Time and priority management.
- IT and computing solutions.

**Dealing with required legislation:**

- Registration requirements.
- National Credit Act.
- Company regulation.
- Commission for Conciliation, Mediation and Arbitration (CCMA).

**On a more advanced level:**

- Marketing and research.
- Business cycles.
- Risk management.
- Industry trends and analysis.
- Relevant events in economics, markets, politics.

In the following Section (2), the participants were asked their view on what a proposed Credit Policy should be for small business lending. The first set of questions under this section began with whether the participants agreed if the options provided were acceptable as proof of income for small business lending.

### 5.4.6.2 Section 2: Credit Policy for small business lending

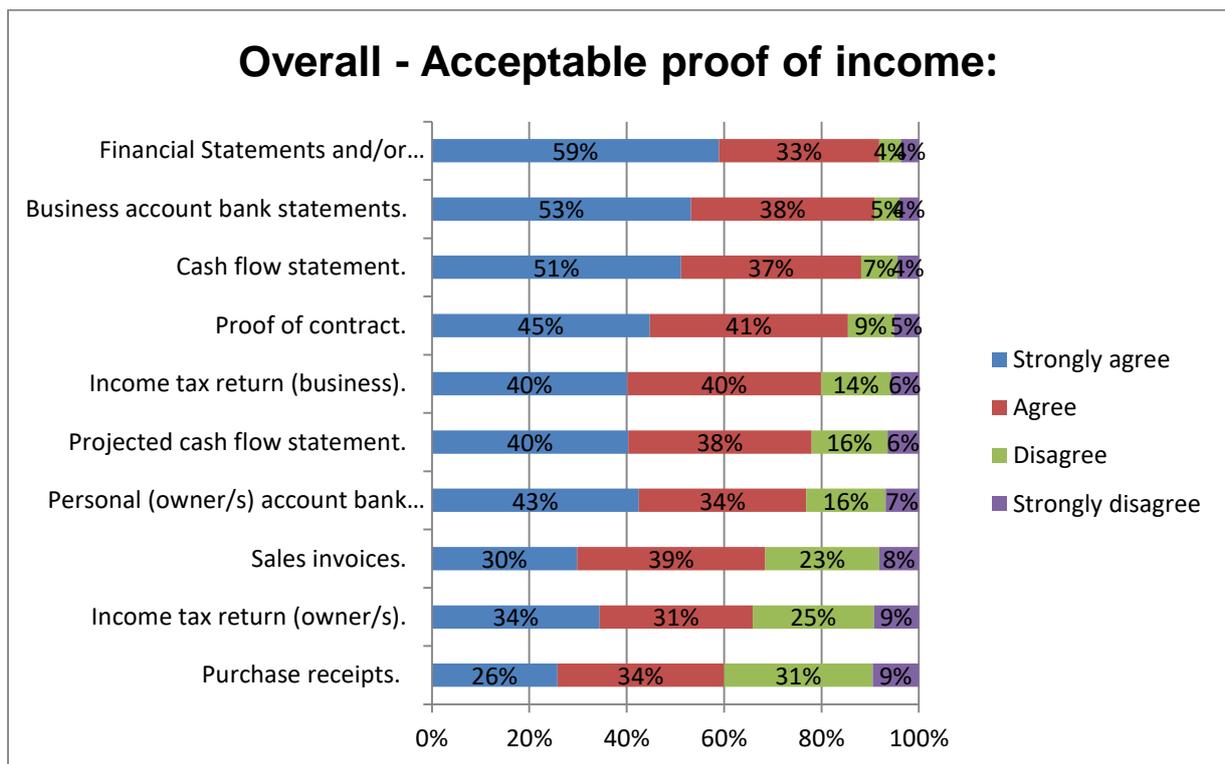


Figure 5-19: Overall: Acceptable proof of income

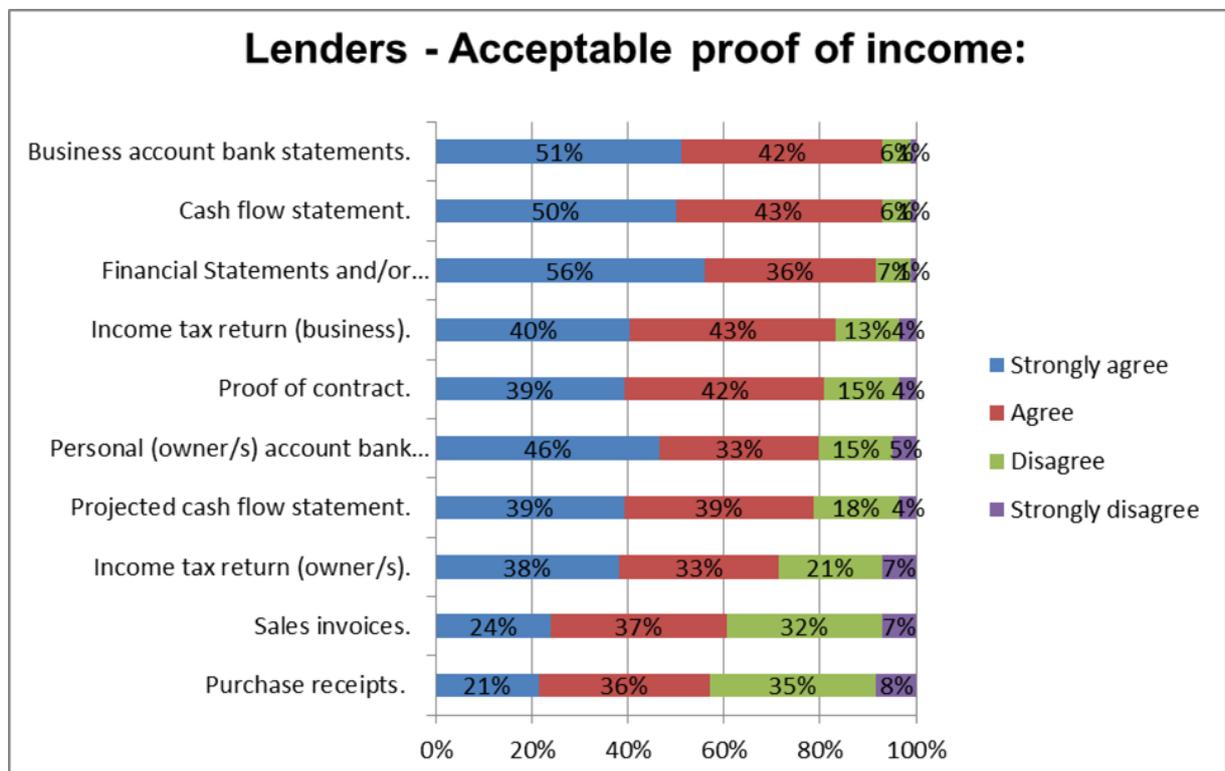


Figure 5-20: Lenders: Acceptable proof of income

### Non-Lenders - Acceptable proof of income:

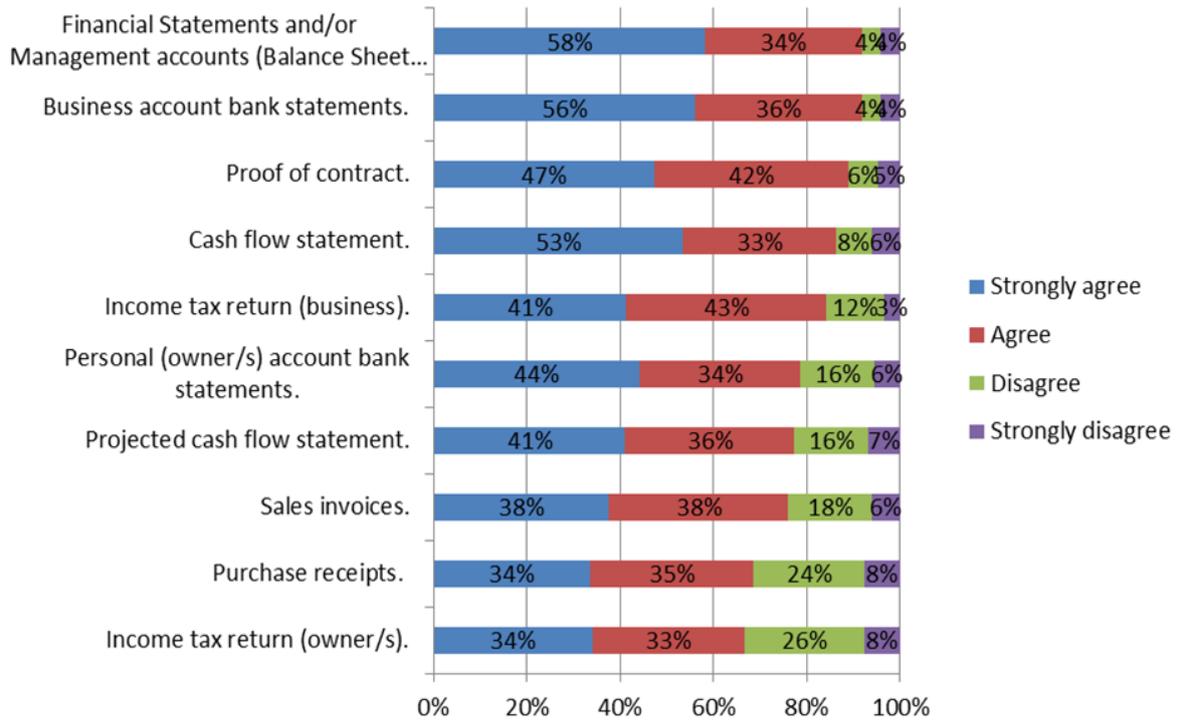


Figure 5-21: Non-lenders: Acceptable proof of income

### Accountants in Practice - Acceptable proof of income:

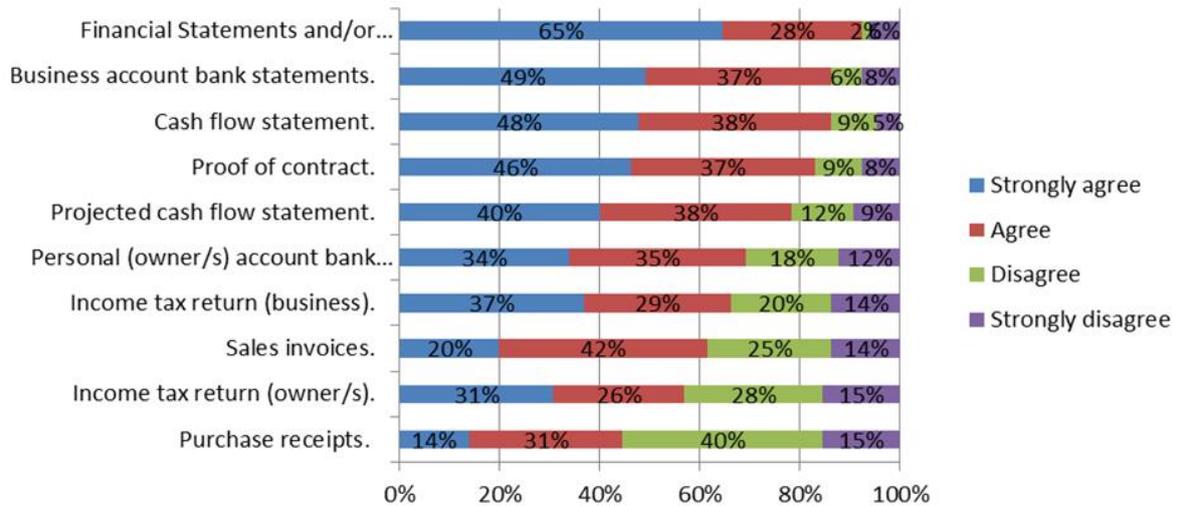


Figure 5-22: Accountants in practice: Acceptable proof of income

Using 50% as a cut-off point, overall all the proof of income options provided to the participants are deemed acceptable, with the exception of the accountants in practice who seemed to disapprove of purchase receipts. The traditional form of proof of income is the most significant overall, namely financial statements. Interestingly, the bank lenders seem to rate the business account statements and cash flow statements more highly than financial statements. The non-lenders seem to rate the proof of contract in the top three which do not appear in the top three in the other categories.

The participants were then asked in an open-ended question whether there is any other proof of income, other than the options provided above, that can be used as proof of income for small business lending. The results are listed in Table 5-11.

Table 5-11: Other proof of income

<b>OTHER PROOF OF INCOME</b>
<ul style="list-style-type: none"> <li>• Proof of interest from investments/ proof of dividends from shares/unit trusts.</li> <li>• Non-interest revenue on assets.</li> <li>• Proof of income derived from other business interests.</li> <li>• Proof of income derived from a Point of Sale register.</li> <li>• Debtor contracts supported by a debtor's age analysis.</li> <li>• Letters of undertaking/guarantees.</li> <li>• Confirmation letter from a registered accountant/auditor stating the average monthly income generated by the business.</li> <li>• Vat returns/Form IT34.</li> </ul>

For start-ups, it is unlikely that the owner will have even these alternative incomes (as listed above). The participants were, therefore, asked their view on how start-up businesses which have a viable business idea, but are unable to provide proof of income, can be assisted with finance. The results follow in Table 5-12.

Table 5-12: Start-up business – alternative proof of income

<b>OWNER/S CREDIT RISK PROFILE CHECKS</b>
<p>If the bank is satisfied with the feasibility of the business idea:</p> <ul style="list-style-type: none"> <li>• Obtain the CVs of the owner/s.</li> <li>• A suitably qualified banking official is to conduct a thorough interview with the owner/s. Owner/s must have the competence and be 100% dedicated and focused on the business success. Owner/s must meet the criteria of the “character” aspect of the 5C’s of credit.</li> </ul>

- Conduct credit risk profile checks – if the owner is taking care of his/her personal finances, there is a high likelihood that the owner will be responsible with the business finances.
- Owners must have experience of the specific type of business (sector).
- Obtain references on owners/ testimonials/business history, any documented evidence of success elsewhere.

**ENSURE THAT THERE IS A CAPITAL CONTRIBUTION BY THE OWNER**

- There must be a minimum acceptable capital contribution (owners' equity) by the owner into the business.
- Preference shareholding can be considered.

**OBTAIN COLLATERAL SECURITY WHERE IT IS AVAILABLE**

- Cede any available tangible assets of the owner.
- Take security on debtors/stock on hand.
- Guarantor/surety by:
  - An investor.
  - A family member/friend with tangible assets to cede as security.
  - By the owner/s in favour of the business if it is a separate legal entity.

Below the questions and relevant responses are related to the credit decision process.

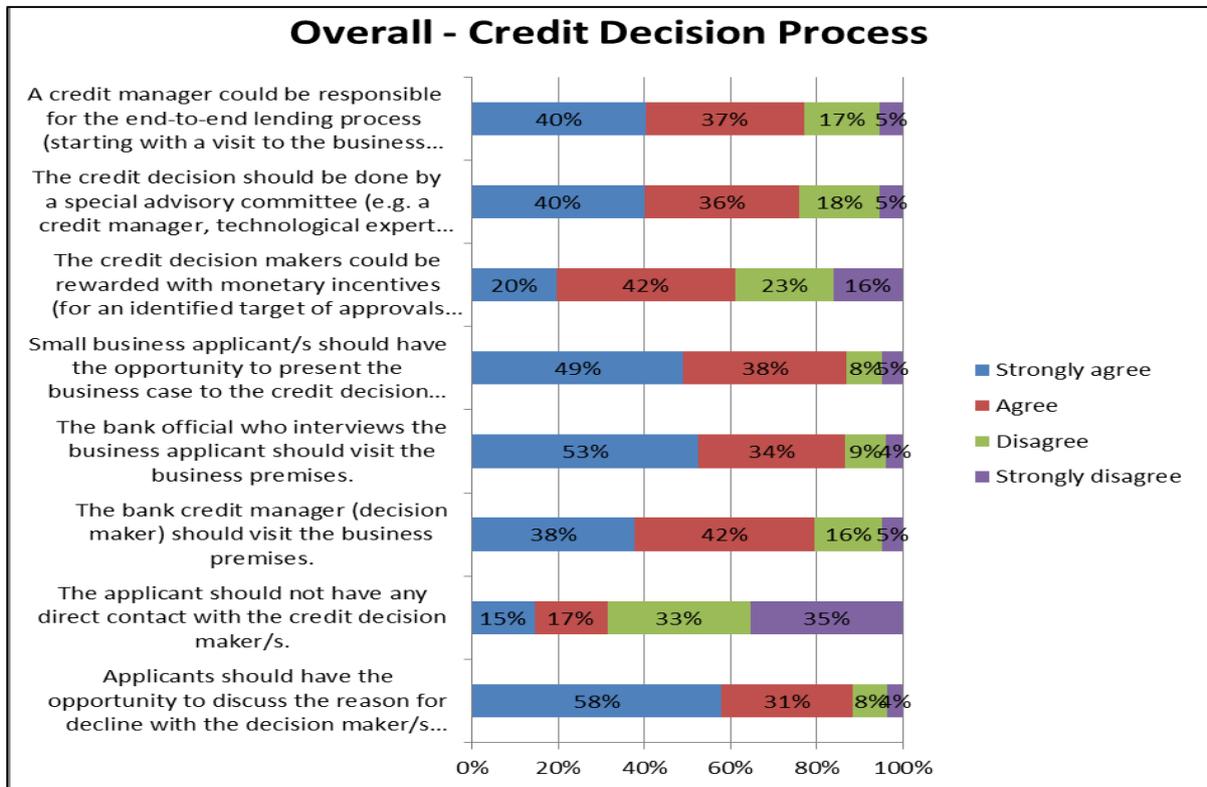


Figure 5-23: Overall: Credit Decision Process

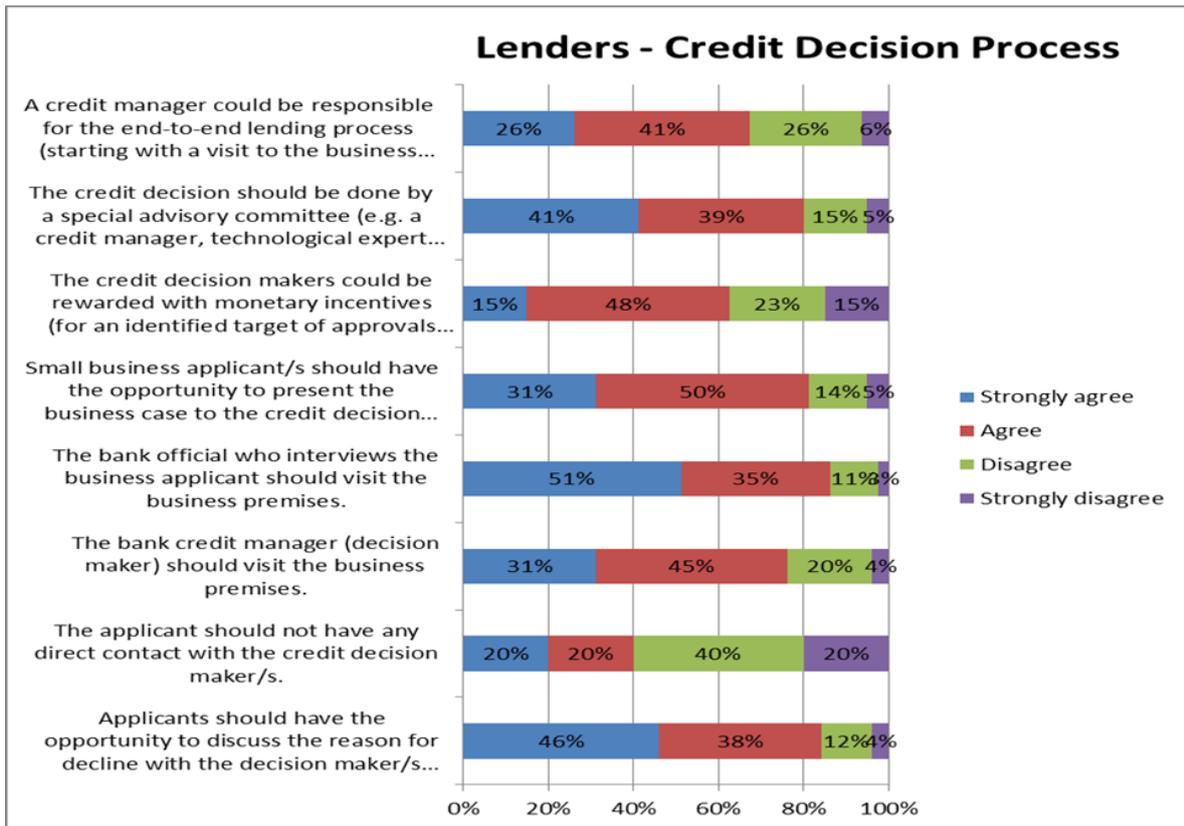


Figure 5-24: Lenders: Credit Decision Process

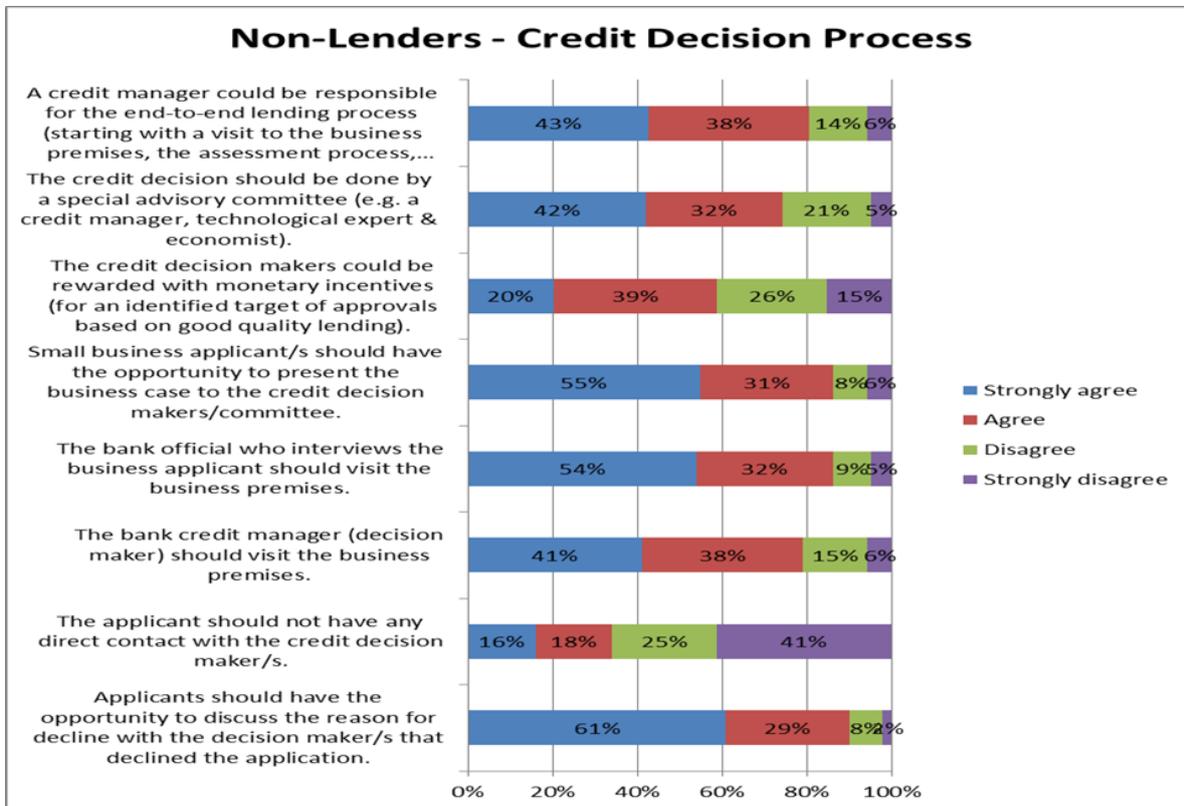


Figure 5-25: Non-lenders: Credit Decision Process

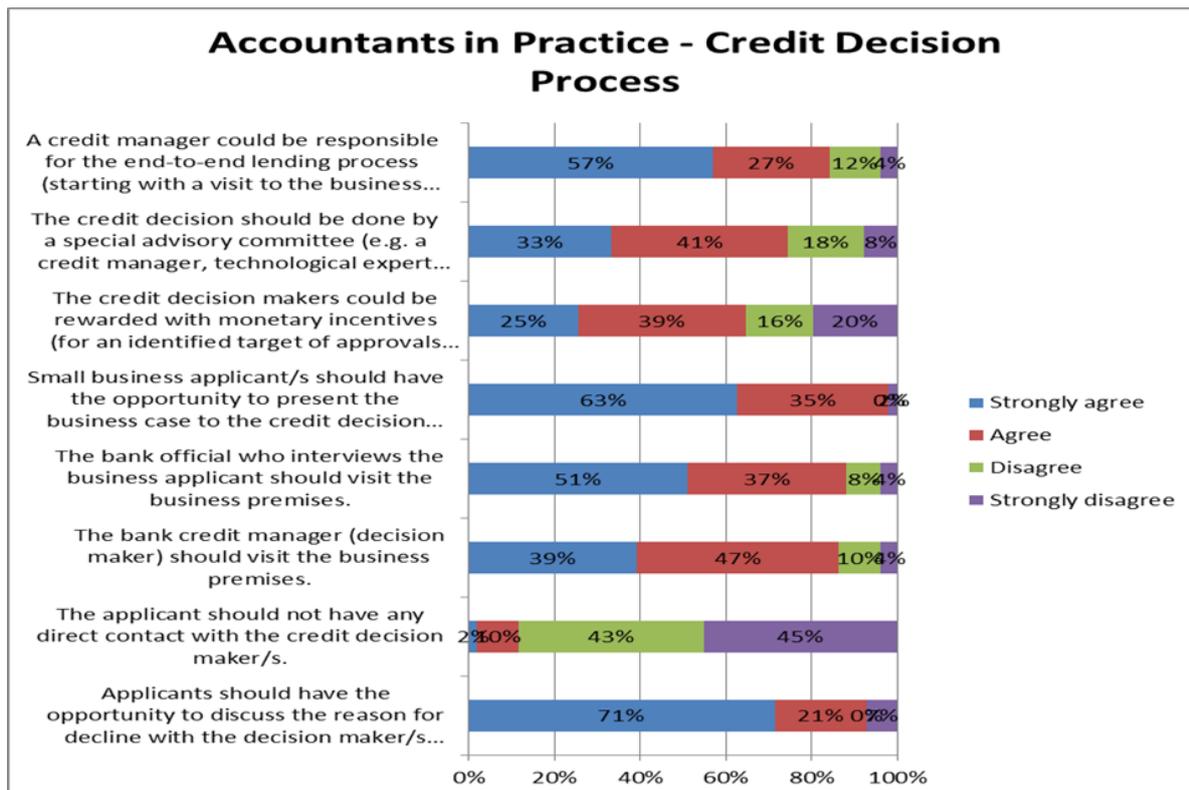


Figure 5-26: Accountants in practice: Credit Decision Process

It was identified during the literature review that banks in South Africa have centralized the credit approval process. Applicants are interviewed by a portfolio manager at a branch (bank outlet) and the application is then sent by the portfolio manager to a credit manager (decision maker) at Head Office for approval. The applicant, therefore, does not have any form of contact at any stage of the application with the credit manager. Furthermore, there is not always a visit to the business premises of the customer either by the banking official interviewing the customer or the credit manager.

Overall the participants felt that there must be direct contact by the applicant with the decision maker, furthermore, the participants agreed to a visit to the business premises by either the bank official interviewing the applicant (87%) or the credit manager (80%). It was also agreed that the applicant should have the opportunity to present the business case directly with the decision maker and in the event that the application should be declined, have the opportunity to discuss the reason for decline directly with the decision maker.

The participants were then in an open-ended question asked what appropriate tools can be used to evaluate small business credit applications. The results were split for tools that can be used to assess the business and the tools that can be used to assess the owner/s (individuals) of the business in Table 5-13.

Table 5-13: Tools for assessing small business credit applications

<b>Business: Models</b>
<ul style="list-style-type: none"> <li>• Scorecards to determine a score/credit scoring.</li> <li>• Credit /statistical/mathematical modelling.</li> <li>• Business scoring system:               <ul style="list-style-type: none"> <li>○ Compliance rules.</li> <li>○ Bank scoring (behaviour on bank statement/s).</li> <li>○ Bureau scores.</li> </ul> </li> <li>• Provide detailed questionnaires for businesses, answers are to be used in the scoring process, with some fuzzy logic.</li> <li>• In-house model to identify the likelihood of the various business ventures succeeding taking into consideration the following:               <ul style="list-style-type: none"> <li>○ Location of the business and the number of similar businesses in the area.</li> <li>○ Strengths, weaknesses, opportunities, and threats (SWOT) analysis.</li> <li>○ Political, economic, social and technological (PEST) analysis.</li> </ul> </li> <li>• Time series analysis model for seasonal predictions and evaluations.</li> <li>• Financial forecasting models.</li> <li>• Affordability models.</li> <li>• Risk models.</li> <li>• Cash flow models.</li> <li>• Profitability models.</li> <li>• Behavioural Scorecard to identify payment performance.</li> <li>• Credit bureau scorecards.</li> <li>• Cash flow assessments and business plan modeling.</li> <li>• A scoring model that incorporates cash that is not realised as yet and projections.</li> <li>• Opportunity scoring models.</li> <li>• Industry averages for similar types of businesses to use as comparisons.</li> <li>• Technology S-curves, proof of commercialization.</li> <li>• Decision trees.</li> </ul>
<b>Owners (individuals): Models</b>
<ul style="list-style-type: none"> <li>• Credit scoring - using proprietor's information.</li> <li>• Minimum requirement rules - Upfront decline rules.</li> <li>• Compliance rules, for example, applicants are under debt counselling/sequestration.</li> <li>• Criminal checks.</li> <li>• South African Revenue Service (SARS) and utility bill data.</li> </ul>

- Behavioural scorecard to identify payment performance.
- A model that incorporates psychometric assessments, that evaluates the knowledge of the applicant on the business idea.

What was highlighted through these responses is that no one seems to have successfully been able to make a “break-through” for start-up small business credit yet, and hence scorecards are to be built through experience. Furthermore, the motivation for developing opportunity scoring models from one of the participants was rather profound “Entrepreneurship is about the opportunity - realizing it, gathering the resources and making use of it. A good opportunity model taking the opportunity, the small business, the employee skills and so on into consideration, can be just as valuable as traditional scoring models”.

The complexity of developing models was also evident from the responses, and joint efforts by experienced specialists are required. For example, for the time series analysis model for seasonal predictions and evaluations, it is suggested that there should be a joint effort from Information Technology (IT), an accountant, statistician (or actuary) and business analyst specialists to evaluate profitability and constantly evaluate the business' financial and market situations.

Further, from the responses, in the absence of the “traditional branch manager with a credit mandate”, there seems to be a view for an experienced credit manager to make the credit decisions. From my credit lending experience and in my view, there is, however, basic quantitative and compliance data that can be automated. An open-ended question was thus posed to the participants to determine how a combined approach can be implemented, where there is an automated decision process together with a subjective decision by a credit manager. The recommendations are provided in Table 5-14.

Table 5-14: Combined credit decision approach: Automated decision and subjective decision

<b>COMBINATION</b>
<ul style="list-style-type: none"> <li>• Automate all quantitative data ↔ manual (subjective) decision where discretion is required.</li> <li>• Scorecards to determine a score (if passes score/base level acceptance) → ultimate decision to be made by a credit manager to interpret the data – stress test the assumptions - derive if the risk is calculated.</li> <li>• Automate: Built-in risk factors ↔ subjective: business plans and projections.</li> <li>• The system can make decisions based on certain values/parameters set. If the value of the application exceeds the scorecard mandate ↔ system to refer for manual review.</li> </ul>

- Allocate an appropriate weight to both automated and subjective.
- Where there is insufficient information, or where it may be required to structure the loan and the term ↔ system to refer for manual review.
- An inconclusive outcome/borderline cases/exceptional cases/declined due to credit rating → system to flag for manual review.
- Decide on a scoring range that is “borderline” cases (just missing the automated approval score) ↔ system to flag for manual review.
- Where an applicant contests an automated decline decision ↔ a credit manager is to review the application.

An open-ended question was then posed to the participants requesting suggestions on which members could be part of a special advisory committee when assessing credit applications. The suggestions are listed in Table 5-15.

Table 5-15: Special advisory committee members

<b>SPECIAL ADVISORY COMMITTEE MEMBERS:</b>
<ul style="list-style-type: none"> <li>• An independent finance professional conducting due diligence procedures (SAICA / SAIPA / SAIBA); or the applicant's accountant.</li> <li>• Subject matter specialist/market analyst in the industry of the business that is also a specialist in the geographic area of the proposed business. It could be a local business member.</li> <li>• Depending on the type of business, experts in the following fields could be called in: Legal/Compliance, Statistician/ Actuary, Product, Fraud, Entrepreneurial/SME, Business development/New business/Commercial, Risk, Agricultural, Information technology.</li> <li>• Community leader; Business coach; Business Angels.</li> <li>• Representatives from: a Credit bureau; Business incubator/accelerator; Small Business Chamber/body or Chambers of Commerce.</li> </ul>

Below the micro (firm-based) and macro-economic factors to be taken into consideration in the assessment process are addressed. Beginning with scheduled questions posed to the participants, then expanding to open-ended questions to cover this topic, with the aim to gain more insight. The results of the scheduled questions for the micro-economic (firm-based) factors are shown in Figures 5-27 – 5-30.

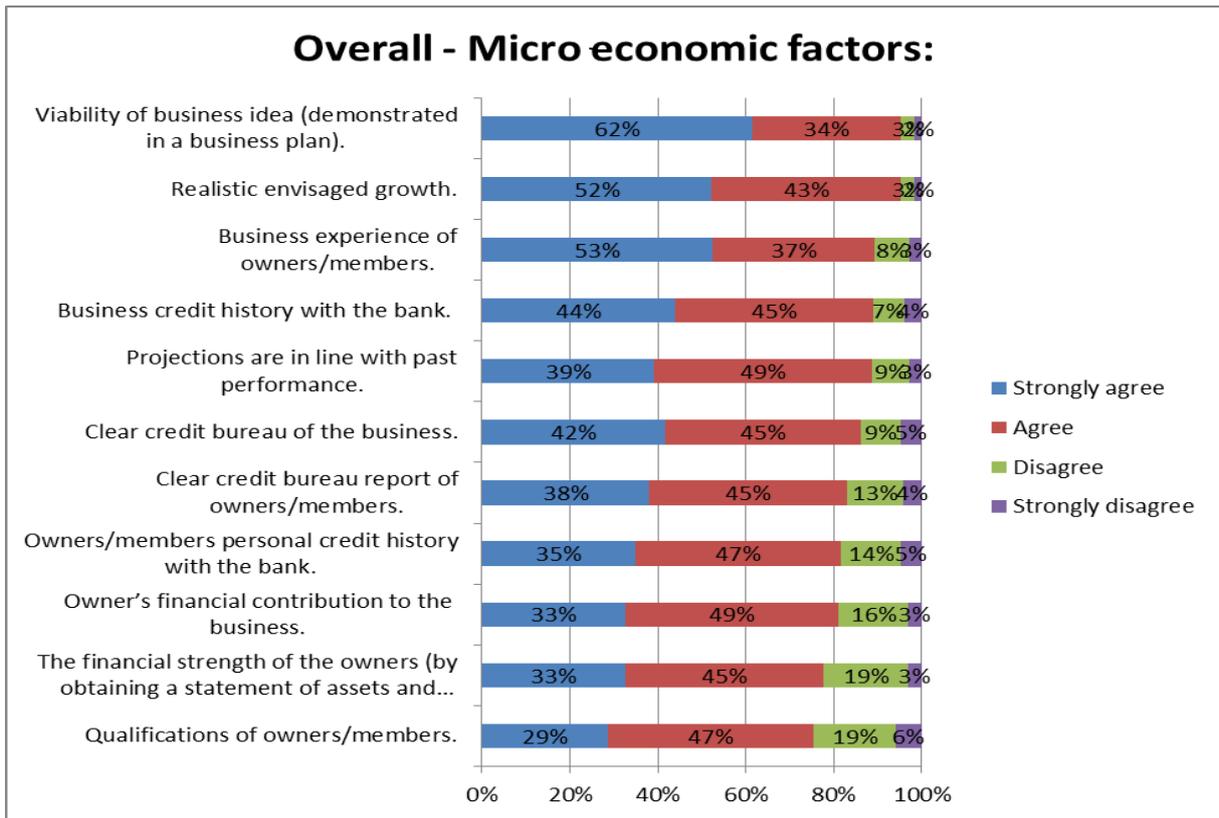


Figure 5-27: Overall: Micro-economic (firm-based) factors

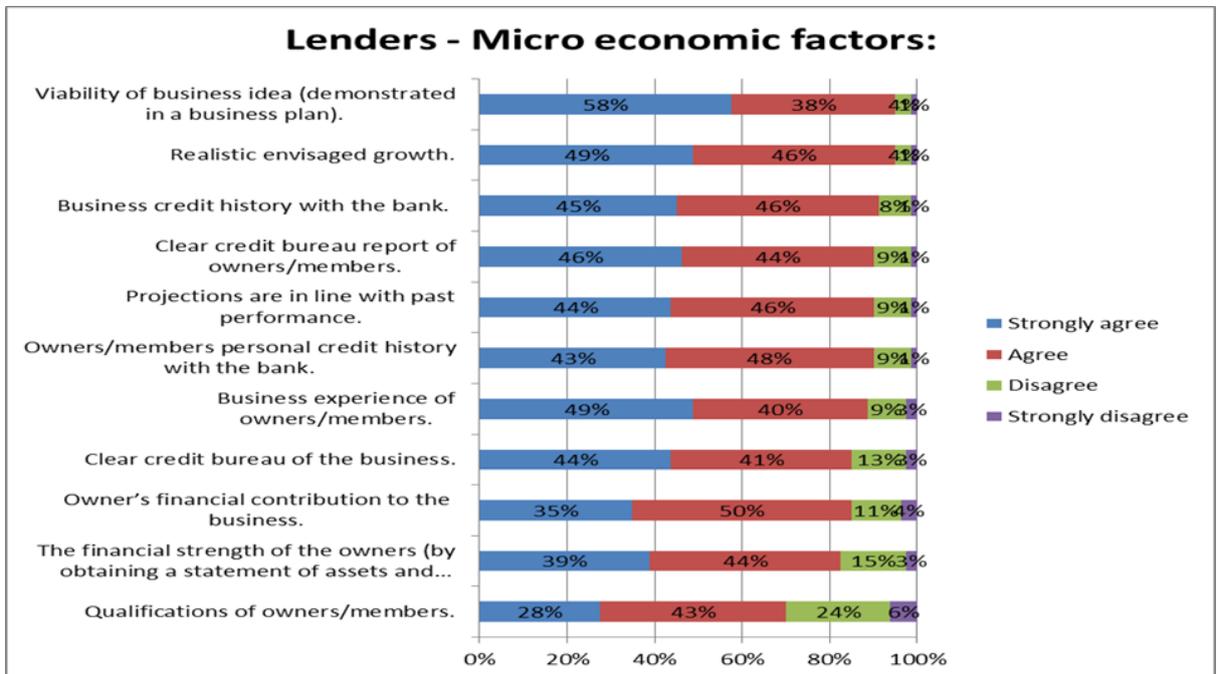


Figure 5-28: Lenders: Micro-economic (firm-based) factors

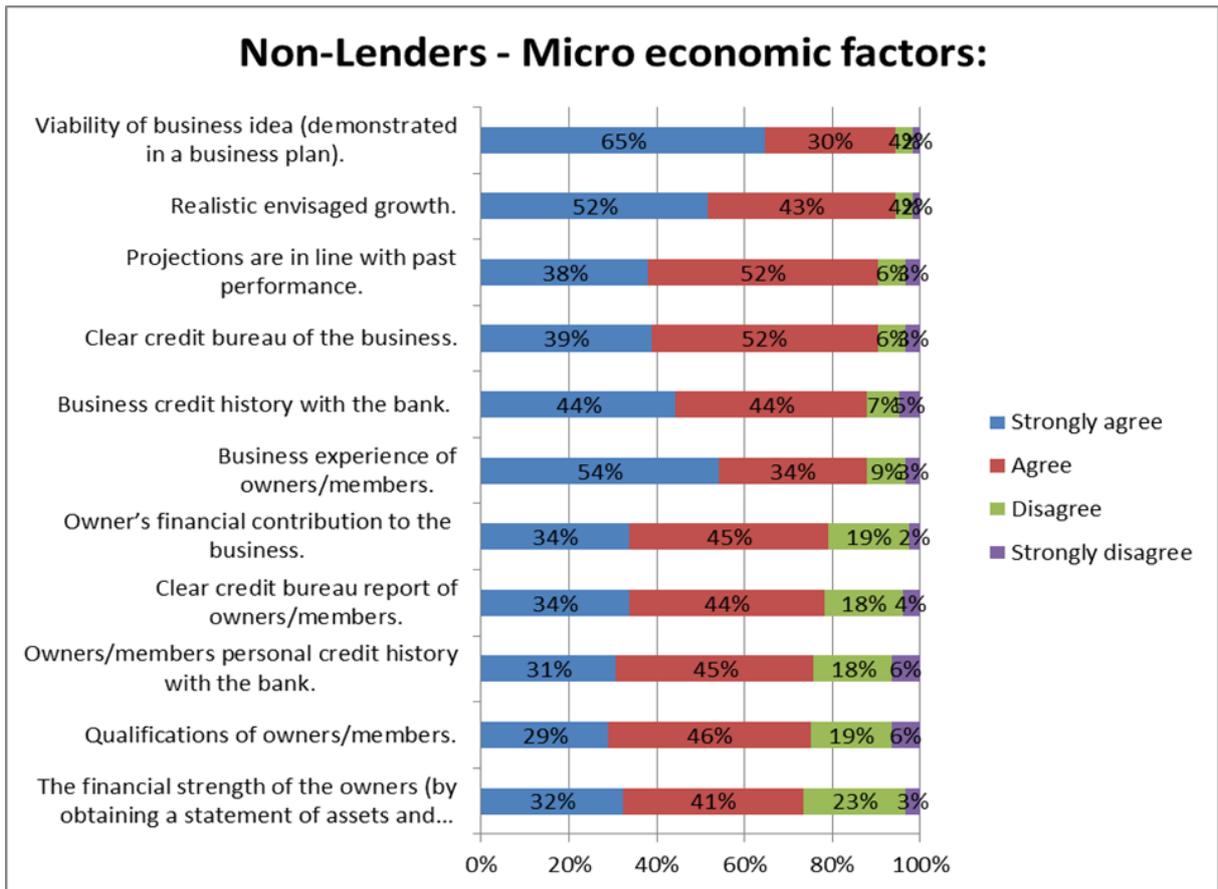


Figure 5-29: Non-lenders: Micro-economic (firm-based) factors

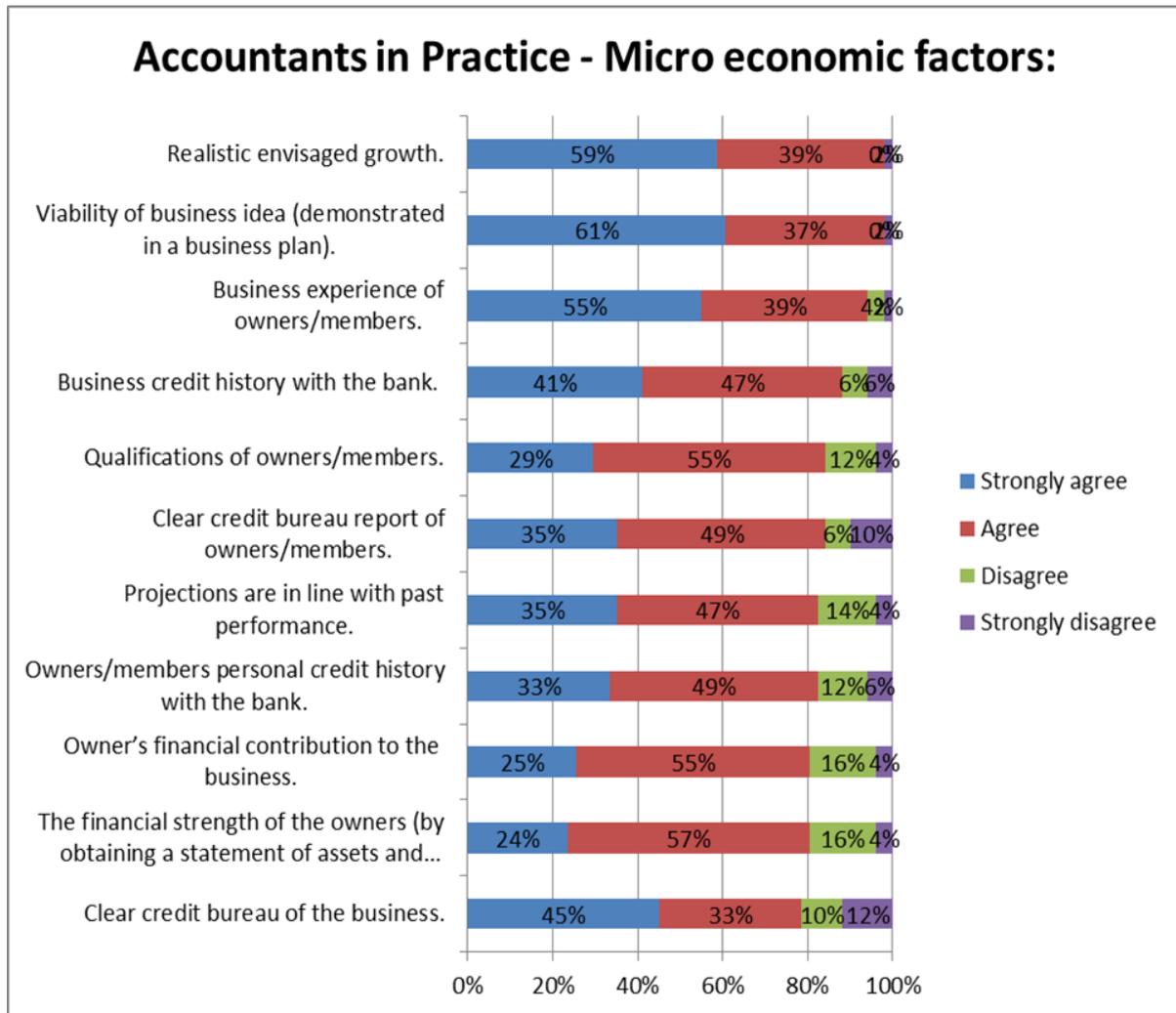


Figure 5-30: Accountants in practice: Micro-economic (firm-based) factors

Based on the overall figures, the highest ranking three most significant micro-economic (firm-based) factors are very much in line with those identified as significant in the literature review. It is interesting to note, however, that the “qualifications” of the owners/members was listed as the least important from the options provided to the participants, whereas the “business experience” of the owners/members was rated highly (third) from the options provided.

It is also interesting to note that only the lenders ranked the clear credit bureau of the owners/members in the top 5. The lenders also ranked the qualifications of the owners/members as last and the non-lenders ranked this option as second last, whereas the accountants in practice seemed to feel that this is significant, ranking it at 5<sup>th</sup> place. The accountants in practice also seemed to feel that a clear credit bureau report of the business was of least significance from the options provided. In reality, taking into consideration the situation of rising retrenchments from big corporate companies, there are more and more people laid off, this may result in a bad credit record due to unforeseen circumstances (Mutyenyo &

Madzivhandila, 2014). This, however, does not mean that this should be seen as the destiny of the credit position of the applicant going forward.

Other than the options related to micro-economic factors provided to the participants, an open-ended question was posed asking for any other micro-economic (firm-based) factors that should be considered in the credit application process. The results were split to differentiate for the micro-economic considerations for the owner/s and the micro-economic considerations for the business, as follows:

Table 5-16: Credit assessment: Micro-economic (firm-based) factors

<b>OWNERS/MEMBERS:</b>
<ul style="list-style-type: none"> <li>• The character of the owner/members: credibility, trustworthiness moral or ethical standing.</li> <li>• Conduct the following additional checks on the owners: any business with other funders/business associates/suppliers; talk to other business associates and creditors of the business; criminal records.</li> <li>• Financial position: determine the drawings required by the owner to service his/her personal debt/living expenses (the drawings are often the downfall of small businesses with potential).</li> <li>• Business experience: in other sectors, previous or existing businesses, skills, or franchise training.</li> <li>• Succession planning: key positions, key man insurance, life cover of owners/members.</li> </ul>
<b>BUSINESS:</b>
<ul style="list-style-type: none"> <li>• The business must be viable, have a budget and all necessary statutory, tax and accounting processes in place.</li> <li>• Cash flow forecast must be substantiated based on a high level of probability, for example, letter of intent, and contracts.</li> <li>• Industry, sector reports, statistics of similar businesses.</li> <li>• Performance, success factors, lessons learned, risks and reasons for the failure of similar businesses.</li> <li>• Financial information validity checks.</li> <li>• Visit the business premises to verify assets and buildings.</li> <li>• Confirm the credentials of the accountant.</li> <li>• Letter from the mentor.</li> <li>• Tax clearance certificate/Form IT34.</li> <li>• Ability to deliver its goods and/or services timeously to its customers.</li> <li>• Good customer relationships.</li> <li>• The quality and performance of the product.</li> <li>• Production cost.</li> </ul>

- Creating awareness of the business offering, advertising.
- Location of the business, infrastructure.

The abovementioned results addressed the micro-economic (firm-based) factors which are internal to the business. The questionnaire then addressed the macro-economic factors, which are external to the business. The results of the scheduled questions follow.

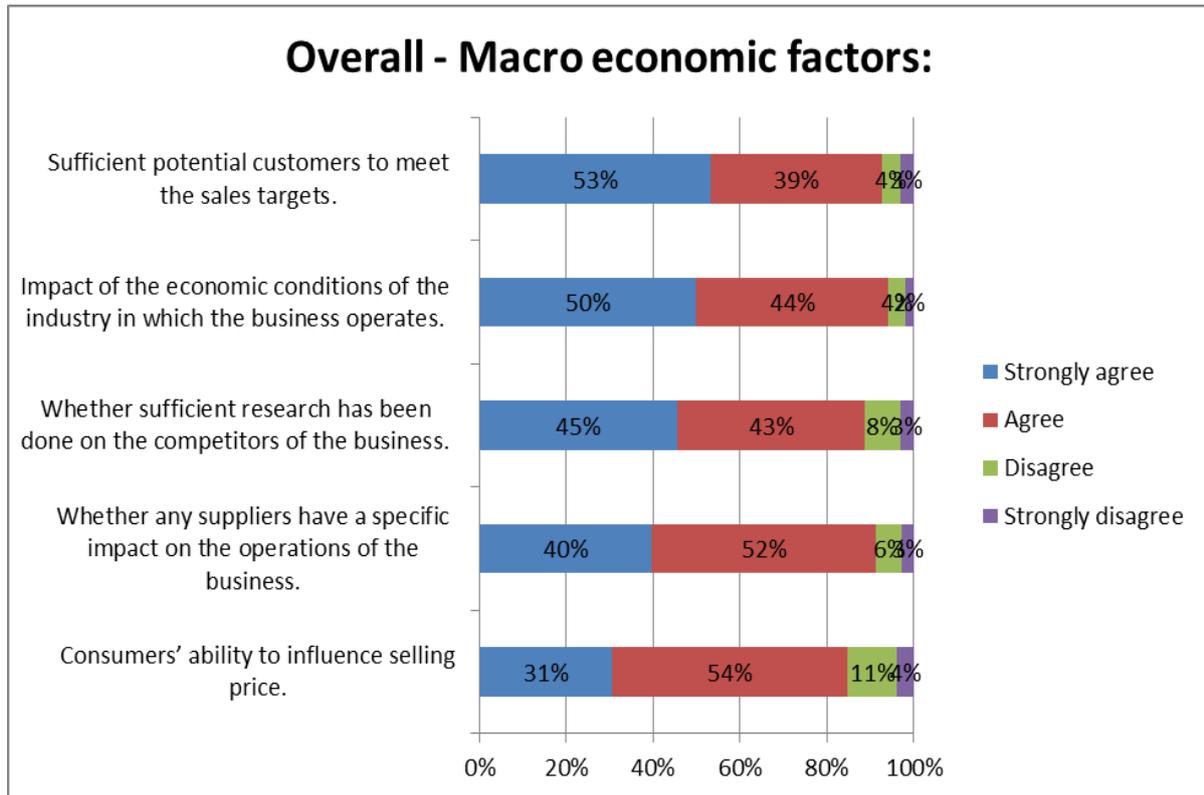


Figure 5-31: Overall: Macro-economic factors

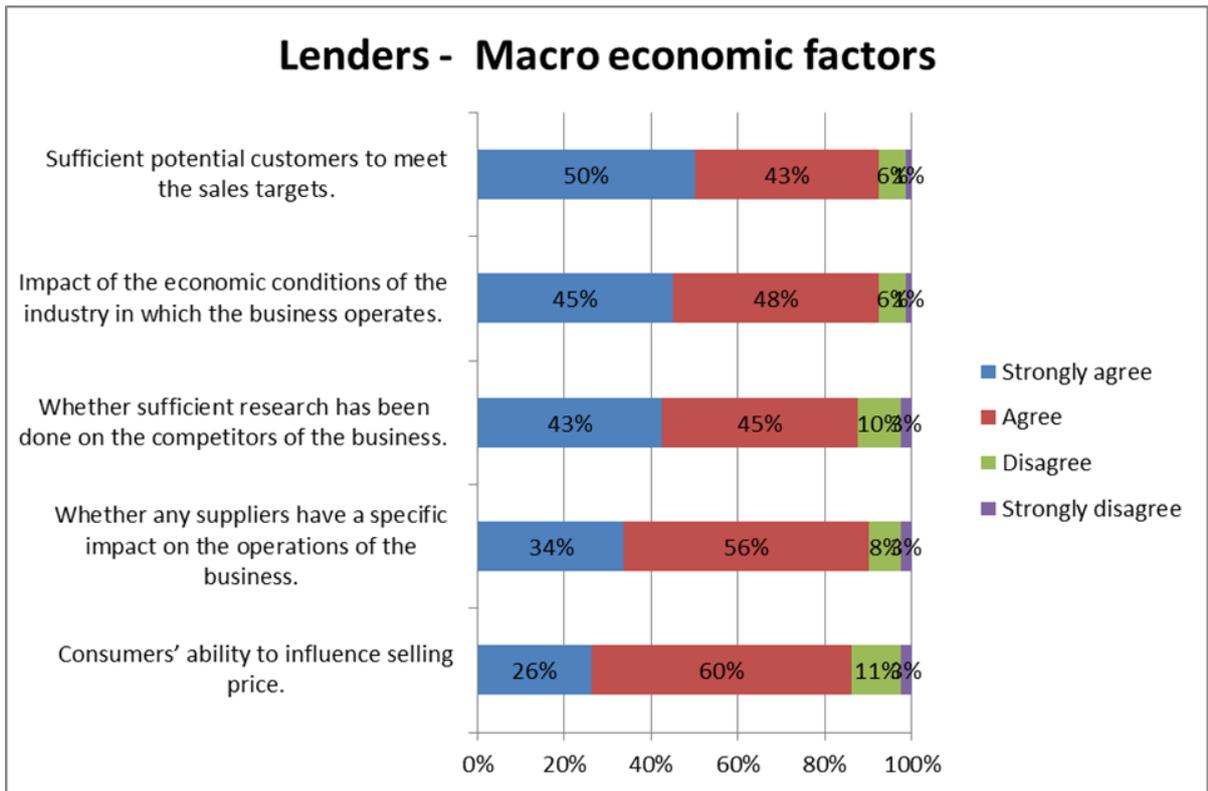


Figure 5-32: Lenders: Macro-economic factors

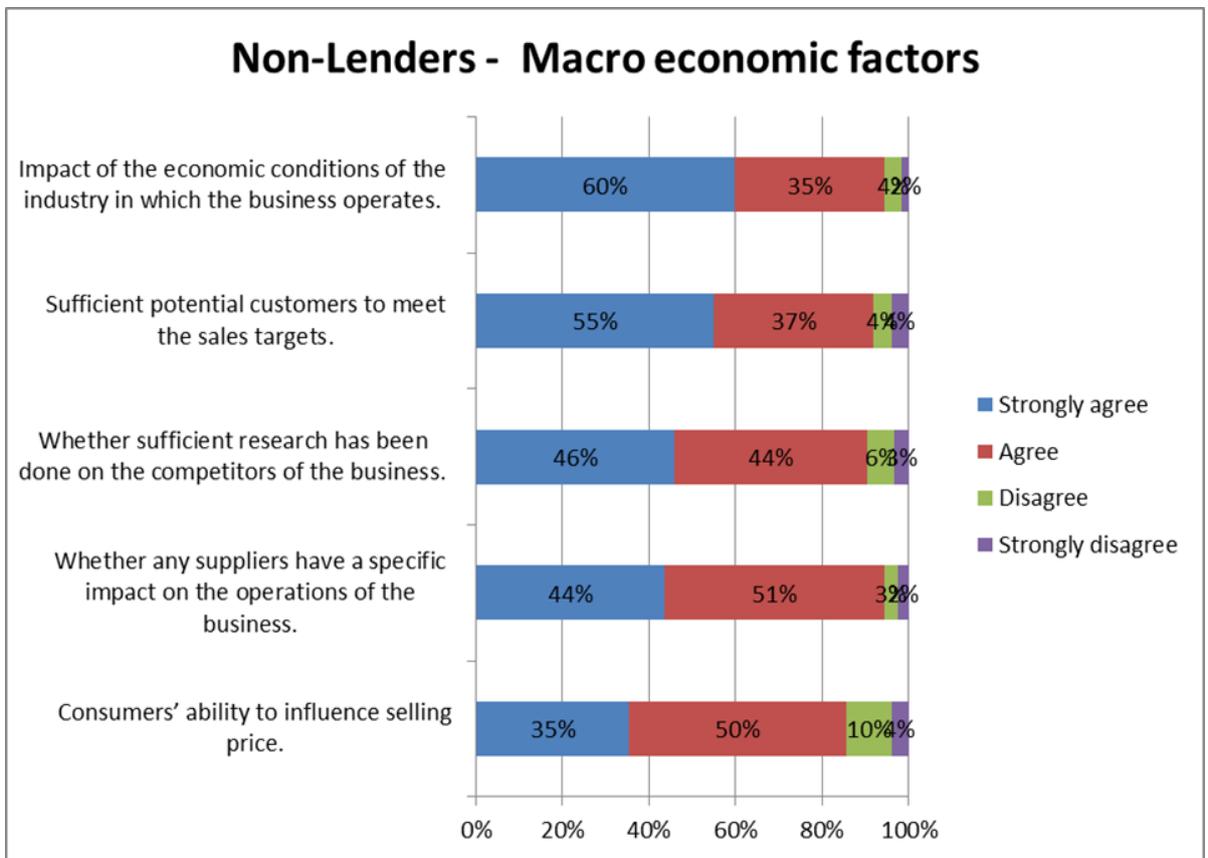


Figure 5-33: Non-lenders: Macro-economic factors

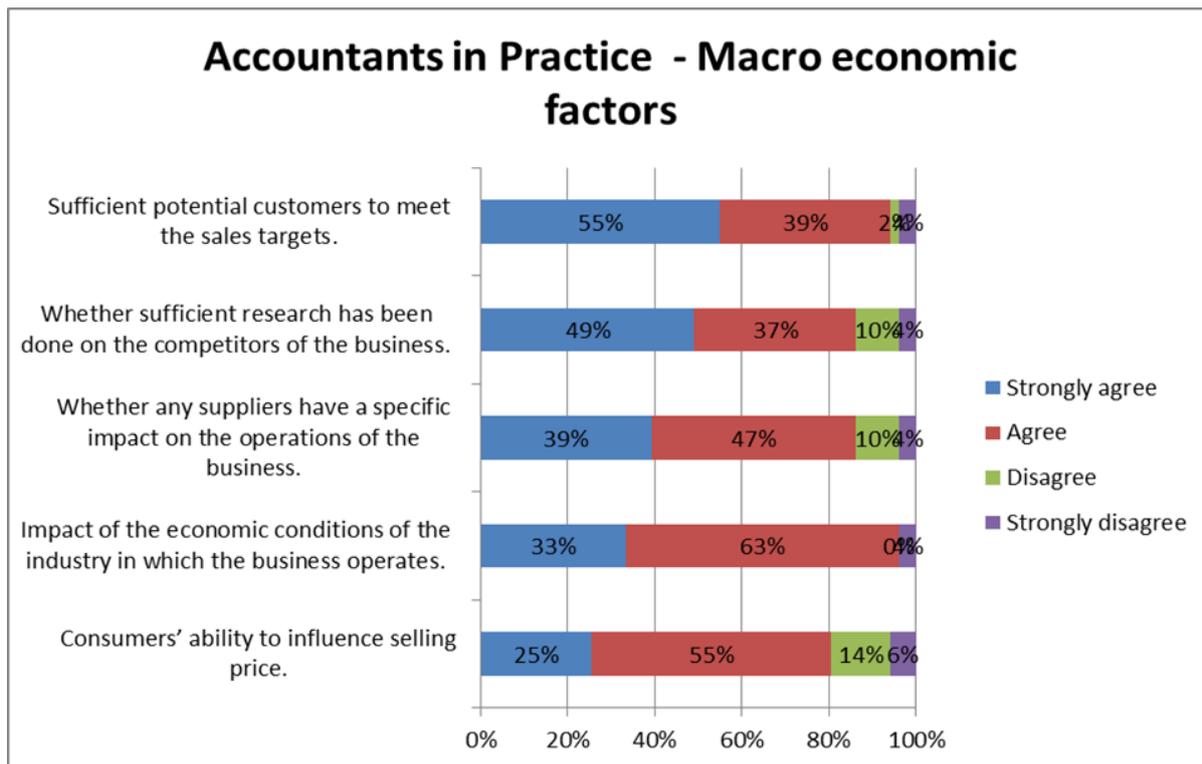


Figure 5-34: Accountants in practice: Macro-economic factors

Overall all the macro-economic factors presented are considered important by the participants. The participants were then asked an open-ended question to obtain a view on what other macro-economic conditions should be taken into consideration when assessing a small business credit application. It must be noted that some of the results may seem duplicated, as they cover topics already asked in the “scheduled” questions, however more detailed information is provided which may be considered valuable input to credit assessors. The results follow.

Table 5-17: Other macro-economic factors

CUSTOMERS
<ul style="list-style-type: none"> <li>• Size of the market; whether the market is growing or shrinking; earning capacity of the potential customers; behavioural/buying patterns of the potential customers; the age of the market; coverage.</li> <li>• Concentration risk – whether the business is dependent on one big customer, for example, in tenders.</li> <li>• Impact of the geographical area where the business operates.</li> <li>• Impact of a seasonal business.</li> <li>• The lifecycle of the product/industry.</li> </ul>

<b>COMPETITORS</b>
<ul style="list-style-type: none"> <li>• Obsolete products due to technology.</li> <li>• Overseas competition, for example, China and the USA.</li> <li>• The probability of new similar businesses, barriers to entry, patents, ease of entrants, substitute products.</li> <li>• Competitors' ability to impact sales price.</li> <li>• Assessment of the service, quality, and price of the competition.</li> </ul>
<b>SUPPLIERS</b>
<ul style="list-style-type: none"> <li>• Suppliers' ability to influence sales price.</li> <li>• Availability of alternative suppliers.</li> <li>• Reliability of suppliers of raw materials.</li> <li>• Transportation costs.</li> </ul>
<b>DEBTORS</b>
<ul style="list-style-type: none"> <li>• The ability of debtor's repayment and the business's ability to absorb the terms, for example, if payments are received late from debtors.</li> </ul>
<b>ECONOMIC ENVIRONMENT</b>
<ul style="list-style-type: none"> <li>• Foreign exchange rates/Interest rates/Gross domestic product (GDP)/Rental property prices/Inflation/Currency devaluation/Market/Industry changes/National credit rating/Environmental restrictions. Domestic and international trends in the specific market.</li> <li>• Global potential of the business. Both importing of supplies and exporting of product.</li> <li>• Whether a major change in any particular factor, such as the fuel price or cost of raw materials may cause the business to no longer be viable.</li> <li>• Changes in income levels/average income/future prospects of individuals (target market).</li> <li>• Where there is a reliance on the owners' contribution to the business - consider the potential macro-economic impact on the owners' financial situation.</li> <li>• Labour: availability and/or scarcity of skills, strikes and stay-aways.</li> <li>• Political forces: political stability, riots, criminal activity, cartels, trade unions.</li> <li>• Legal forces: impact of black economic empowerment, legislation, Government policies.</li> <li>• Social environment: how "green" is the business as this is the "buzz word" in business at the moment.</li> <li>• A disaster recovery plan - to keep the business sustainable during quiet periods.</li> </ul>

The above addressed the micro and macro-economic factors. The participants were then asked an open-ended question to obtain a view on what can be considered a viable and sustainable business idea. The results follow in Table 5-18.

Table 5-18: Viable and sustainable business idea

<b>VIABLE AND SUSTAINABLE BUSINESS IDEA</b>
<ul style="list-style-type: none"> <li>• The business idea must be adequately researched using basic marketing strategies: product, price, promotion, place, and people.</li> <li>• Realistic start (the idea makes sense), realistic projections (reasonable returns), owners have experience in the industry.</li> <li>• Increase in costs must not be more than the inflation rate, and must be supported with innovative ways of cutting manufacturing costs and overall costs (if applicable).</li> <li>• The project or product must be in demand in the industry – it must have a competitive advantage.</li> <li>• Must be able to demonstrate that the product/service will be provided in sufficient quantities to service the demand, on a consistent basis.</li> <li>• The business should be able to produce a positive cash flow within 12 months and break-even within three years.</li> <li>• The business must be solvent, liquid and profitable. Creating value (goodwill).</li> <li>• After paying expenses, the surplus is to be re-invested into the business.</li> <li>• An ROI of minimum &gt;10% but ideally &gt;16% Y-o-Y.</li> <li>• The business must have the ability to create jobs, benefit the broader society/economy, and the community must want to support the business.</li> <li>• The business must comply with tax return requirements and all required legal requirements.</li> </ul>

The above provided valuable input into what could be considered a viable and sustainable business idea. For existing businesses, as part of a bank’s credit assessment to determine the potential for a business to repay the interest and/or monthly instalments of the credit applied for, the financial ratios are calculated and typically compared to the “norms” of businesses in the same industry which serves as a benchmark for banks.

During the scheduled questions, the participants were asked to provide input on the key ratios/measures from the options provided. The results follow in Figures 5-35 – 5-38.

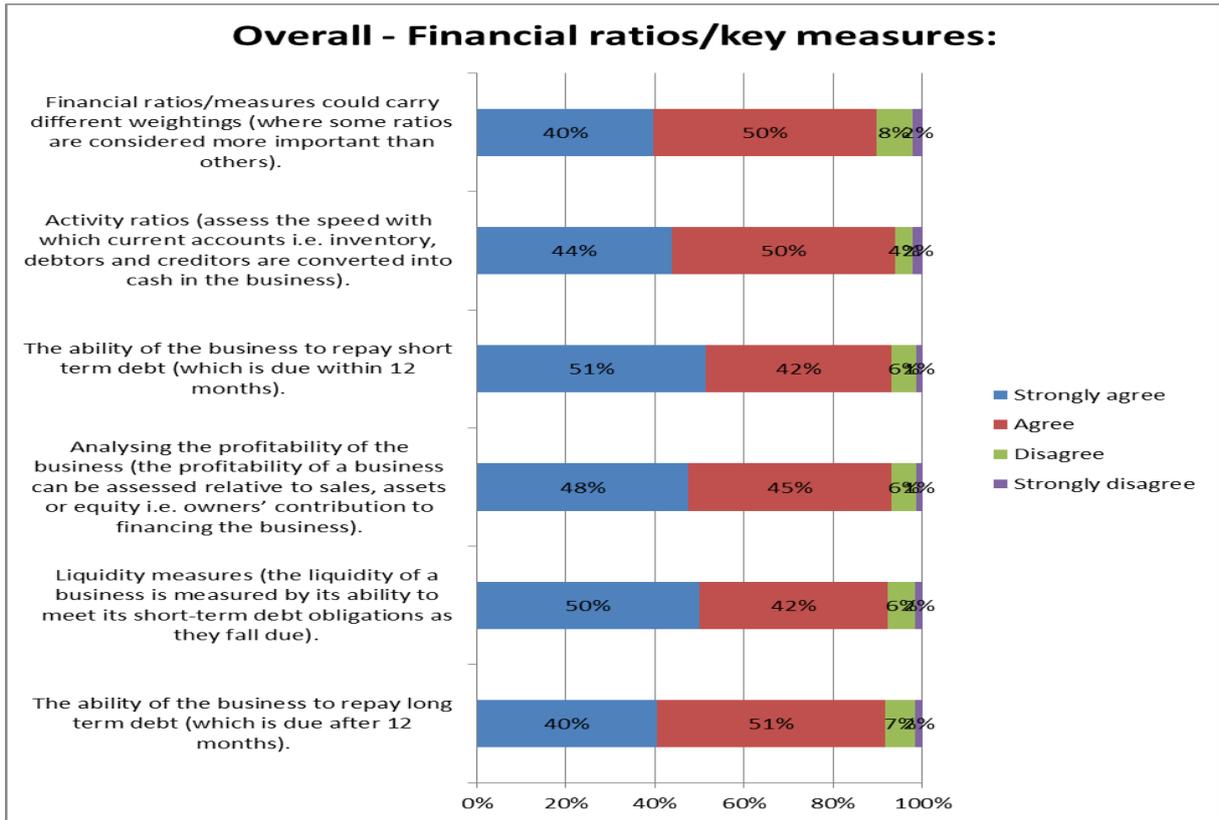


Figure 5-35: Overall: Financial ratios/Key measures

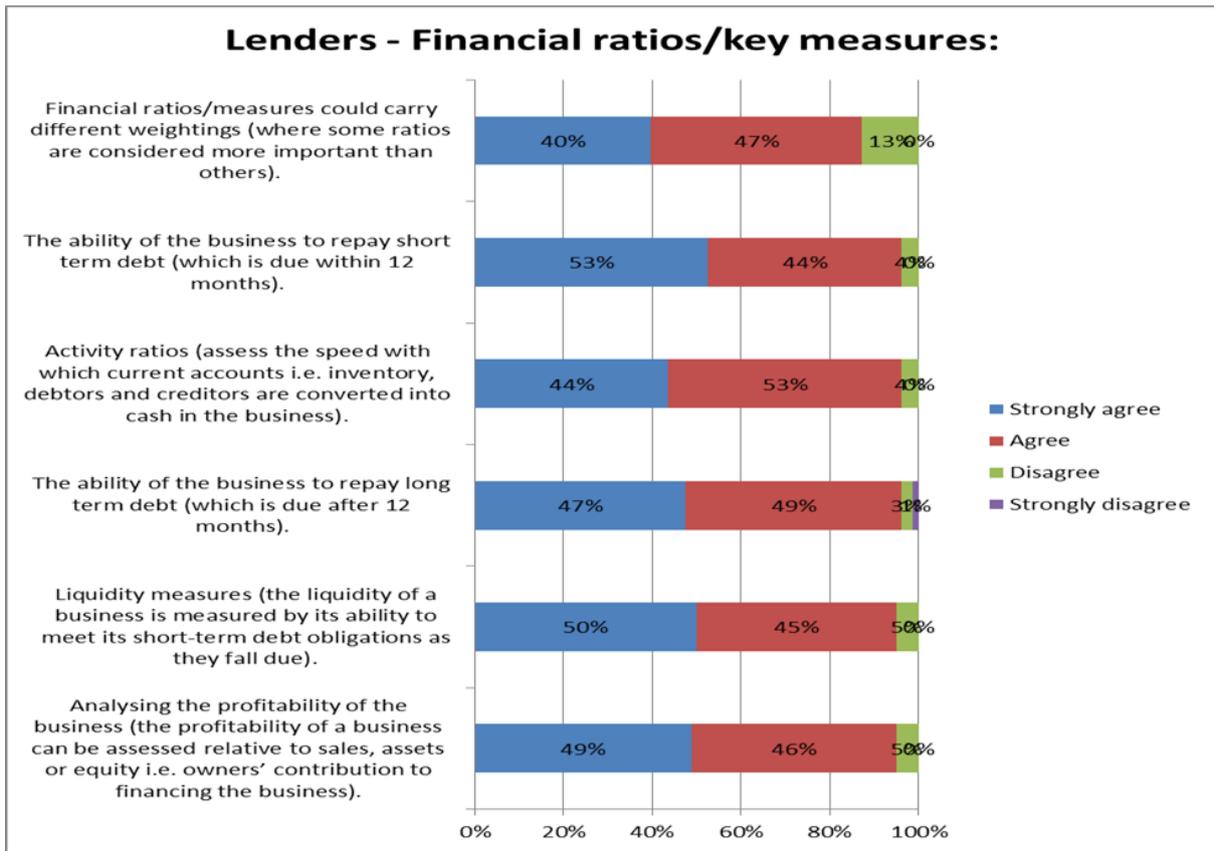


Figure 5-36: Lenders: Financial ratios/Key measures

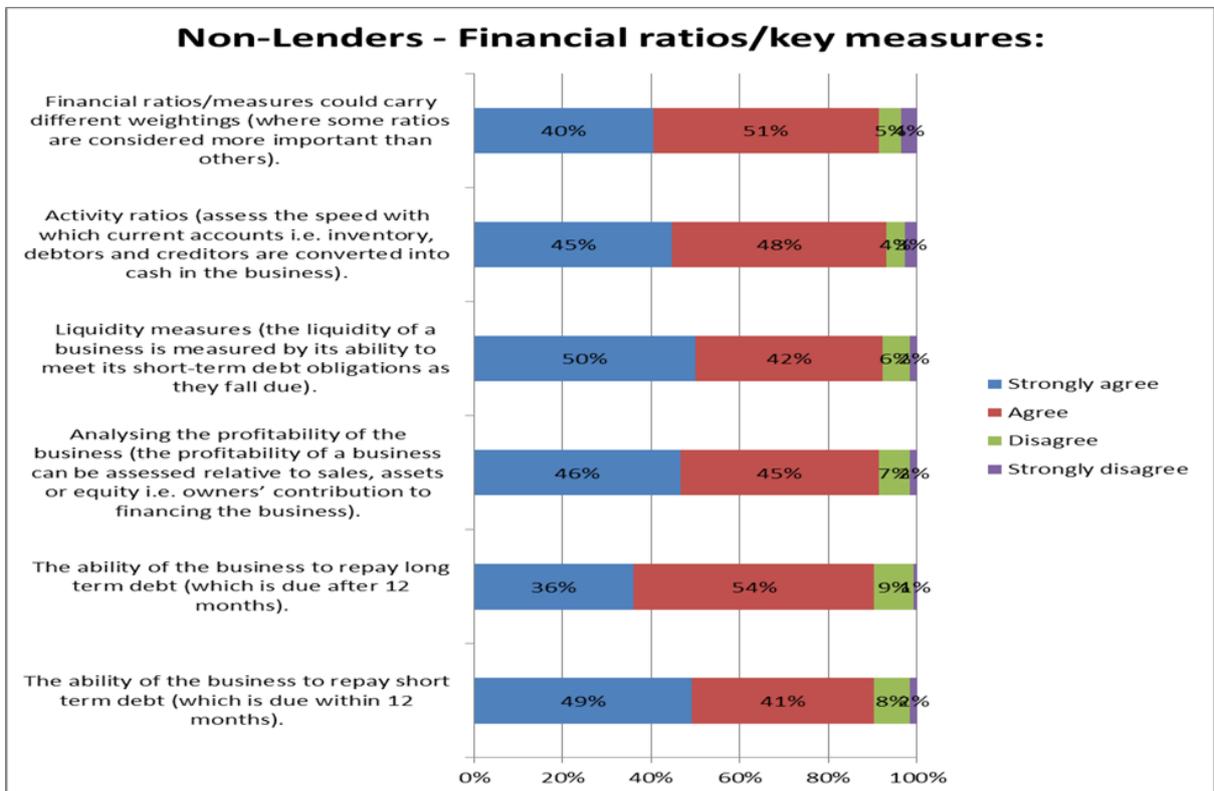


Figure 5-37: Non-lenders: Financial ratios/Key measures

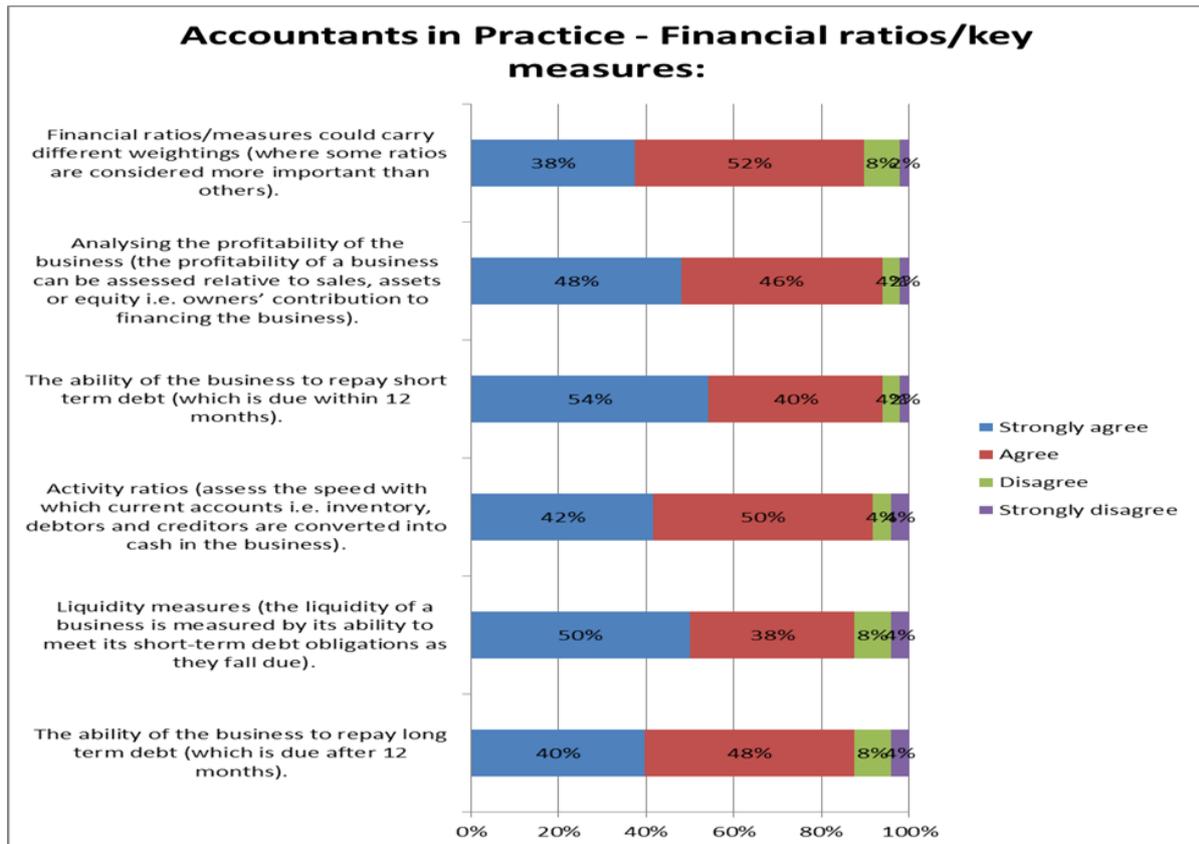


Figure 5-38: Accountants in practice: Financial ratios/Key measures

Overall the respondents agreed (90%) that financial ratios should carry different weightings. The ratios/key measures provided to the participants were all considered important. Furthermore, the same key measures/ratios are highlighted as important during the literature review. A breakdown of the ratios which would fall under the abovementioned categories is provided below for information purposes (Farrell *et al.*, 2011):

### Activity (Turnover/Efficiency) ratios

A business will normally aim to turn their production into cash or sales as fast as possible as this should bring in higher revenues. The banks, therefore, look at the activity ratios to measure the efficiency of a business's collections, cash flow, and operations. These measurements could include Inventory turnover ratio; Average collection period (accounts receivable turnover ratio); Total assets turnover ratio; Average sales period (turnover in days).

### Ability to pay short-term debt within 12 months

This is a measure of the cash flow available to pay current debt obligations. These measurements could include: (Debt service coverage ratio (DSCR)/Debt coverage ratio (DCR)). DSCR is calculated as net operating income as a multiple of debt obligations due

within one year. Typically a credit provider will require a debt service coverage ratio higher than 1.0 x in order to provide comfort.

**Profitability (sustainability) ratios**

This evaluates the viability of a business. These measurements could include Gross/Operating profit margin (Coverage ratio) – measures earnings before interest and taxes; Net profit margin; Return on Equity (ROE); Times interest earned; Return on total assets; Return on common shareholders’ equity; Return on investment (ROI).

**Liquidity ratios**

These are a measure of the amount of cash and assets that the business has that can easily be converted to cash in order to pay debts. It provides a view of the overall financial health of the business. Liquidity measurements would typically include Current Ratio/Working Capital Ratio; Quick (Acid Test) ratio.

**Ability to repay long-term debt**

The key measurements are the leverage ratios (funding – debt, equity, grants). These measures provide an indication of the long-term solvency of the business. It also indicates to what extent the business is using long-term debt to support the business operations. The measurements would typically include: Leverage Capital Structure Ratio/Debt to equity/Solvency/Gearing ratio; Debt to asset ratio; Long-term debt ratio; Long-term debt to total capitalization ratio; Debt to tangible net-worth ratio; Times interest earned.

Other than the above-scheduled question relating to financial ratios, the participants were asked an open-ended question about what other ratios or key measures should be taken into consideration when assessing small business credit applications. The results are split for the key measurements for the owners and for the business in Table 5-19.

Table 5-19: Credit assessment: Additional ratios/Key measures to be considered

<b>OWNERS</b>
<ul style="list-style-type: none"> <li>• Debt to equity ratio.</li> <li>• Cost to income ratio.</li> </ul>
<b>BUSINESS</b>
<ul style="list-style-type: none"> <li>• Break-even point.</li> <li>• How many times the financial commitment (monthly or annually) is covered by the net cash generated in that same period. Break-even point for sales.</li> </ul>

- Cash flow cycle.
- Working capital cycle: Percentage of working capital absorption per rand of sales. Both of these should be trend based. The gross and net margins indicate appropriate pricing and the working capital measures whether the working capital cycle is moving out or is being managed in line with the sales trends. If, for example, debtors are increasing as a percentage of sales, then the business may be offering too much credit, or it may be inappropriately risked.
- Debt ratio: Interest cover ratio.
- Key staff turnover/management/shareholders.
- Weighted average cost of capital (WACC). This is typically a calculation of the business cost of capital in which each category of capital is proportionately weighted.
- Internal rate of return (IRR). This is a metric used in capital budgeting measuring the profitability of potential investments. Internal rate of return is a discount rate that makes the net present value (NPV) of all cash flows from a particular project equal to zero.

The above denotes the key financial measures to be considered when assessing existing business applications. The participants were then asked an open-ended question asking how an applicant with a viable business idea can be assisted, instead of declining the application if the owner cannot provide tangible security. The results follow in Table 5-20.

Table 5-20: Credit assessment: Applicant has a viable business idea but cannot provide security

<ul style="list-style-type: none"> <li>• <b>THE PERSONAL FINANCIAL POSITION AND TRACK RECORD OF THE OWNERS MUST BE SATISFACTORY.</b></li> </ul>
<ul style="list-style-type: none"> <li>• <b>A DUE DILIGENCE/FEASIBILITY STUDY IS TO BE DONE BY AN INDEPENDENT FINANCE PROFESSIONAL (SAICA, SAIPA, SAIBA) AND APPROVED BY A CREDIT MANAGER.</b></li> </ul>
<p><b>OR</b></p>
<ul style="list-style-type: none"> <li>• <b>A SPECIALIZED COMMITTEE IS TO MAKE THE CREDIT DECISION.</b></li> </ul>
<p><b>MITIGATE THE RISK AS FOLLOWS:</b></p>
<ul style="list-style-type: none"> <li>• Obtain proof secured contracts/Agreements for services/products to support the income projections.</li> <li>• Obtain an owners contribution or surety/guarantor where available.</li> <li>• Staggered finance: Provide only the working capital that is necessary upfront and then make progress payments, linked to goals (once certain deliverables are met, for example, obtain proof of an order, overdraft to be repaid once this is finalized. The next amount is to be considered, and so on).</li> <li>• Make payments on the business' behalf where appropriate, for example, suppliers. The owners supply a pro-forma invoice, the bank then pays the invoice.</li> <li>• The bank could make arrangements with suppliers to cover the goods costs and issue these goods in phases; the customer has to repay each "phase" as they receive their</li> </ul>

money from the end user. If the customer fails to pay then the bank can stop the supply of goods.

- Assist the owner to find willing investors should the customer be open to this avenue. Provide exposure to communities seeking new investment opportunities.

### CLOSE MONITORING OF ACCOUNT

- Make it a condition of grant that the small business appoints a registered accountant to:
  - Ensure procedures and policies are implemented and followed.
  - To obtain monthly management accounts and provide feedback to the bank monthly, or as required.
- Set-up financial performance triggers.

The participants were then asked what alternative sources of financing are recommended for small businesses based on the options provided. The results follow in Figures 5-39 – 5-42.

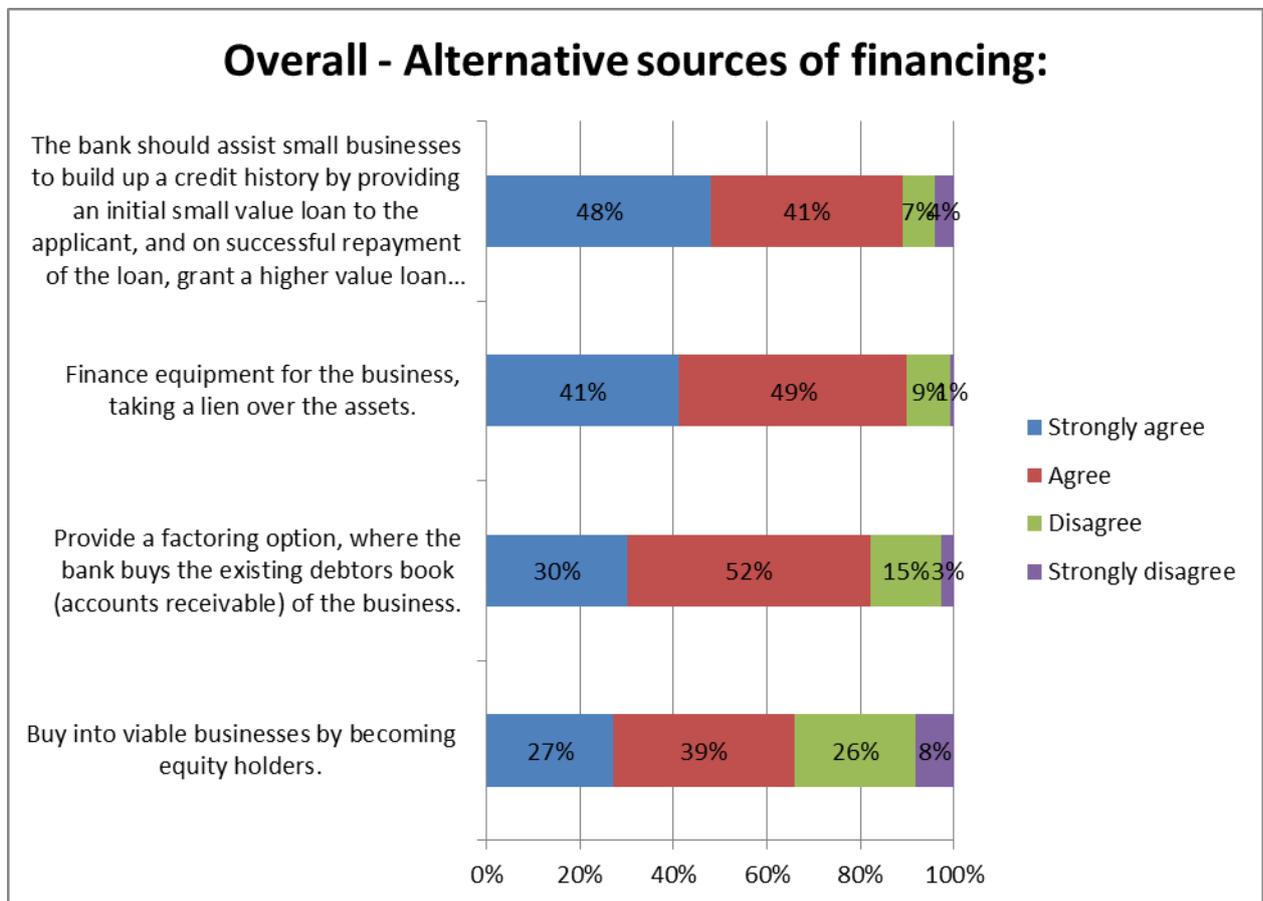


Figure 5-39: Overall: Alternative sources of financing

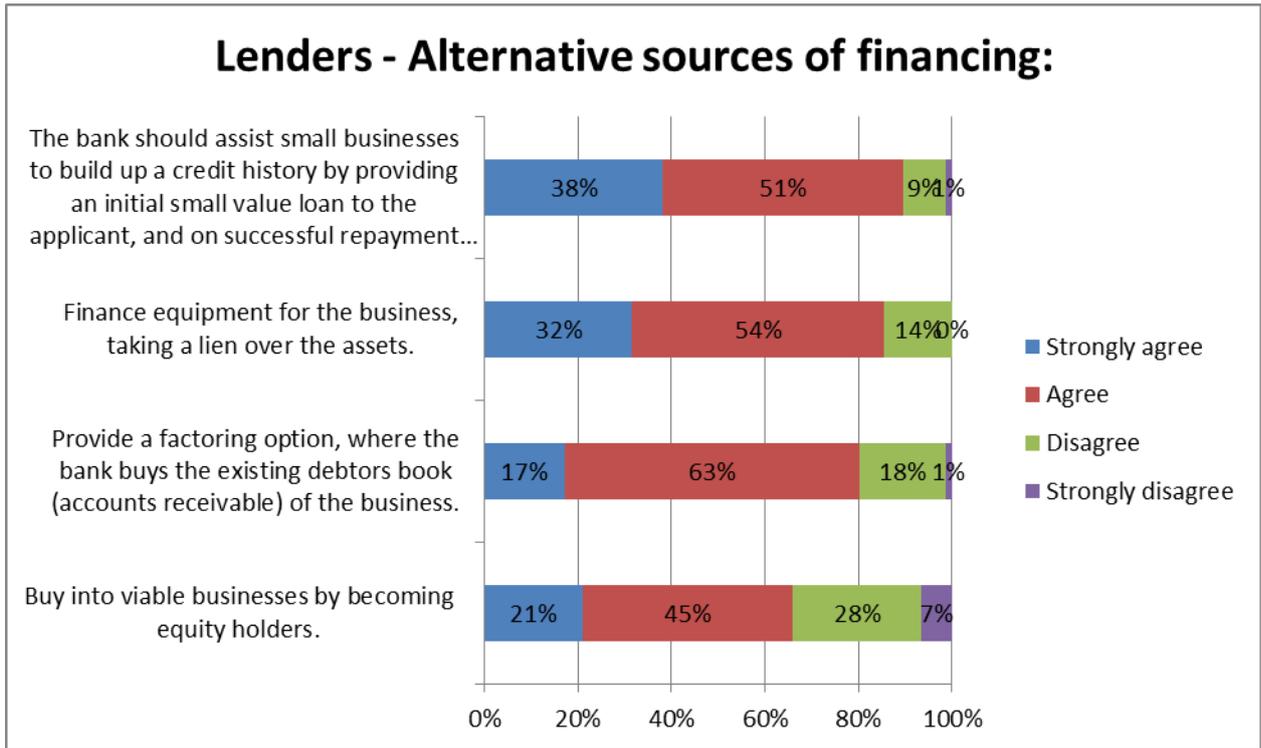


Figure 5-40: Lenders: Alternative sources of financing

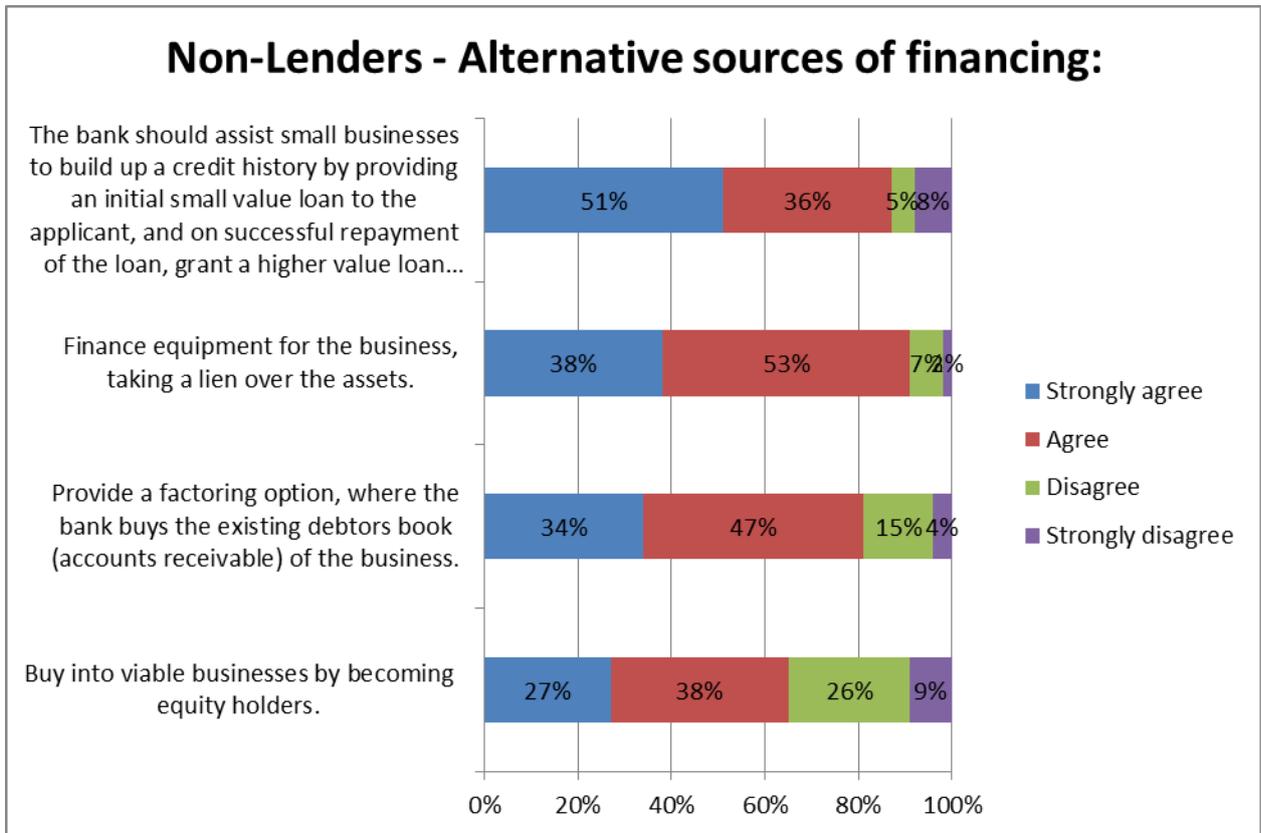


Figure 5-41: Non-lenders: Alternative sources of financing

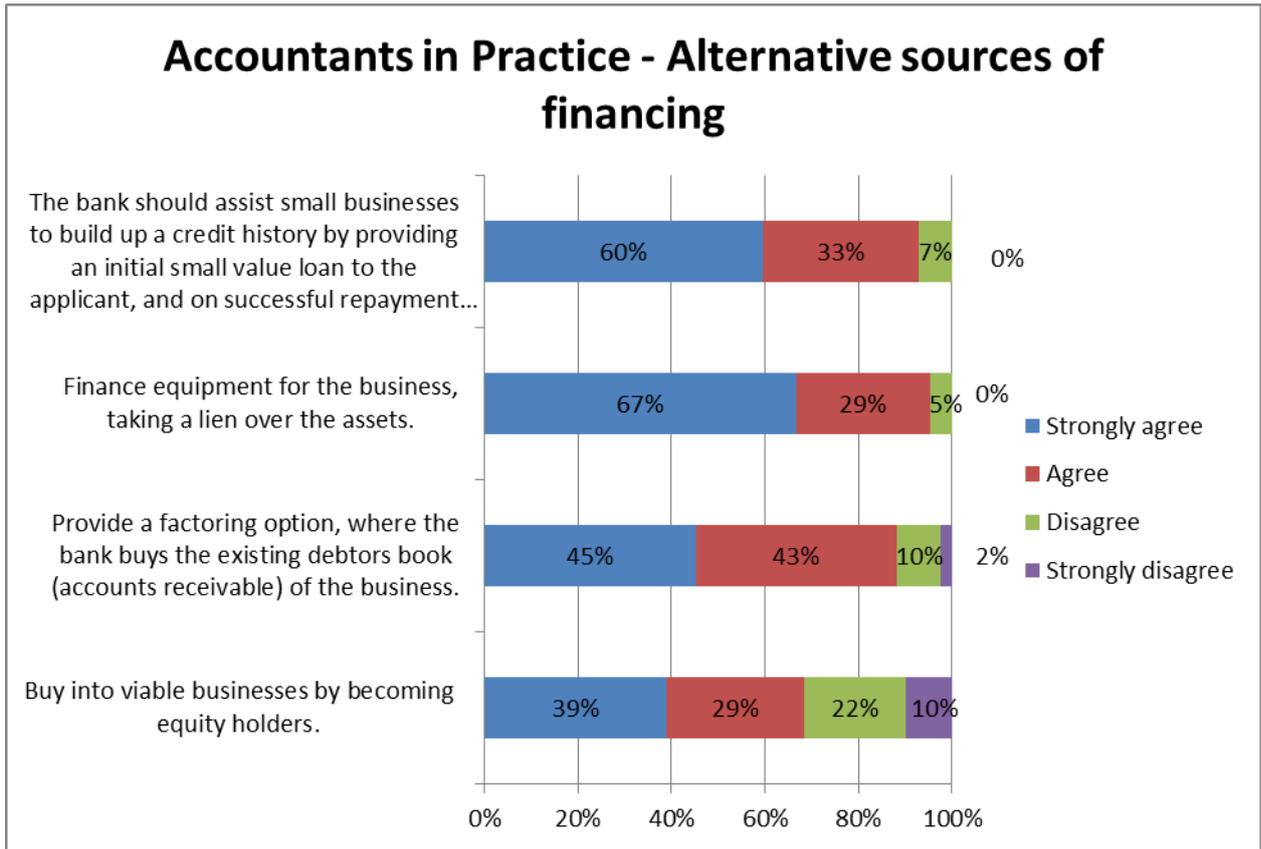


Figure 5-42: Accountants in practice: Alternative sources of financing

Overall, all the respondents responded positively to the options presented to them under this category. Other than the financing of equipment and taking a lien over the asset financed, the other options are not traditional to bank lending.

Further to the options provided above, the participants were asked an open-ended question asking what other alternative sources of financing would be appropriate for small businesses. The results follow in Table 5-21. It must be noted that some of the options provided below have already been covered in the results above; however, there are more ideas provided on how the option can be executed.

Table 5-21: Alternative sources of financing for small businesses

Alternative sources of financing
<ul style="list-style-type: none"> <li>• Incubators, Business accelerators, Private equity, Venture capitalists, Crowd funding.</li> <li>• Incremental lending, Coupon loans.</li> <li>• Social investors on the internet.</li> <li>• Exposure to communities seeking new investment opportunities.</li> </ul>

<b>Alternative sources of financing</b>
<ul style="list-style-type: none"> <li>• Supplier-based funding: Pay expenses directly to suppliers and employees on behalf of the business.</li> <li>• Provide a credit undertaking to key suppliers. Should business owners not meet payment terms with suppliers, the undertaking should be revoked and assistance terminated. Suppliers are far more efficient to manage delinquent customers.</li> <li>• Allow for a monthly income to business owners while the business is growing slowly and not generating an income yet for the owner.</li> <li>• Provide credit based on turnover and good conduct of account. A percentage of the sales turnover as the repayment.</li> <li>• Cash-flow securitization using the point of sale (POS) machines to determine how much money the business generates, and also how much it can pay back.</li> </ul>

The above covered possible alternative sources of financing. The participants were then asked an open-ended question to determine what the bank can do to assist in the instance where a business applicant does not qualify for the full amount applied for, instead of outright declining the application. The results follow in Table 5-22.

Table 5-22: Business applicant does not qualify for the full amount applied for

<b>ADVISE CUSTOMER ON OPTIONS</b>
<ul style="list-style-type: none"> <li>• Depending on the reason that the applicant does not qualify for the full amount, provide the owner/s with advice.</li> </ul>
<b>RE-ASSESS THE BUSINESS PLAN/BUSINESS IDEA</b>
<p>A bank-appointed specialist* is to re-assess the business plan/idea to:</p> <ul style="list-style-type: none"> <li>• Assess whether the business model can be adjusted/re-structured to apply a different implementation strategy with an initial smaller credit amount. Usually, a change in the business model means a much more efficient and profitable approach for less money.</li> <li>• The business must still be able to perform in terms of the contract (if applicable), or establish the business on an initial smaller scale, or if an existing business, still is able to expand on a smaller scale.</li> <li>• The business owners must be engaged and the proposition discussed before a final decision is made to grant the smaller credit amount.</li> </ul> <p>*Specialist: Industry expert/Qualified accountant/Business consultant/Specialized committee/Incubators /Business accelerators.</p> <ul style="list-style-type: none"> <li>• If there is no prospect to adjust the current business model to accommodate the smaller credit facility, the application should be declined. By providing insufficient working capital, the business would be undercapitalized and most likely be set up for failure.</li> </ul>
<b>RESTRUCTURE CREDIT TERMS</b>
<p>If the lower amount will be sufficient for a scaled-down project:</p>

- Provide the reduced credit amount to meet the immediate need as per the adjusted business case.
- Reduce the repayment term in accordance with the reduced credit amount granted. For example, if a business asked for a 90-day loan of R90, 000, but the bank approves R30, 000, the repayment term must be reduced to 30 days.
- Thereafter fund the business in stages, for example, once the set targets are reached, provide the next credit progress payment. This will serve as an incentive to meet the revised business case targets set.

The above suggestions are intended to show how a small business customer can be assisted in the event of not qualifying for the full amount applied for. On the opposite end of the scale, there is the risk of over-lending to a business (Krog, 2008). The participants were asked in an open-ended question on how the bank can prevent providing an excessive amount resulting in over-lending to the business. The results follow in Table 5-23.

Table 5-23: Steps to prevent over-lending to a small business

<b>INITIAL ASSESSMENT OF CREDIT APPLICATION</b>
<ul style="list-style-type: none"> <li>• Correct initial assessments (as per the 5C's of credit).</li> <li>• Analyze needs to start-up/maintain/grow (throughout the lifecycle of the business). Ensure correct assessment of working capital.</li> <li>• Projected cash flow statement/forecasts must be reasonable with conservative assumptions.</li> <li>• Compare the credit amount requested, with the credit required according to the projections.</li> <li>• Business to provide proof of contract(s) to warrant the amount that it wants to borrow.</li> <li>• A proper understanding of the business, sector and the state of the economy.</li> <li>• Many small businesses fail because they grow too fast and cannot maintain the growth profitably.</li> <li>• Ensure the credit profile of the business and the owner is aligned, taking into consideration the political, economic, socio-cultural and technological (PEST) analysis.</li> </ul>
<b>CREDIT DISBURSEMENT</b>
<p>For start-ups:</p> <ul style="list-style-type: none"> <li>• Provide working capital in stages based on actual performance/once certain milestones/targets are met, or</li> <li>• Create a preservation fund where the excess amount should be kept. It must be an interest-bearing account and should only be utilized when the need to re-capitalize the business arises.</li> <li>• Put a cap on the maximum loan amount equal to the forecasted value of the business after year two. Work on an average income over a two-year period.</li> </ul>

Existing businesses:

- Limit working capital to 15% of turnover.

**MONITORING AND SUPPORT**

- Regular interaction with the business owner/s. Visits to the business.
- Monitor the financial behaviour of the business: review the business account regularly; reduce the overdraft/credit amount as and when necessary; focus on the debt ratio.

The participants were then asked a variety of structured questions as listed in the Figures below.

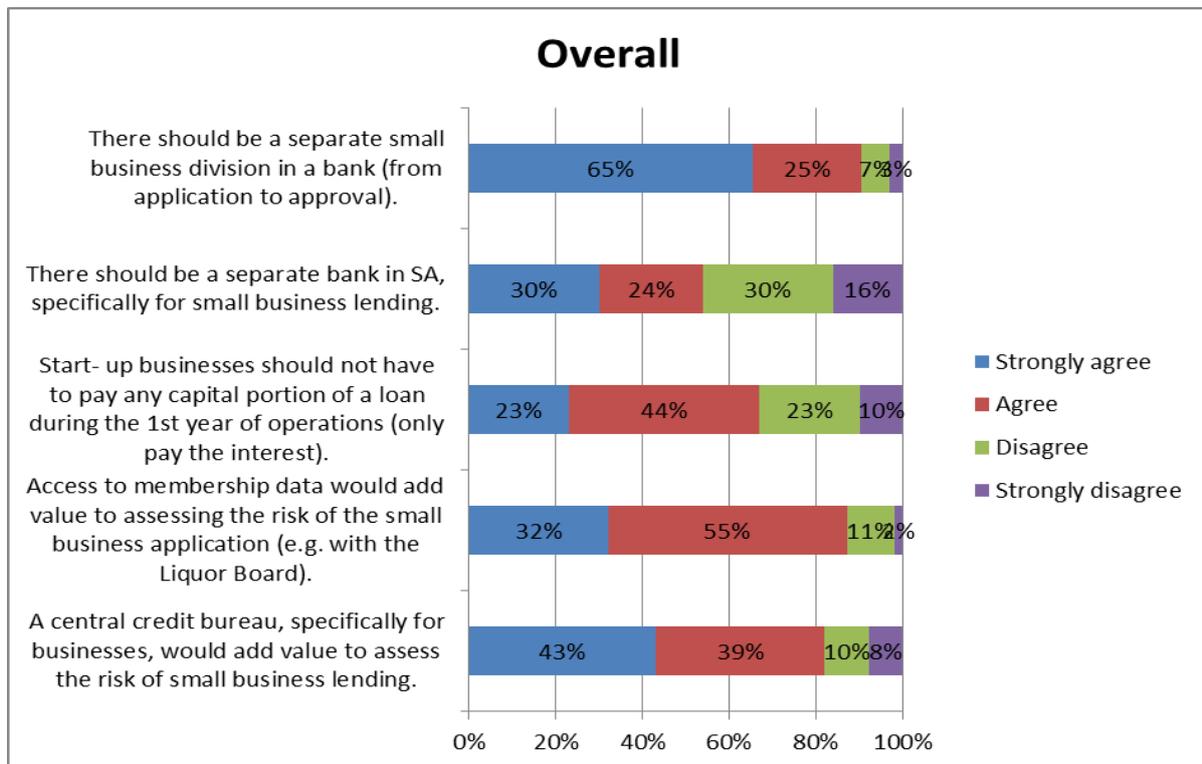


Figure 5-43: Overall: Bank structure

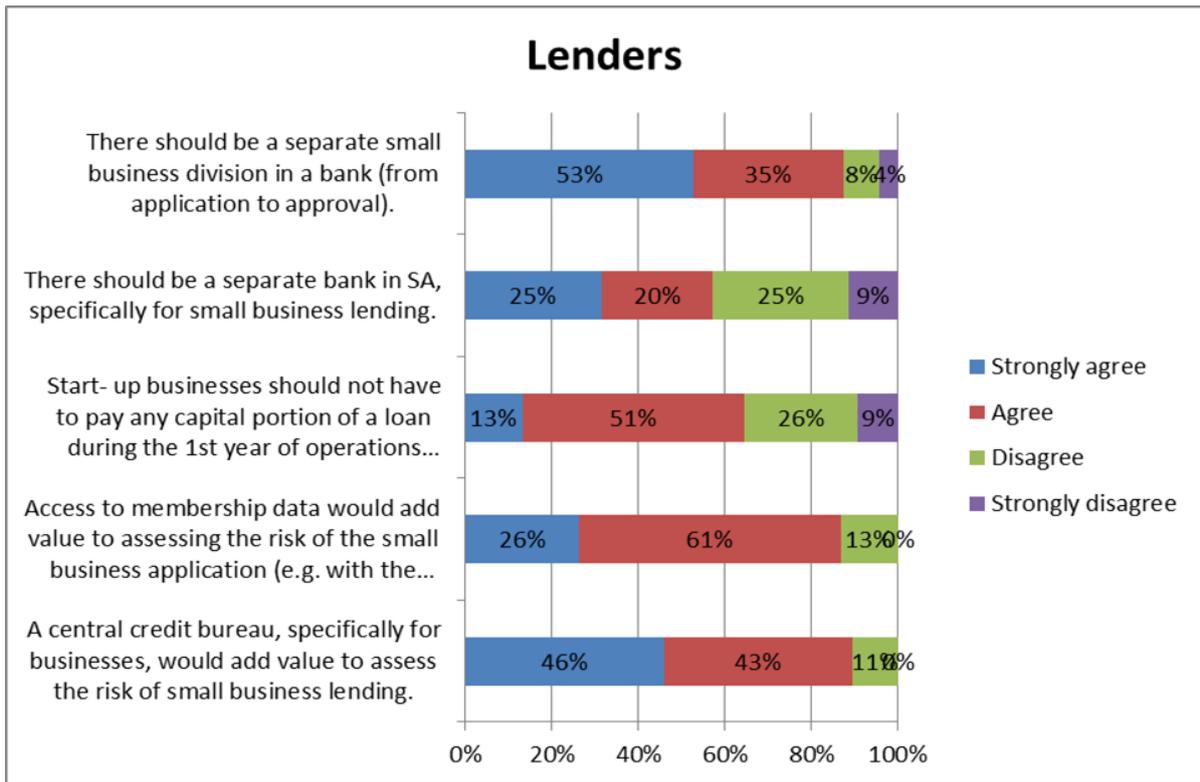


Figure 5-44: Lenders: Bank structure

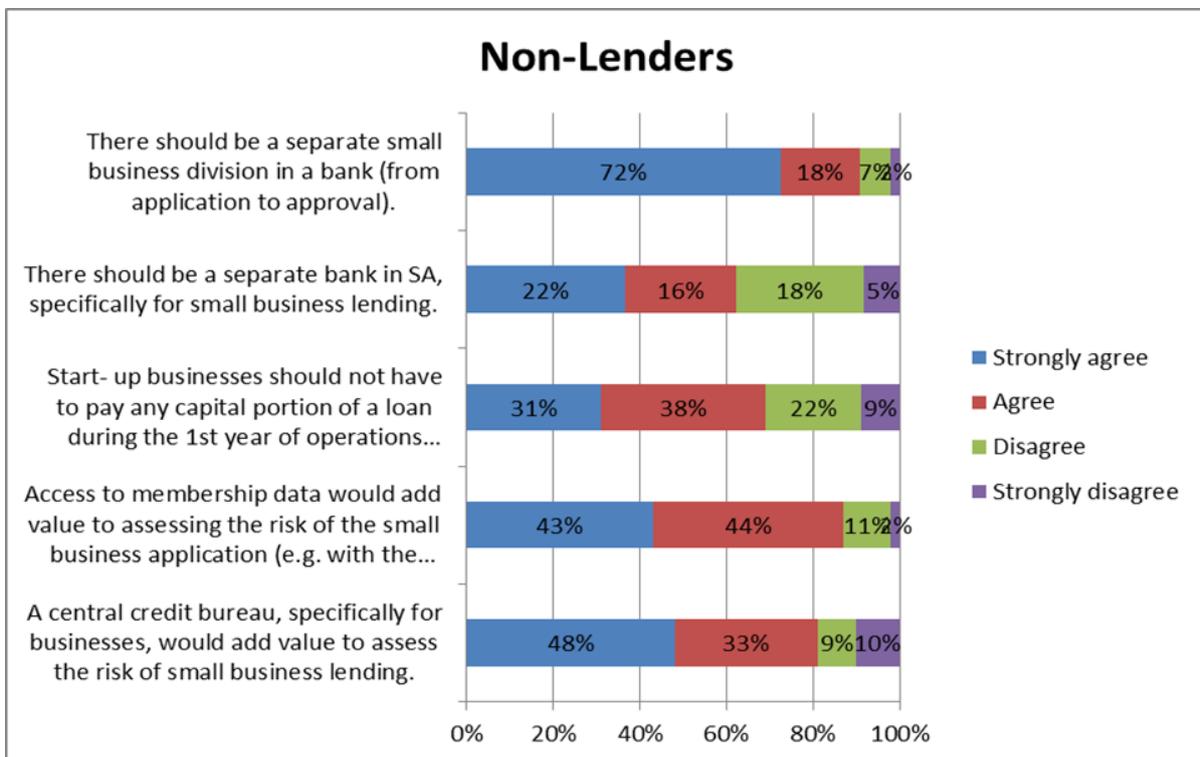


Figure 5-45: Non-lenders: Bank structure

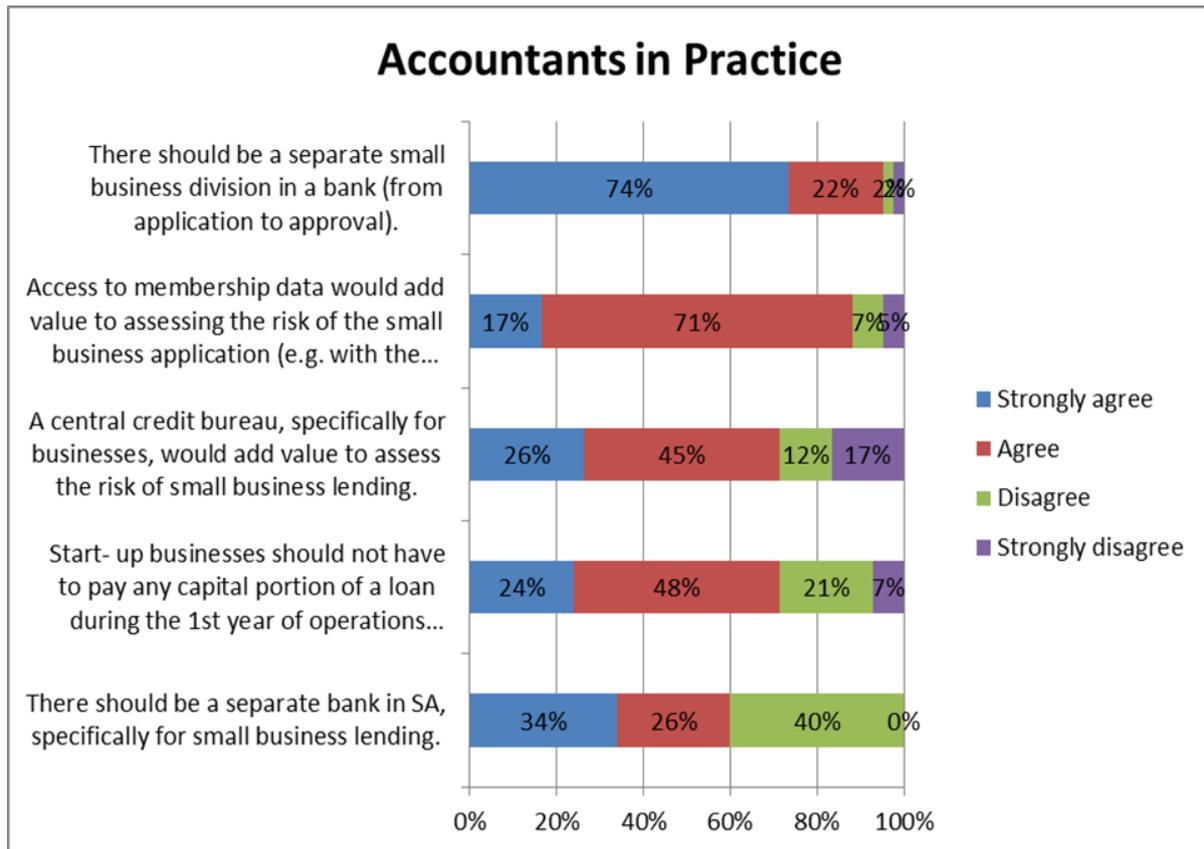


Figure 5-46: Accountants in practice: Bank structure

Overall the respondents are very much in favour of a separate small division within a bank (90%), from application to approval (this does happen at the big banks in South Africa to some extent), more so than having a separate bank in South Africa specifically for small business lending (54%).

The respondents were also positive about the ideas of having access to membership data of the businesses, a central credit bureau specifically for small businesses, and allowing start-up businesses to not pay any capital in the first year of being granted a loan. There is currently two credit bureaus which provide business reports, however, the data available is very limited and could be expanded. The participants were asked in an open-ended question what membership data could add value, and also what credit bureau data could add value to reduce credit risk when lending to small businesses. The results follow in Table 5-24.

Table 5-24: Credit assessment: Membership data and credit bureau data

<b>REGULATORY AND COMPULSORY MEMBERSHIP/ MEMBERSHIP WITH INDUSTRY BODIES</b> (where a registration/ license is required to trade)
<ul style="list-style-type: none"> <li>• Licensing boards, Compliance with the liquor board, SABS, SAB, National Home Building Association (NHBRC), SARS, Labour department, ABS - if specific product CIPCA. Business registration board. CIPC.</li> <li>• Attorneys: Law Society; Estate Agents: EAAB; Chartered Accountants: SAICA; ACCCA; SAIPA.</li> </ul>
<b>PROFESSIONAL AFFILIATION</b>
<ul style="list-style-type: none"> <li>• Industry Board, Taxi Association.</li> <li>• Chamber of Commerce.</li> <li>• Local business forums membership, Geographic area requirements.</li> <li>• Economic forums.</li> <li>• Informal societies such as Stokvels.</li> <li>• Registration with the Ministry of Trade and the Social Security Commission, and have proof of good standing.</li> </ul>
<b>MEMBERSHIP DATA</b>
<ul style="list-style-type: none"> <li>• Permits, Unions, and number of staff, UIF contributions.</li> <li>• Payment of annual fees.</li> <li>• Period of membership.</li> <li>• Expiry dates of licenses.</li> <li>• Professional affiliation: any indication of conflicts of business interest; how active the individual is in the membership; whether the business was involved in any proven wrongdoing/gross negligence; any breaches of membership rules.</li> </ul>

The above covers the membership data that could add value. The results for the suggestions on the data that could be stored at the small business credit bureau follow in Table 5-25.

Table 5-25: Credit assessment: Small business credit bureau data

<b>TRADE ACCOUNT DETAIL FOR THE BUSINESS AND BUSINESS OWNERS/DIRECTORS/MEMBERS</b>
<ul style="list-style-type: none"> <li>• Credit history, payment profile, debt structures, and adverse information.</li> <li>• Size of loans defaulted on, total number of loans successfully paid back – information should provide an indication of whether the applicant is a habitual non-payer if there are any defaults, or for example, only a single cell-phone contract payment caused the applicant to be black-listed.</li> <li>• Decline statistics with reasons.</li> </ul>

<ul style="list-style-type: none"> <li>• Credit scores.</li> <li>• Unpaid accounts with suppliers.</li> <li>• Unpaid school/tuition fees, utility bills and club membership fees.</li> </ul>
<b>APPLICANT DEMOGRAPHIC INFORMATION/OTHER</b>
<ul style="list-style-type: none"> <li>• Company details: business name, address, contact details, description of business and industry, number of employees, number of offices, website information.</li> <li>• Owners/members/directors details: Know Your Customer (KYC) information, contact details.</li> <li>• Previous businesses by the individuals and the status of those businesses.</li> <li>• Professional registrations and memberships, significant associates, successful contracts, procurement information.</li> <li>• CIPC (for ownership), SARS (compliance information), Geographic information system (GIS), Licenses data.</li> <li>• VAT return, indicating turnover.</li> <li>• Third party references – good or bad.</li> </ul>
<b>BUSINESS BENCHMARKING</b>
<ul style="list-style-type: none"> <li>• Information about businesses in various sectors and their success rate, for example, a beauty salon in a particular area - have there been any in the past, and whether they were successful.</li> <li>• Industry-specific data geographic analysis - rural profile, demographic analysis.</li> </ul>
<b>FRAUD ALERT</b>
<ul style="list-style-type: none"> <li>• List of known scammers/fraudsters.</li> </ul>

Below the respondents were asked what percentage of turnover on the applicant's small business current account should be used as a benchmark for providing an overdraft facility, for example, for working capital or to expand the business. Banks typically have a benchmark of not granting an overdraft facility on a current account in excess of 10% of the annual turnover.

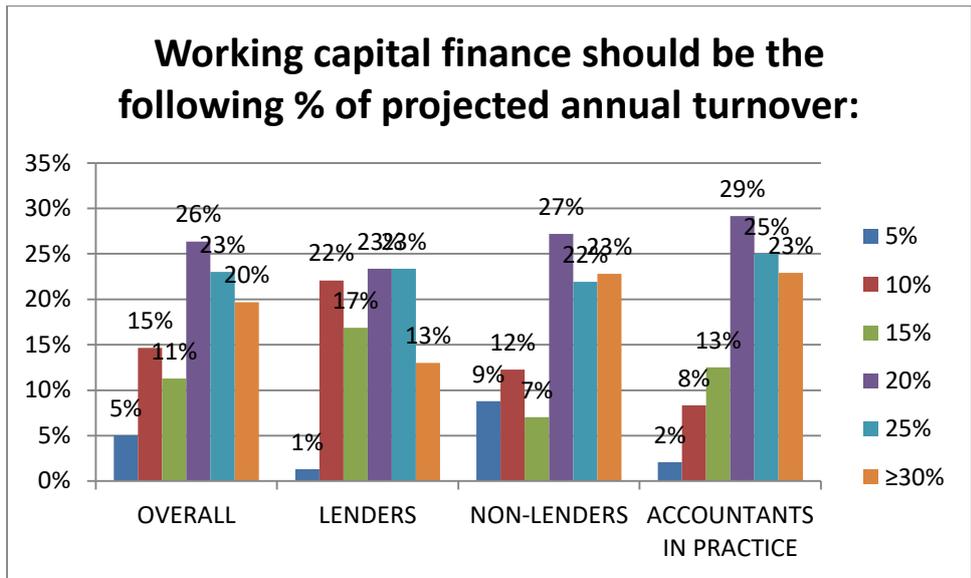


Figure 5-47: Working capital finance should be the following % of projected annual turnover

Overall 26% of the survey population feel that the working capital finance should be 20% of the projected annual turnover. The participants were then asked in a structured question what the minimum period must be for a small business to be operational in order to qualify for credit. The results follow in Figure 5-48.

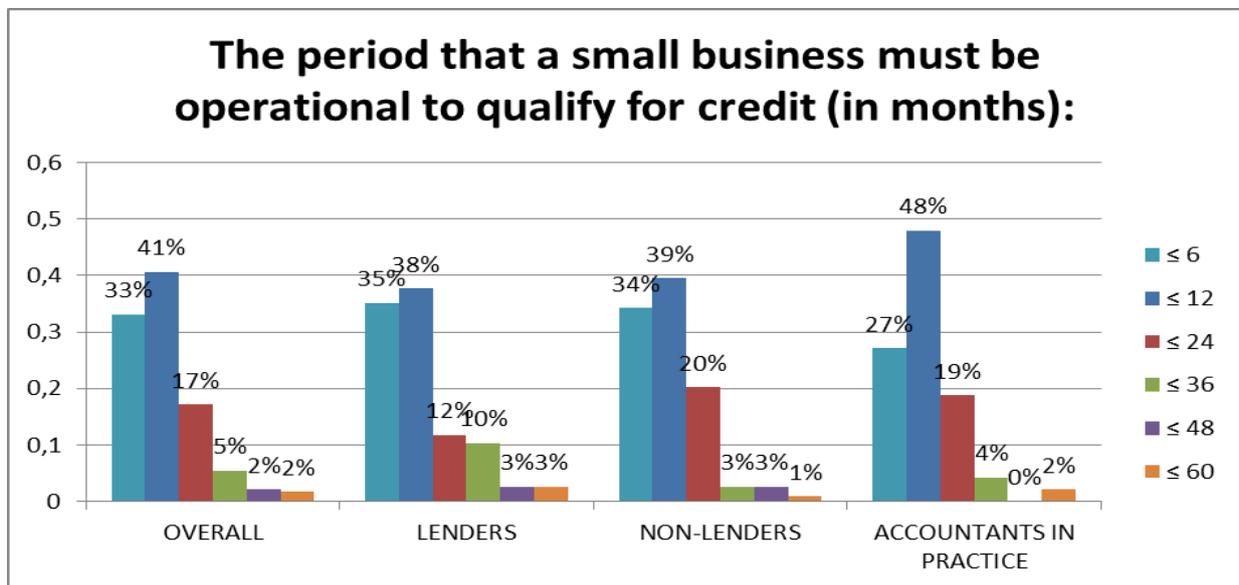


Figure 5-48: The period that a small business must be operational to qualify for credit (in months)

Overall the respondents agreed that a small business must be operational for a minimum period of between six months and twelve months to qualify for credit. The respondents were then asked whether credit decisions should be subjective (based on human judgment),

whether decisions should be automated, or whether decisions should be based on a combination of the two. Refer to Figure 5-49.

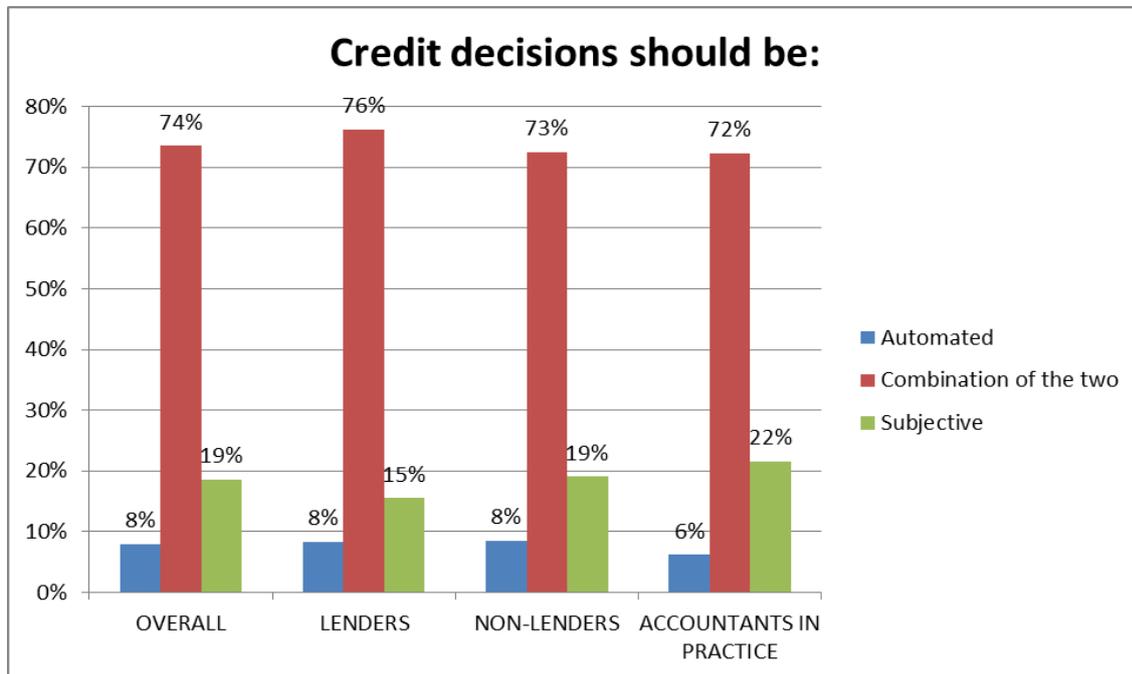


Figure 5-49: Credit decisions

Overall the respondents agreed that credit decisions should be a combination of automated and subjective lending (74%).

The participants were then asked whether the subjective credit decision should be made at the Head Office or at the Branch.

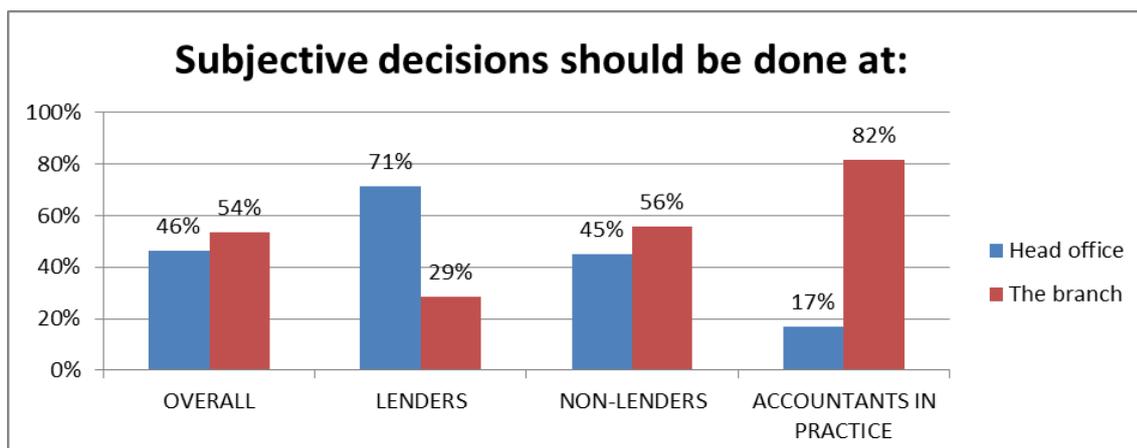


Figure 5-50: Subjective decisions should be done at Branch/Head Office

Overall the respondents agreed that the subjective credit lending decisions should be done at the Branch, as opposed to Head Office. The lenders, however, seemed to feel that the subjective decisions should be done at Head Office, and contrary to this, the accountants in practice seemed to feel that the subjective decisions should be done at the Branch. The Big 4 banks in South Africa have centralized credit facilities where the credit decisions are made at the Head Office.

Below the participants were asked whether they agree that no tangible security is required for start-up businesses who have a viable business idea which is demonstrated in a business plan.

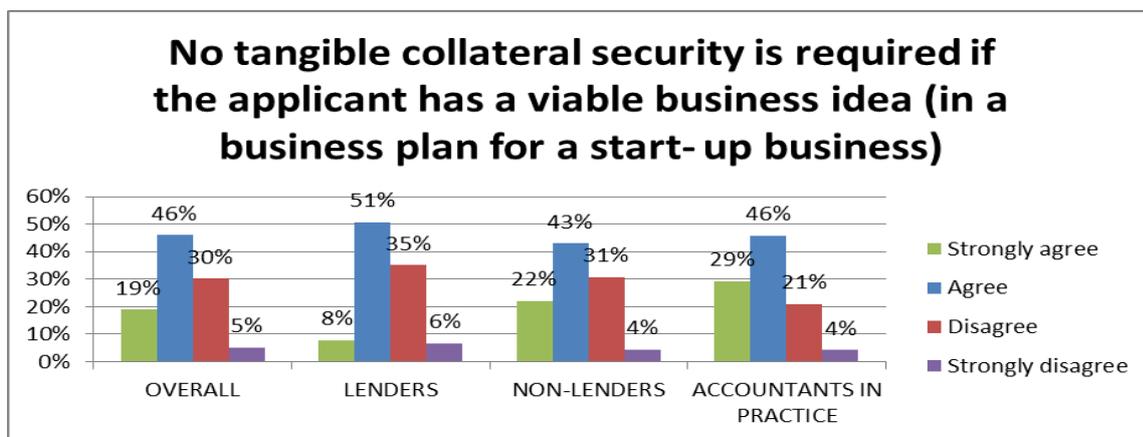


Figure 5-51: No tangible collateral security is required if the applicant has a viable business idea (in a business plan for a start-up business)

Overall 65% of the participants agreed that no security is required if the applicant has a viable business idea demonstrated in a business plan for a start-up business, where the accountants in practice seemed most in favour of this option.

For the participants that had the view that security is required, a structured question was posed, providing options of what percentage security should be obtained. The options provided ranged from: 0 to 15%; 16% to 25%; 26% to 50%; 51% to 75%; 76% to 100%.

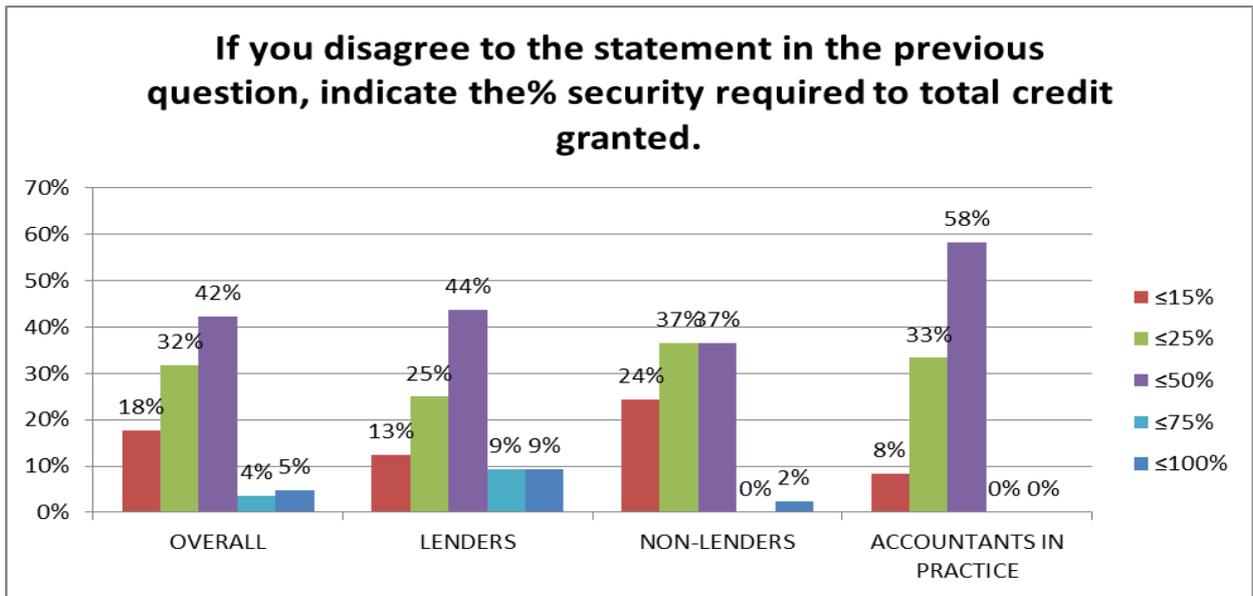


Figure 5-52: Percentage security required to total credit granted

Of the participants who felt security was required, the consensus was that the percentage of security required should be between 26% and 50% to total credit granted.

The participants were then asked an open-ended question on which sectors are considered high risk. Table 5-26 is made up of two components. The first provides the prominent high-risk sectors according to the participants, the second provides factors which may contribute to a business being considered as higher than average risk.

Table 5-26: Sectors that could be considered as high risk

<b>Sectors that could be considered as high risk</b>
<ul style="list-style-type: none"> <li>• Retail and also specifically imports.</li> <li>• Construction.</li> <li>• Manufacturing.</li> <li>• Public transport; transportation; trucking.</li> <li>• Mining or mining dependent; supplies and services to the mining industry.</li> <li>• Food outlets; restaurants; take-away outlets.</li> </ul>
<b>Certain factors may impact on the risk level of a business, resulting in the business perceived has higher than average risk</b>
<ul style="list-style-type: none"> <li>• Seasonal businesses.</li> <li>• Retail of products subject to "Sin Taxes"/ any sector controlled by cartels.</li> <li>• Labour intensive industries, due to the impact of strikes.</li> <li>• Businesses where the barrier to entry is not high.</li> </ul>

- Products requiring a long-term commitment (for example, subscriptions).
- Travel and advanced booking, due to the possibility of cancellations.
- Telemarketing, competitive due to technological advancement.
- Commission based business.
- Outlets where the sale of goods are luxury items and do not fall into the first few rungs of Maslow's hierarchy of needs.
- A business which is only dependent on one person.

It is important to note that the impact of the economy can play a significant role in the risk level position of a specific segment or industry. Hence, a business may be considered as above average risk at one point in time, but may not be considered above average risk at another point in time. Examples which were highlighted from the results are the following:

- State of the macro-economic environment of the business segment/industry.
- Shifts in demand and supply; and
- Local and international interest rates and exchange rates will make importers versus exporters and manufacturers versus wholesalers preferable at different times.

What was also highlighted from the results is that small businesses which are in retail have too much competition and cannot compete with bigger players. "When smaller businesses do business with the bigger businesses, the bigger businesses don't always pay the small business on time. A bridge between big business payment and small business would add significant value".

The participants were then asked an open-ended question to obtain innovative ideas on how the banks can improve the lending criteria for small businesses. The results are listed in Table 5-27.

Table 5-27: How banks can improve the lending criteria for small businesses

<b>Collaborate to address the needs of small businesses</b>
<p>Put a team (committee) together to:</p> <ul style="list-style-type: none"> <li>• Share knowledge.</li> <li>• Identify the needs of small businesses.</li> <li>• Identify ways to mitigate risk.</li> <li>• Design the lending criteria to address the gaps identified.</li> <li>• Develop a policy to be used across all banks. Banks should not compete against each other with this specific project.</li> </ul>

- Once the Credit Policy has been agreed on, a joint funding project must be agreed on with mandates. The aim is to lend to small business through this project. Joint funding by banks and the Government.
- The team must meet regularly and should include representatives from the Government, Banks, Accountants/auditors, SEDA (provides pre-loan support) and Industry/business specialists.

### **Continuous research**

- Gain a proper understanding of venture capital projects /small businesses.
- Engage with small business owners: Ask for suggestions and feedback at the bank. Arrange focus groups.
- Better use of technology to conduct surveys.
- Make use of institutions with innovative capability.
- Get universities and business schools to set up and run small business simulations and research models to highlight problems and work toward possible solutions to benefit lenders and borrowers. Make this a high profile issue for political candidates.
- Research best practices from abroad.
- Research local best practices.
- Engage with organizations such as Zimele (Anglo-American) that has developed more than 1000 businesses.
- Maintain information on franchisors where due diligence has been completed, to enable easy understanding of the market/concept. Main assessment to be on the owner.
- Use technology to link the bank database with the credit bureau, customers, and other credit providers to improve on the supply chain.

### **Facilitate**

- New business Forums/Seminars/Entrepreneurship workshops:
  - For training and networking.
  - Where various industries are discussed and facilitated by specific industry experts.
  - On new industry fraud and scams.
  - Case studies on previous failures or successes.
- Entrepreneurship Internship Programme (such as the Anglo-American model).
- Encourage well-established businesses to provide technical support to start-ups.
- Discussion groups where members could help each other with specific issues.
- Try and borrow from the open market by attracting equity partners. Match equity partners with appropriate skills to mentor.
- Create a platform where small business owners can meet potential investors and "regulate" the process so that it is beneficial for the small business owner and investor.
- Outside investors must be listed on the bank's database.

- Grooming process - where lenders give small business an idea as to what makes a fundable business idea.

### **Be clear on lending requirements for applicants**

- Develop a template detailing all the bank's requirements to be used by small businesses when preparing their proposals.
- For example, in order to borrow 30% of projected turnover, the requirements could include forecast, orders on hand, profit forecasts and security.
- Arrange for education campaigns on the requirements.

### **Products**

- Have a separate micro lending facility with a small ceiling and very limited qualifications for a loan and more relaxed repayment terms.
- Lease second-hand machinery.
- Business credit card facilities at a discounted rate from known suppliers.
- Lower interest rate and flexible repayments.
- Loyalty schemes and performance bonuses. For example, certain goals could result in lower interest rates, financing options.
- Don't work on a fixed limit over a certain period, work on an average base limit.
- Levies for small business to create their own funding at an interest.
- Link cost of funding to business performance.
- Small business insurance.
- Investment incentives.

### **Credit Policy**

- Get rid of the "one size fits all" Credit Policy.
- Benchmarking against similar industries in geographical relevance.
- Allow for and encourage a credit grantor to engage with an applicant and inquire about any concerns as opposed to outright declining an application. Examples include a bad credit history/credit bureau adverse information, due to the following reasons:
  - The owner may have been retrenched from permanent employment and was unable to pay the monthly debt at the time.
  - Previous business failure.
  - A supplier may have given the customers the incorrect or faulty product. The customers due to insufficient funds are not able to defend the matter.
  - For existing bank customers, there may be deterioration in financial ratios/negative trends.

### **Legislation**

- A national credit lending legislation and regulations to protect both the bank and small business.

The above provides innovative ideas that could be taken into consideration for lending to small businesses. An interesting insight from the responses is that credit providers need to understand that small businesses do not always succeed at the first attempt of constituting a business. The consequences of a failed business may be that the owner/s and/or business may have adverse listings on the credit bureau. Thus, although the negative credit record exists, the owners may still have the passion and skill to succeed in another business venture. The motivation is that although the credit bureau record should be taken into account, a negative credit record in isolation should not be the sole reason for declining an application for credit. An example was provided of an Israeli approach where lenders allow businesses to fail up to three times. The reason for this is that after each failure, there is a greater chance of success as the business owners learn from past mistakes. There is, however, a financial loss to the bank in the event that the business fails and is unable to repay the amount owing to the bank.

The participants were then asked in an open-ended question, what support a bank can provide to business owners that could help to mitigate the credit risk faced by banks. As explained in Chapter 1, any support services outside the banks existing realm, should be offered and funded by Government. The results follow in Table 5-28.

Table 5-28: Recommended support to small businesses

<b>BEFORE APPLYING FOR CREDIT</b>
<ul style="list-style-type: none"> <li>• Educate customers about what banks can offer.</li> <li>• Appoint specialist finance consultants who can support a prospective credit applicant through the requirements, preparation of all requirements, and provide guidance on what the individual can do to strengthen the application.</li> <li>• Conduct seminars and invite businesses where all key topics relating to funding are discussed, and the business owners are empowered about the bank's process and procedures.</li> <li>• Provide access to business and industry specialists.</li> <li>• Provide guidance on how to navigate the start-up of the business properly: CIPC; SARS; Labour departments; and BEE Certification.</li> <li>• Legal assistance: how to deal with required legislation; implications of the Companies Act and Income Tax Act.</li> <li>• Offer free or sponsored list of accredited accounting officers/accounting services; accounting app/packages; readymade business systems in the cloud such as Xero.com for accounting.</li> </ul>

<ul style="list-style-type: none"> <li>• Assist business owners to do proper research and gain a proper understanding of the chosen business.</li> <li>• Provide a Small Business Toolkit.</li> </ul>
<b>WHEN ASSESSING AN APPLICATION</b>
<ul style="list-style-type: none"> <li>• Assess the management style and competencies of the senior employees. Also look at the controls in place, and if the company is conscious of controls.</li> </ul>
<b>ON APPROVAL OF THE CREDIT</b>
<p>Appoint an independent accredited finance professional/accountant (SAICA, SAIPA, SAIBA) to:</p> <ul style="list-style-type: none"> <li>• Advise the owner on how to apply the credit that was granted wisely in the business.</li> <li>• To compile monthly management reports and perform agreed-upon due diligence procedures to identify training needs and any early warning signs of problems/risk.</li> <li>• Suggestions are to be given to the owner/s on how to rectify the identified potential risk/problem. A time limit should be placed on rectifying the problem.</li> <li>• Identify support areas required by the business and allocate respectively.</li> </ul>
<b>AFTER SUPPORT SERVICES</b>
<ul style="list-style-type: none"> <li>• Advisory service; mentoring; coaching.</li> <li>• Provide a database which lists all the members/business, their product or service.</li> </ul>

For the participants who agreed that there should be a separate bank specifically for small businesses, an open-ended question was asked to motivate why. The results follow in Table 5-29.

Table 5-29: Motivation for a separate bank specifically for small businesses

<b>Current banks do not focus on small businesses</b>
<ul style="list-style-type: none"> <li>• Banks are risk averse and banks view lending to small businesses as high risk.</li> <li>• Too few banks in South Africa so there is little competition which allows banks to be too risk averse and avoid small business loans.</li> <li>• The focus will always be on areas which provide a higher profit margin.</li> <li>• Invariably the banks are being asked to take on shareholder risk, and this cannot be done on a basis that will provide a sustainable return to shareholders.</li> <li>• The issue around the high administration and high default rates will not be as high as in the traditional banks, where the focus is on the shareholders' returns.</li> <li>• Not structured to accommodate small businesses, especially in a developing nation such as South Africa.</li> <li>• Banks don't know how to lend to small businesses.</li> </ul>

<b>Niche market with special needs</b>
<ul style="list-style-type: none"> <li>• The risk in this sector requires special regulatory and shareholder demands.</li> <li>• Small business is a niche market with unique needs and unique challenges.</li> <li>• This will allow for proper research, focus, and interactive and specialized attention to small business owners “singleness of purpose has always proved to be beneficial”.</li> <li>• Lending to small businesses requires very specialized skills. All the skill sets can be housed under one roof, including advisory services, end-to-end credit functions, and support.</li> </ul>
<b>One Stop Shop is required for small business lending</b>
<ul style="list-style-type: none"> <li>• Reduced red tape, streamlined processes and improved turnaround times.</li> </ul>
<b>It will increase access to credit for small businesses</b>
<ul style="list-style-type: none"> <li>• One hundred percent focus on small businesses.</li> <li>• This focus and experience gained will enable a model to be developed to become market leaders in supporting small businesses.</li> <li>• It can have a different look and feel to the traditional banks. Small business owners sometimes lack confidence and are largely intimidated by the big operations of the bank.</li> <li>• Personable, diversified, skilled employees conversant in the prominent languages in South Africa, together with the correct risk appetite will make headway in small business lending.</li> <li>• To provide preferential rates and pricing. The bank is to be partially funded by Government, with the four major banks.</li> <li>• This bank can bring investors and start-ups together.</li> <li>• It must be governed differently to traditional banks, as the risk profile is different. A bank lending to Blue Chip industrials should not be held to account in the same way as a bank promoting entrepreneurs and small business ownership.</li> <li>• Proper funded small businesses will increase employment and benefit the economy as a whole.</li> </ul>
<b>Economic development</b>
<ul style="list-style-type: none"> <li>• Small business will always play second fiddle in the hierarchy where prioritization and development are directed.</li> </ul>

The majority of the participants were positive about a separate bank specifically for small businesses. The only concern raised is that it could lead to a monopoly; however, there will always be other financing options provided to small businesses, and based on the responses, the positives outweigh this concern.

The participants were then asked an open-ended question to identify strategies which banks can implement to attract small business customers to the bank to apply for credit. The responses follow in Table 5-30.

Table 5-30: Strategies to attract small business customers

<b>Change of mindset and approach to small businesses</b>
<ul style="list-style-type: none"> <li>• Be an educator of credit and start-up business - “invest in people, and people will invest in your bank”.</li> <li>• A solid value proposition over and above 'credit' will attract small businesses. That is, access to quality support.</li> <li>• Build a reputation for facilitating small business growth and support.</li> <li>• It should rather be seen as a reward system, rather than a loan system.</li> <li>• The bank must be seen as a partner and not a threat to the viability of the business.</li> </ul>
<b>Become more customer friendly</b>
<ul style="list-style-type: none"> <li>• Implement changes to change the mindset of customers to not feel “intimidated” and to become more trusting of banks.</li> <li>• Change the look and feel of the bank, make it less formal.</li> <li>• Become more customer front facing - approachable; accessible; personal interaction.</li> <li>• Be clear on the requirements, explain the implications of the credit agreement.</li> <li>• Appoint friendly employees that are welcoming to the customers; show more empathy; show that you want to sincerely help, and not just do what is best for the bank.</li> <li>• Small business department peopled by names, not titles.</li> <li>• Simplify the application process: simplify documentation; customize applications for small businesses; simple language agreements; do away with language barriers terminology; processes and systems to be simplified; reduce red tape.</li> <li>• Be transparent.</li> </ul>
<b>Marketing and Advertising</b>
<ul style="list-style-type: none"> <li>• Advertising campaigns to educate small business owners about financial management and access to funding.</li> <li>• Sincere advertising in prominent languages.</li> <li>• Marketing aimed at new entrants to specific industries.</li> <li>• Promote product offerings for small businesses.</li> <li>• A media campaign setting out fully the criteria and the cheaper rates and not a "terms and conditions" disclaimer with a multitude of additional paperwork.</li> <li>• Canvassing in own town and introducing the bank to newly opened businesses.</li> <li>• Attend small businesses networking sessions; speak to the business owners; approach small business incubators.</li> <li>• Offer suitable incentives; prizes; awards for new applicants.</li> <li>• Advertise favourable payment terms.</li> <li>• Full media coverage of successful applicants.</li> <li>• Emphasize the advantages of using banks.</li> </ul>

- Promote at schools to get the younger entrepreneurs involved.
- A stated and marketed policy by banks that they are "there to help".

#### **Methods**

- Billboard marketing, Campaigns, Short message service (SMS).
- Personalized letters offering start-up capital for small business ventures to existing customers.
- Competitions; awards evenings; promotions; arrange events.
- Radio, share success stories.
- Word of mouth through the community of the interaction with the bank.

#### **Suitable and attractive products**

- More attractive products like a revolving loan.
- Provide an end-to-end banking solution.
- Allow for delayed payments/payment break.
- Bridging finance for debtor payments.
- Access to business tools and equipment such as printers and laptops with a reasonable payment plan.
- Provide a reasonable grace period to enable the business to break-even and be in a position to pay back the loan.
- Stage-by-stage cash loans.
- Development project interest-free loan for beginners.
- Reward for "good behaviour". Perhaps a reduced interest rate for a month for every 12 months that the business owner pays the installments on time (and no dishonors during that time).

The above summarises the strategies to attract small business customers. There was a feeling from the participants that if the bank demonstrated a genuine interest to support entrepreneurs, the business owners would be willing to engage in discussions with that institution. The difference to the customer will be what support the business will receive from a bank; and not so much how much money they can get in a loan.

The results of the National Credit Act (NCA) data and the Khula Credit Guarantee data are presented below.

### 5.4.6.3 Section 3: Regulation: National Credit Act (NCA)

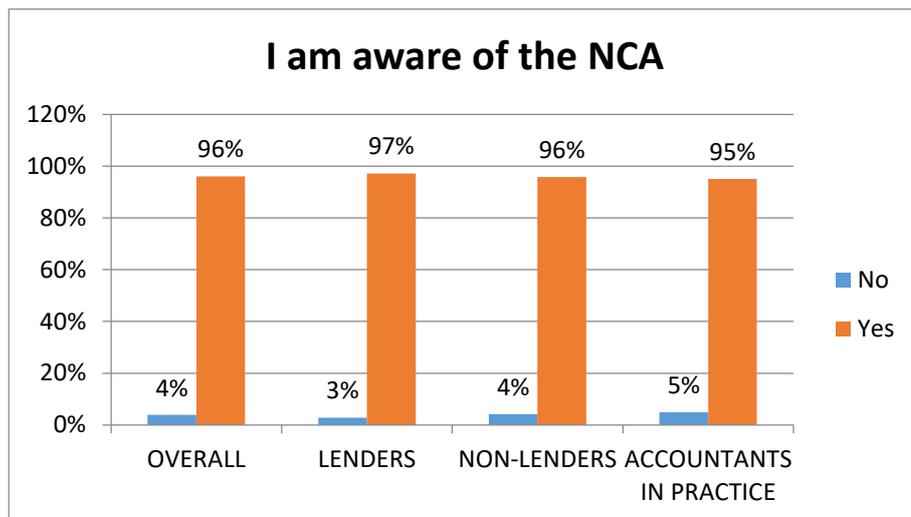


Figure 5-53: NCA awareness

It is positive to note that overall most of the participants are aware of the NCA (96%).

Below the participants were asked a variety of questions with the aim to determine what influence the NCA has had on small business lending.

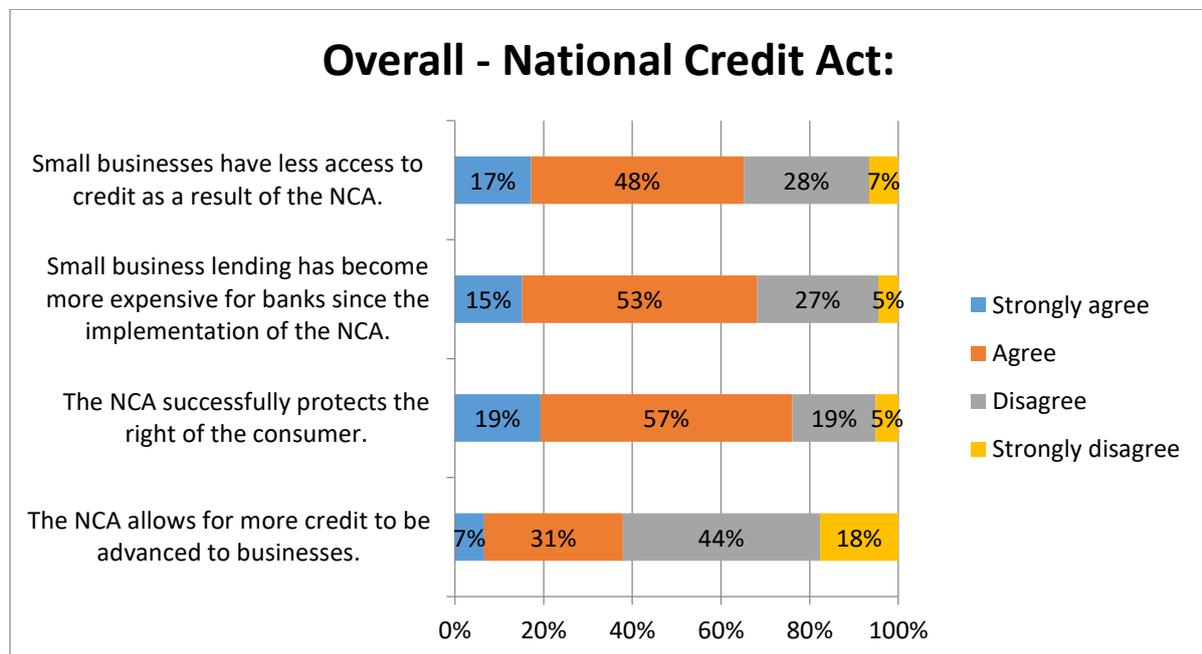


Figure 5-54: Overall: Influence of the NCA on small business lending

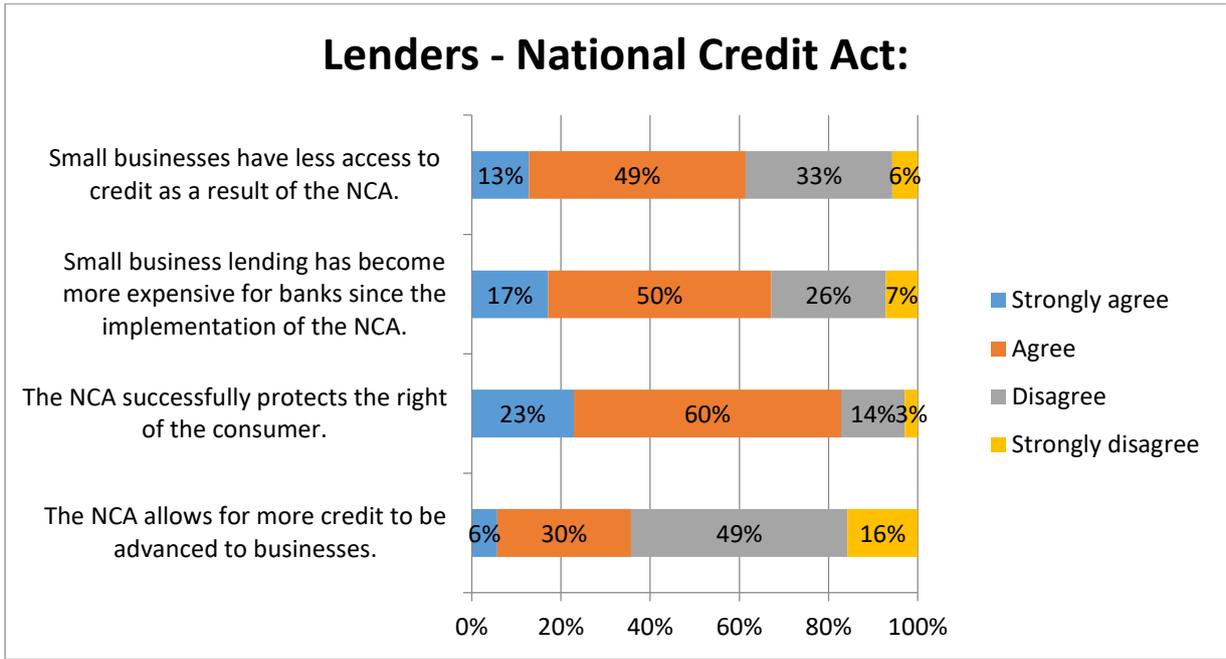


Figure 5-55: Lenders: Influence of the NCA on small business lending

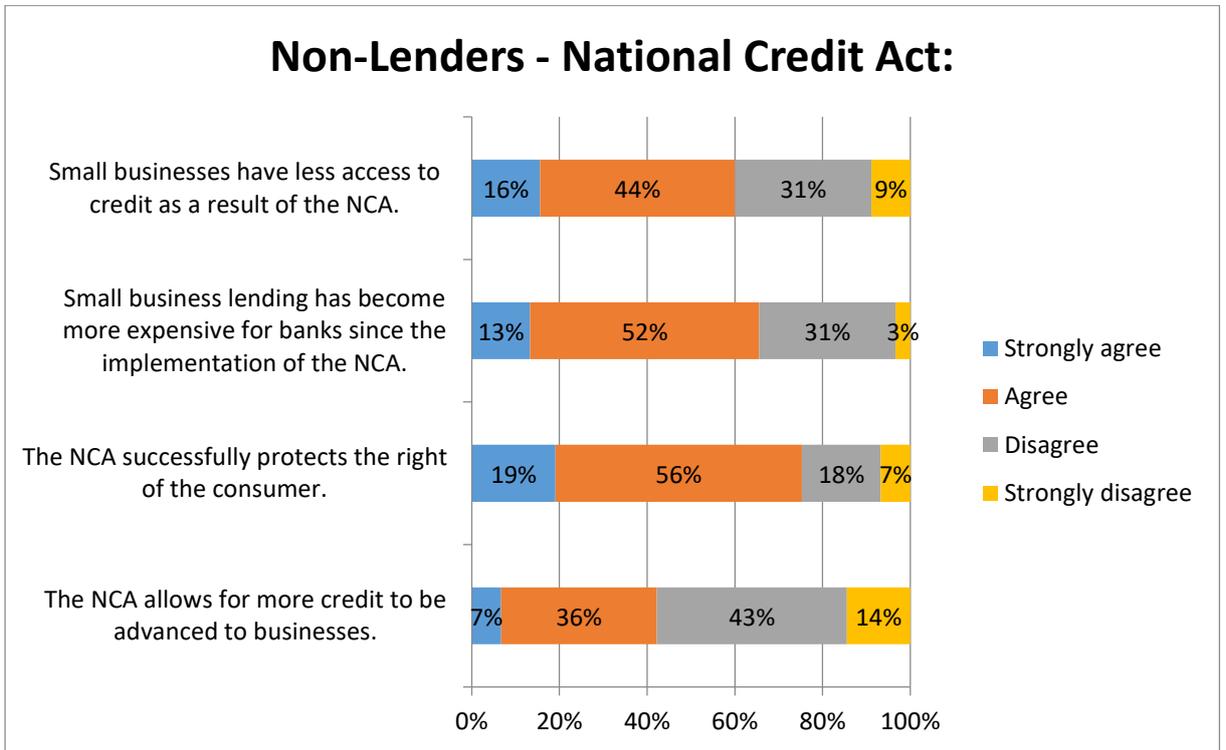


Figure 5-56: Non-lenders: Influence of the NCA on small business lending

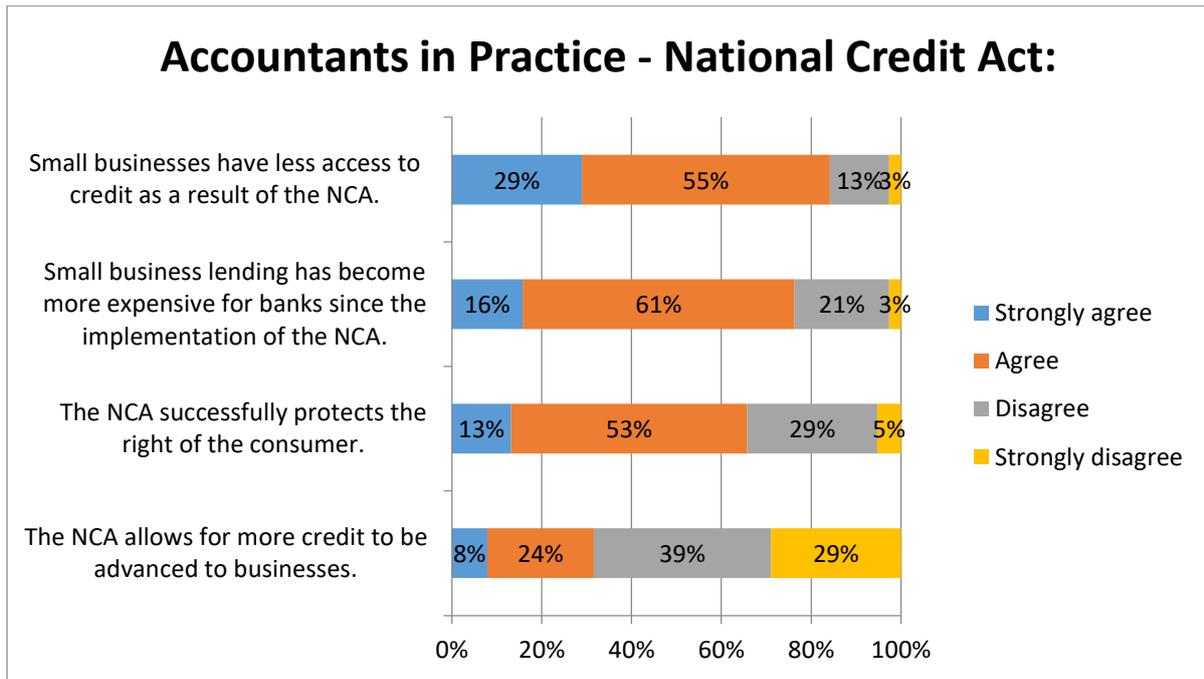


Figure 5-57: Accountants in practice: Influence of the NCA on small business lending

Although overall the participants believe that the NCA successfully protects the rights of the consumer (76%), the participants, however, feel that small businesses have less access to credit as a result of the NCA (65%). The reason for this may be that small business lending has become more expensive for banks since the implementation of the NCA (68%), and the participants overall disagree that the NCA allows for more credit to be advanced to businesses, as only 38% agreed that the NCA allows for more credit to be advanced to businesses.

The lenders seemed to agree more than the overall participants that the NCA protects the rights of the consumer, but at the same time, together with the accountants, seemed to have the view that the NCA does not allow for more credit to be advanced to businesses. The accountants in practice also seemed to have a higher opinion that small business lending has become more expensive for the banks since the implementation of the NCA.

The participants were then asked an open-ended question to freely express their view on any positive impact (influence) that the NCA has had on small business lending, from a banking perspective. Majority of the participants that responded to this question stated that the NCA has had no positive influence on small business lending. The participants that felt that there was a positive influence stated the following reasons as stipulated in Table 5-31:

Table 5-31: Positive influence of the NCA on small business lending, from a banking perspective

<b>PROTECTS THE RIGHTS OF THE CONSUMER</b>
<ul style="list-style-type: none"> <li>• Prevents the customer from over-indebtedness.</li> <li>• Customers are more educated on the cost of credit.</li> <li>• The ability to utilise a cooling off period on hire purchases.</li> </ul>
<b>PREVENTS RECKLESS LENDING</b>
<ul style="list-style-type: none"> <li>• Irresponsible lending is discouraged as credit is granted only to those who can afford it.</li> <li>• More stringent lending criteria applied by banks.</li> <li>• Sets requirements for affordability rules.</li> </ul>
<b>TRANSPARENCY</b>
<ul style="list-style-type: none"> <li>• Ensures the small business owner understands the credit agreement.</li> <li>• No hidden costs.</li> <li>• Exposure to the risks associated with credit.</li> </ul>
<b>COST OF CREDIT IS REGULATED</b>
<ul style="list-style-type: none"> <li>• Pricing is regulated.</li> <li>• Prevents loans from unregistered institutions.</li> <li>• Has provided a regulatory framework in an industry which has been unregulated with many small operators taking advantage of small businesses.</li> </ul>

For the respondents which previously stated that small businesses have less access to credit as a result of the NCA, an open-ended question was provided to state their view on what the reasons are that small businesses have less access to credit. The results follow in Table 5-32.

Table 5-32: Reasons why small businesses have less access to credit since the NCA

<b>MORE EXPENSIVE FOR BANKS TO PROVIDE CREDIT</b>
<ul style="list-style-type: none"> <li>• More administration.</li> <li>• Bank administration costs more or less the same for a big and a small amount to be borrowed. The return is higher for larger loans.</li> <li>• The documentary requirements are excessive.</li> <li>• Takes longer.</li> <li>• Can borrow less to customers than before.</li> <li>• More expensive for banks to collect.</li> </ul>

<b>BANKS ARE UNABLE TO “PRICE FOR RISK”</b>
<ul style="list-style-type: none"> <li>• Banks are unable to price adequately for excessive risk, so decline rates go up.</li> <li>• It may no longer be as profitable for banks due to the lending caps.</li> </ul>
<b>MORE STRINGENT CREDIT POLICIES ARE ENFORCED</b>
<ul style="list-style-type: none"> <li>• Lower risk acceptance levels results in fewer customers qualifying for loans.</li> <li>• Banks are more careful due to potential litigation.</li> <li>• Doesn't allow for a subjective approach to lending.</li> <li>• Rigid criteria do not allow any leeway in decision-making.</li> <li>• Strict criteria prohibit innovation.</li> <li>• Banks have been constrained in their lending abilities due to the potential for reckless lending penalties.</li> <li>• This results in banks basing many of the lending decisions on the owner's ability to repay the loans, and not necessarily the business cash flow to pay the loans.</li> <li>• Small businesses are perceived as high risk and because of the strict guidelines of the NCA; banks are wary to grant credit to small businesses.</li> <li>• It is more onerous for businesses to apply for credit, so fewer customers apply due to the excessive paperwork and processes.</li> <li>• It is now critical for a business to be able to substantiate its cash flow projections to prove affordability to a high level of probability. This generally leads to a more conservative projection.</li> <li>• Banks have tightened their lending criteria to the point that new start-up businesses are unable to qualify based on potential future affordability and earnings.</li> <li>• Restricted lending to small businesses; more paper is dishonored as there are no discretionary overdraft limits; there is also a cost of the dishonors to the business.</li> </ul>
<b>THE REGULATIONS ARE VERY COMPLEX</b>
<ul style="list-style-type: none"> <li>• Due to the complexity, banks prefer to “play it safe” and stay within certain parameters, tightening credit policies to a larger extent than may be required.</li> <li>• It takes a lot of manpower to follow all the regulations set out by the NCA, increasing the cost to the bank.</li> </ul>

The participants were then asked an open-ended question on any negative influence that the NCA has had on small business lending from a banks perspective. The results follow in Table 5-33.

Table 5-33: Negative influence of the NCA on small business lending, from a banks perspective

<b>LESS PROFITABLE FOR BANKS TO LEND TO SMALL BUSINESSES</b>
<ul style="list-style-type: none"> <li>• Capping of interest rates and reduced collections mechanisms make it less profitable.</li> <li>• Rigorous assessment and validation costs. Duplication of efforts.</li> <li>• It has made it more expensive and cumbersome for banks, specifying details in contracts.</li> <li>• Onerous and expensive compliance regulations.</li> <li>• Banks cannot mitigate their risk with higher interest rates and costs.</li> <li>• More processes require more employees, added training, and system development.</li> <li>• Higher decline rates.</li> <li>• More controls required.</li> <li>• Excessive default penalties.</li> <li>• Creates massive opportunities for unscrupulous operators in the market that are below regulatory radars.</li> </ul>
<b>ONE SIZE FITS ALL APPROACH</b>
<ul style="list-style-type: none"> <li>• Credit lending criteria is very strict on individuals and small businesses are treated the same. The two should be separated completely and be encouraged - not discouraged as per present.</li> <li>• Does not allow for any flexibility. Rigid approach by banks, checklist ticking.</li> </ul>
<b>THE REGULATION IS COMPLEX</b>
<ul style="list-style-type: none"> <li>• Affordability assessment is complicated. Obtaining suretyships are more complicated.</li> <li>• The requirements for historical financial/credit history which are mostly automated is a huge barrier.</li> <li>• The NCA has simply created barriers with no palpable benefit to anyone.</li> </ul>
<b>NEGATIVE INFLUENCE ON SMALL BUSINESS CUSTOMERS</b>
<ul style="list-style-type: none"> <li>• The paperwork can be confusing, onerous, and expensive to obtain by new businesses.</li> <li>• Added cost to the bank will add cost to the customer.</li> <li>• Less small businesses will qualify for credit.</li> <li>• Business owners do not understand the requirements of the NCA and the impact on their business.</li> <li>• Prior to the NCA, credit providers used to charge interest rates similar to the competition. Since the implementation, credit providers have now resorted to making the maximum allowable rate the benchmark, justifying the higher rate by quoting the NCA (mostly applicable to unsecured lending). Restricts the bank from being considerate to the needs of the business.</li> <li>• Legitimate businesses are being disadvantaged.</li> </ul>

The participants were then asked their view on how the NCA regulation could be changed to enhance small business lending. The results follow in Table 5-34.

Table 5-34: NCA recommended amendments to enhance small business lending

<b>LENIENCY FOR BANKS</b>
<ul style="list-style-type: none"> <li>• Allow banks to price for risk to a larger extent.</li> <li>• NCA should not apply to any lending to self-employed customers either in juristic or individuals name.</li> <li>• Do not apply the rigid rules applicable to individuals to businesses.</li> <li>• Registered small businesses should be exempt from the NCA.</li> <li>• More leniencies especially towards start-up businesses, but with specific caveats.</li> <li>• Softer criteria with the affordability criteria and reckless lending allegations.</li> <li>• Allow the industry to self-regulate to a point.</li> <li>• Any regulation which restricts normal market trends (supply &amp; demand) creates an artificial market.</li> <li>• Go back to a willing buyer/seller principle and let the market sort it out.</li> <li>• Create a maximum lending rate and link it to the consumer protection act.</li> </ul>
<b>PROVIDE CLEAR DISTINCTIONS FOR SMALL BUSINESSES</b>
<ul style="list-style-type: none"> <li>• Amend the NCA to specifically include a “Small Business” chapter. Tailor made to be practical.</li> <li>• Recognize the business as a separate entity to the person running it.</li> <li>• Clear definitions between retail and small business.</li> </ul>
<b>ADVISORY SERVICES BY THE REGULATOR</b>
<ul style="list-style-type: none"> <li>• Offer the service of experts to assist with business matters.</li> </ul>
<b>ACCOUNTABILITY</b>
<ul style="list-style-type: none"> <li>• The NCA is seen as a bunch of regulations without any real control or accountability.</li> </ul>

To complete the NCA section of questions, the participants were asked an open-ended question on what other regulation could be changed or implemented to promote access to credit for small businesses. The results follow in Table 5-35.

Table 5-35: Other regulation that could be changed to promote access to credit for small businesses

<b>CERTAIN LEGISLATION TO BE RELAXED FOR SMALL BUSINESSES</b>
Labour legislation:

- To allow small business to manage employee relations easier. Many small businesses do not take up opportunities due to the increased labour law implications associated with growth.

Tax/Vat legislation:

- Reduced tax rates for small businesses, especially if additional employees are hired.
- Review the definition.
- The R2.5m limitation in section 15(2) (b) of the VAT act should be increased to R15m. The small businessman is funding government and not vice versa (as well as the limitation on natural persons in this section).

Registering a business:

- The cost, lengthy process, and red tape must be revised (for example; CIPC and BEE certificates costs).
- Licensing regulations.

Other regulations:

- Customs and excise act, municipal licensing regulations, e-tolls, BBBEE Act.
- Companies Act.

### **Financial Intelligence Centre Act (FICA)**

- This is systematically killing the business by stifling start-ups in paperwork VAT/Tax registration - simply far too time-consuming and onerous in terms of registering.
- It is not effective legislation. Another tick list which makes it more difficult for people who are legal and easier for those that do not exist in the system.
- Provide a central facility to supply documents once, which can be accessed as needed electronically by credit providers. Repeating the tasks of proof of residence every time is a waste of resources.

### **LENIENCY OF BANK REGULATION WHEN LENDING TO SMALL BUSINESSES**

- Exemption from BASIL.
- Relaxation on the discretionary criteria of a bank to lend to small businesses.
- Reduce capital weighting to small business loans upfront, but increase it to a penalty level if it later appears that irregular or reckless lending has occurred.
- Allow for a community-based lending approach with different rules of engagement.
- Stipulate small minimum lending exposures for registered banks to commit to small business, subject to generating targeted returns. This should be tested. Combine this for incentives, for example, tax breaks, and/or cheaper Government funding to banks engaged in this business.

### **CREATE A LEGISLATION SPECIFIC TO SMALL BUSINESSES**

- Customize regulations specific for small businesses. Streamline and ensure simplicity for ease of doing business, for example, similar to the New Zealand and California models.

The above concludes the empirical results for the NCA. Below the results for the Khula Credit Guarantee Scheme are presented.

#### 5.4.6.4 Section 4: Government Khula Credit Guarantee Scheme

The Khula section of the questionnaire began with structured questions asking the participants whether they are aware of the Khula Credit Guarantee Scheme. The results follow in Figure 5-58.

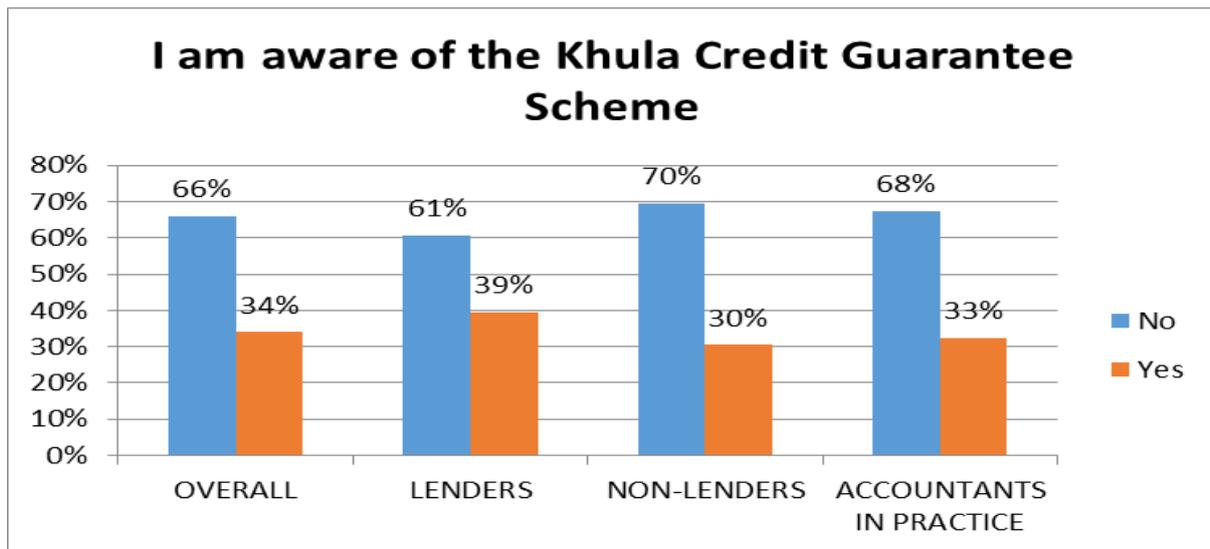


Figure 5-58: I am aware of the Khula Credit Guarantee Scheme

Overall only 34% are aware of the Khula Credit Guarantee Scheme. It would seem that the lenders are the category that is most aware of the Khula Credit Guarantee Scheme, which is understandable considering that the Khula Credit Guarantee Scheme provides guarantees to banks for qualifying SMME customers.

The applicants who said “yes” to the above question were asked to continue with the questionnaire to answer further questions regarding the Khula Credit Guarantee Scheme. The results are listed below.

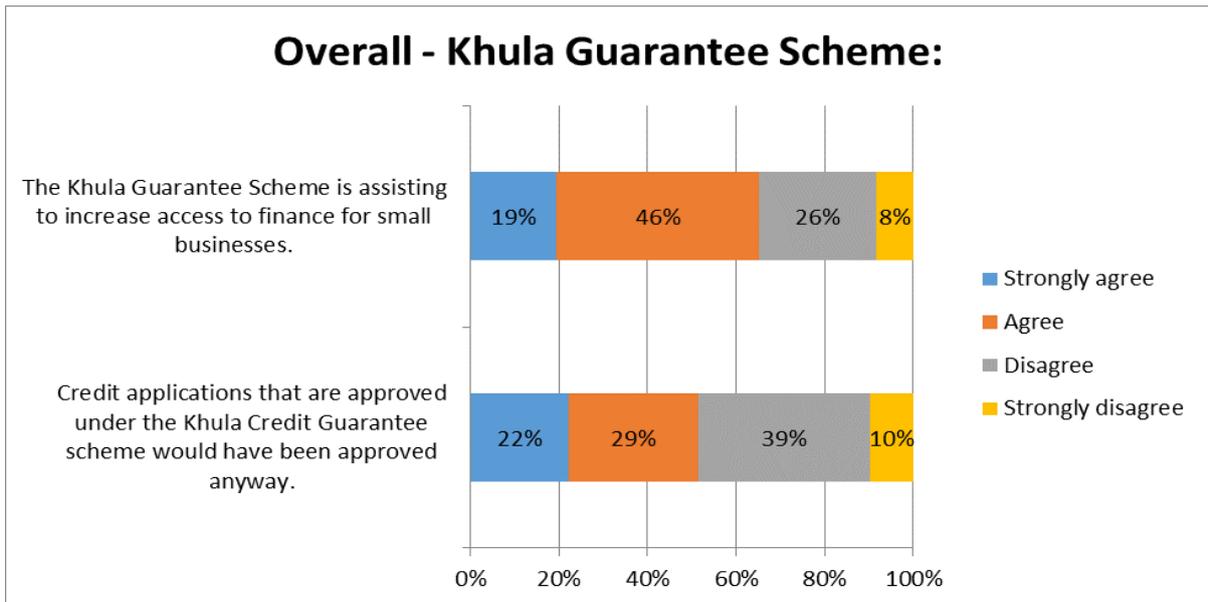


Figure 5-59: Overall: Khula Guarantee Scheme

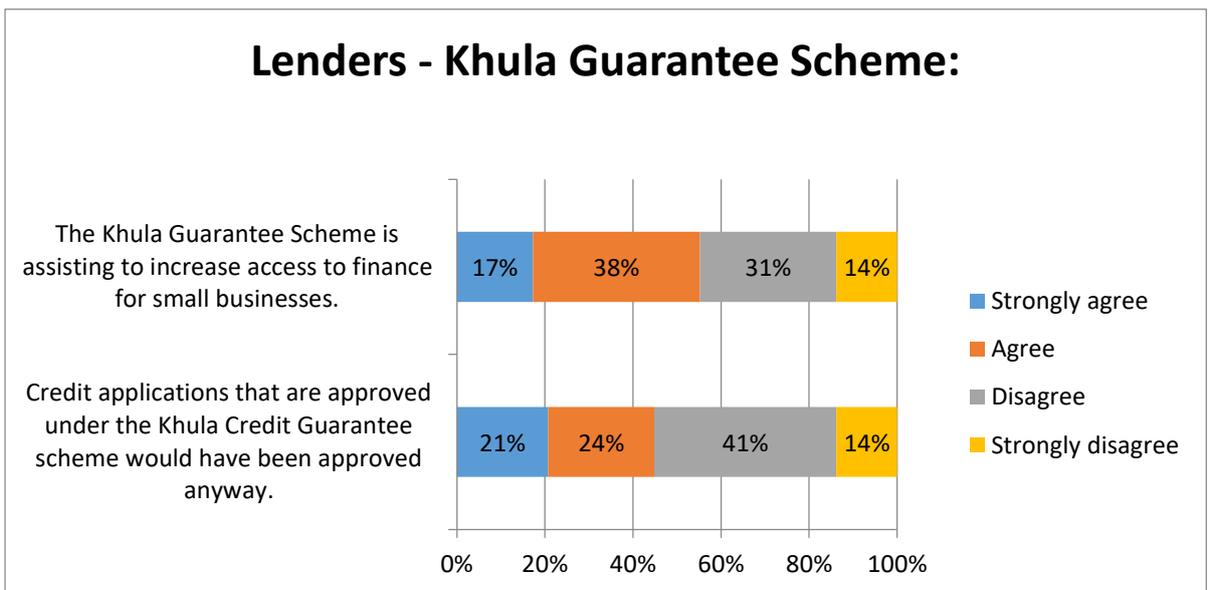


Figure 5-60: Lenders: Khula Guarantee Scheme

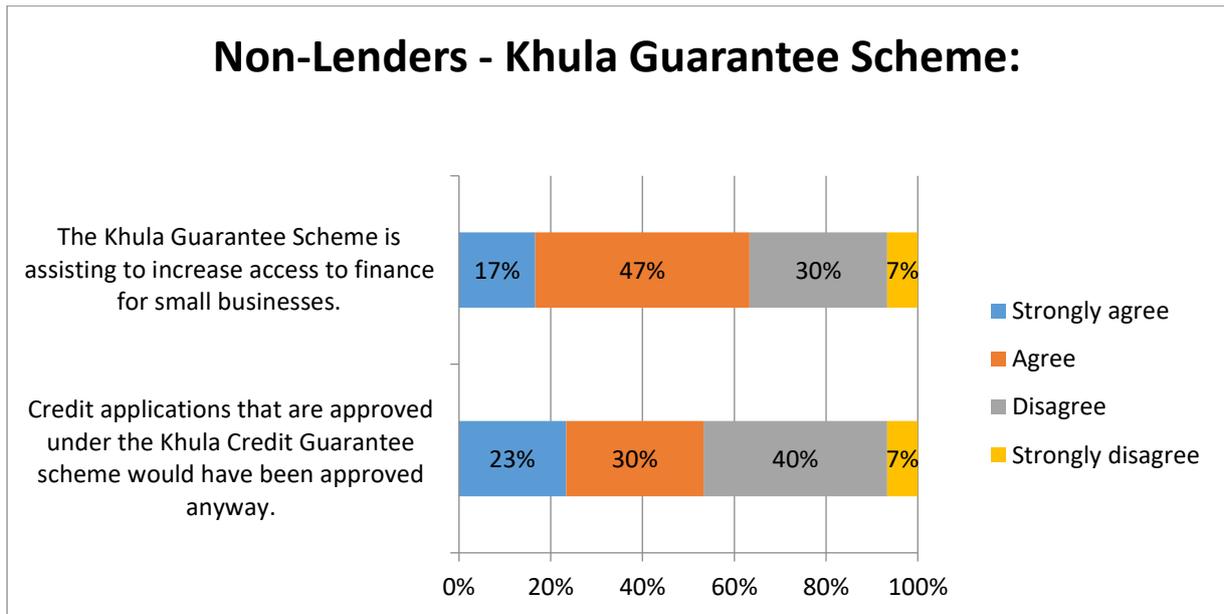


Figure 5-61: Non-lenders: Khula Guarantee Scheme

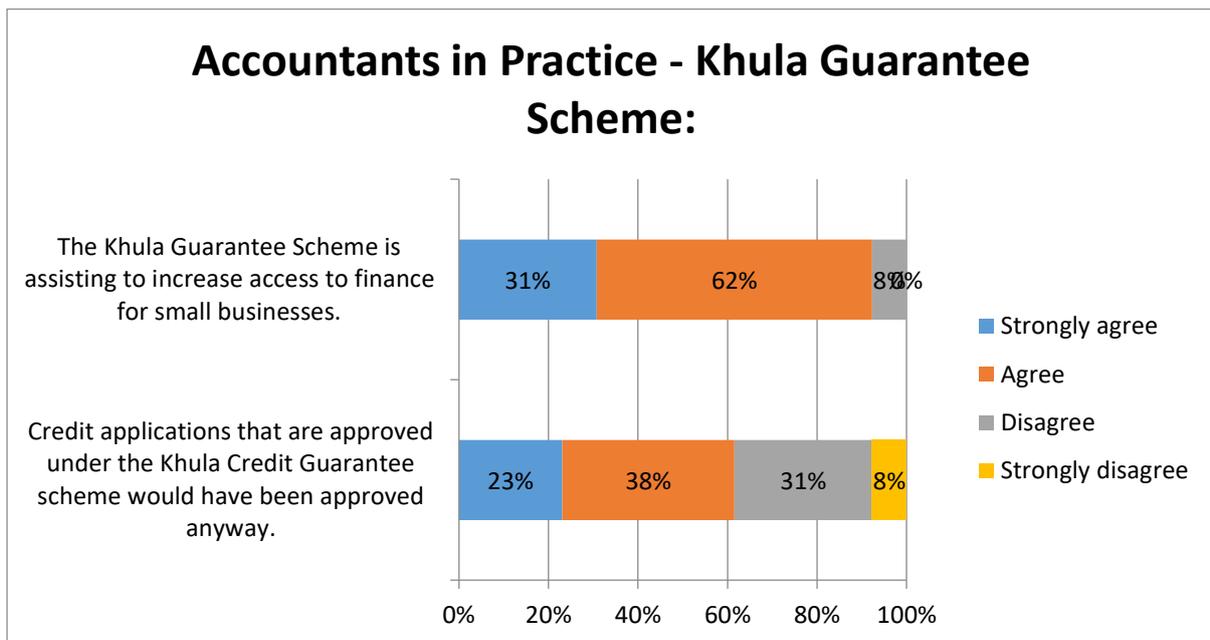


Figure 5-62: Accountants in practice: Khula Guarantee Scheme

Although the overall majority agreed that the Khula Guarantee Scheme is helping to increase access to finance for small businesses (65%), the overall majority also agree that credit applications that are approved under the Khula Credit Guarantee Scheme would have been approved anyway (51%). This is in line with the literature review where it was stated that the Khula Guarantee Scheme did not provide any additionality (banks would have approved these applications anyway). It seems that the lenders, however, do not completely agree with this statement.

Below the participants were asked in a structured question to identify from the options provided what the biggest challenges are for banks when utilizing the Credit Guarantee Scheme. The results follow in Figures 5-63- 5-66.

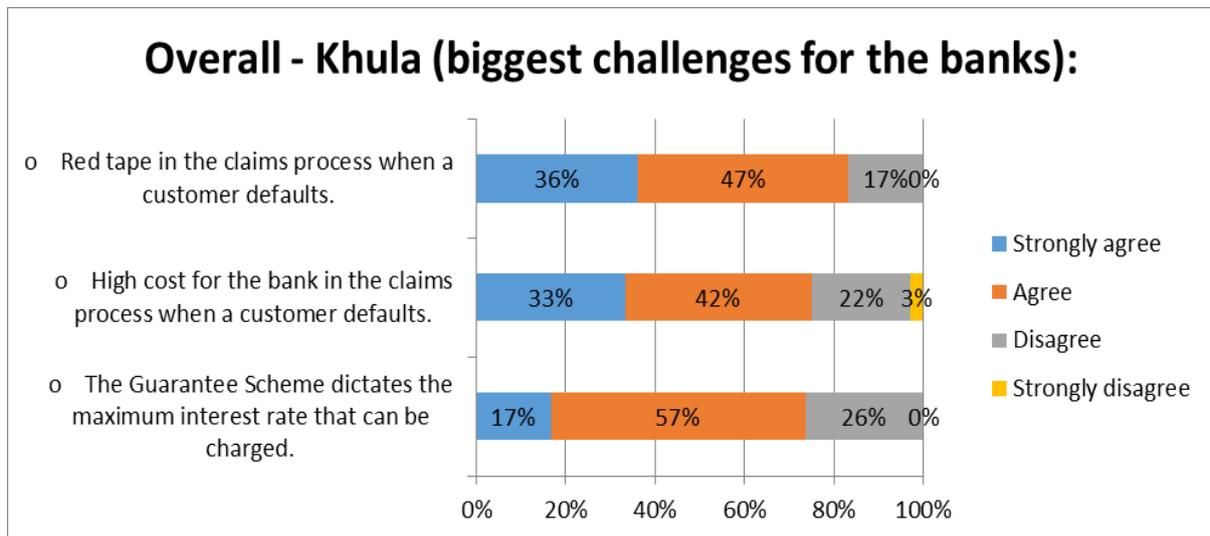


Figure 5-63: Overall: Challenges for banks when utilizing Khula

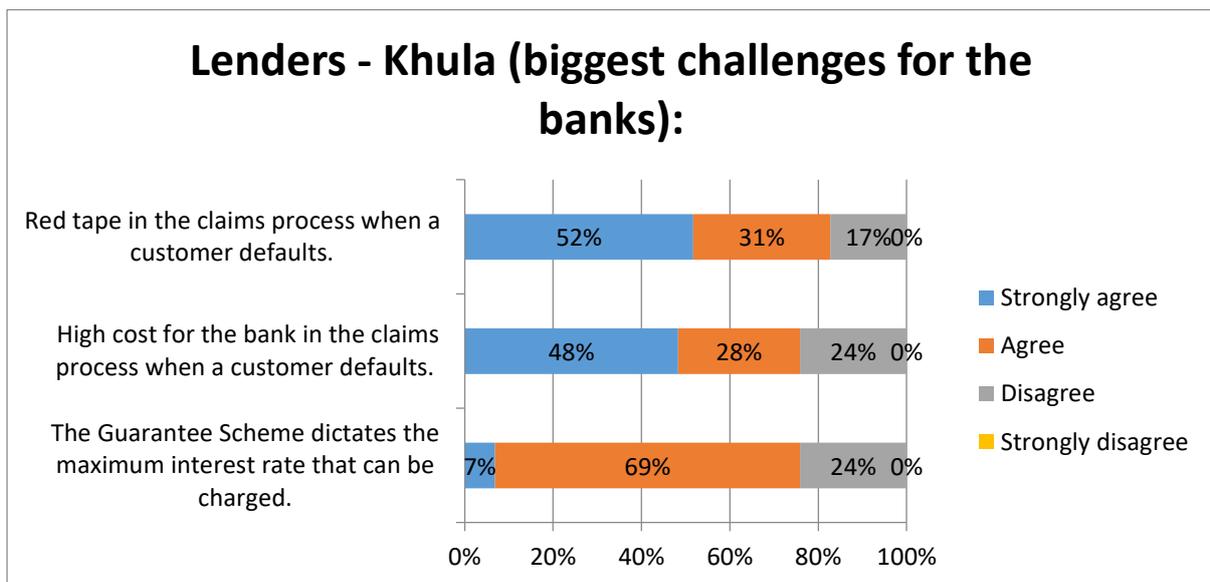


Figure 5-64: Lenders: Challenges for banks when utilizing Khula

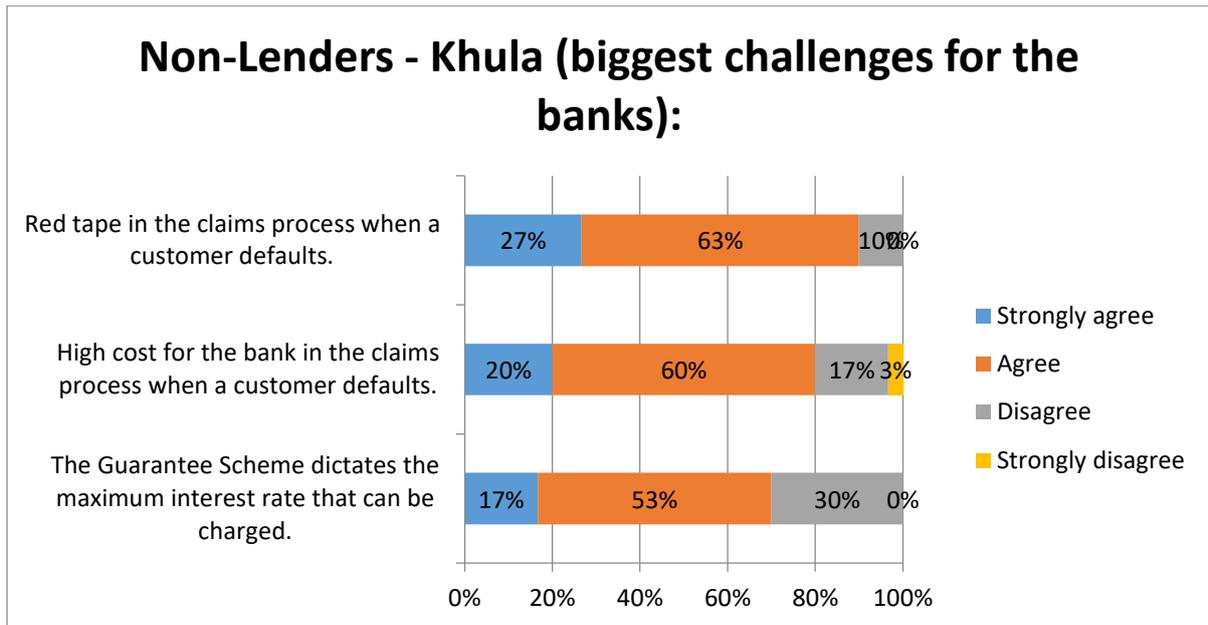


Figure 5-65: Non-lenders: Challenges for banks when utilizing Khula

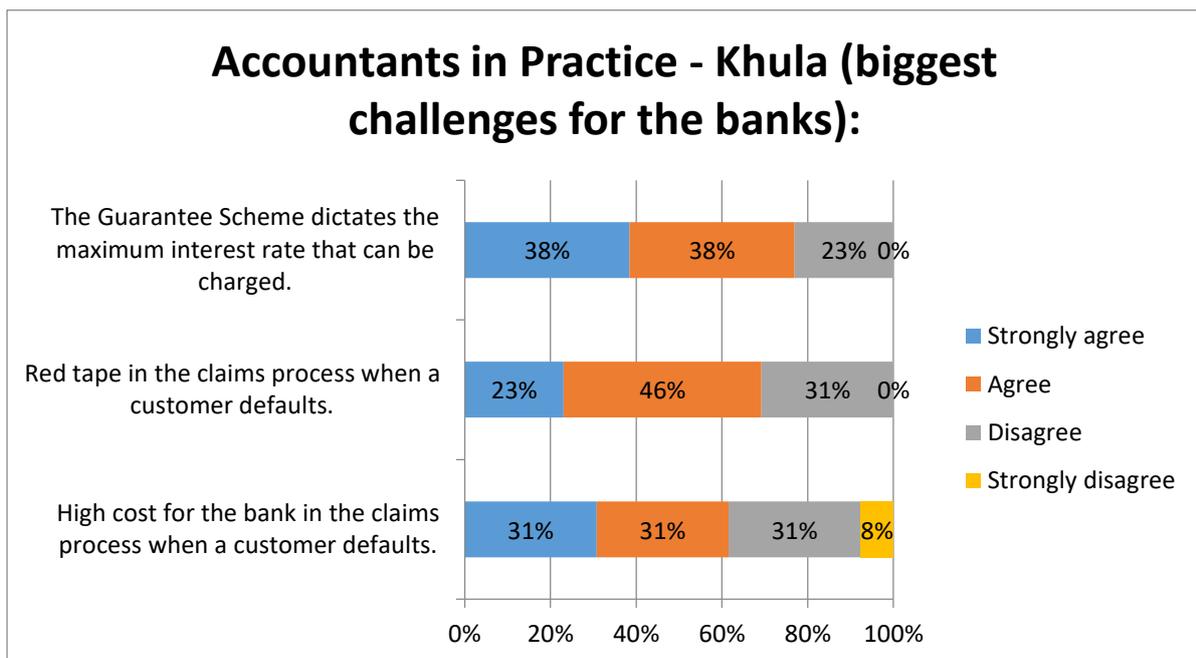


Figure 5-66: Accountants in practice: Challenges for banks when utilizing Khula

Overall the participants agreed that all the options presented to them were considered a challenge to the banks when making use of the Khula Credit Guarantee Scheme. The most prominent challenge being the red tape in the claims process when a customer defaults, which was also highlighted during the literature review as a prominent challenge.

The participants were then asked an open-ended question to obtain their view on whether there are any other challenges for banks in participating in the Credit Guarantee Scheme. The results follow in Table 5-36.

Table 5-36: Other challenges for banks to participate in the Khula Credit Guarantee Scheme

<b>HIGH ADMINISTRATION FEES</b>
<ul style="list-style-type: none"> <li>• The monthly administration is labour intensive.</li> <li>• Annual fee collection for the cost of the guarantee.</li> <li>• Regular reports.</li> <li>• Monitoring covenant laborious.</li> <li>• Mentorship and follow up visits to premises.</li> <li>• The application process is difficult to access.</li> <li>• More costly for the customer.</li> </ul>
<b>THE BANK DOES NOT HAVE CONTROL</b>
<ul style="list-style-type: none"> <li>• Dependent on a third party.</li> <li>• The scheme has its own credit committee which second-guesses the bank's credit committee.</li> <li>• The indemnity is for 60 months only and cannot be extended.</li> <li>• Customers realised somebody else is guaranteeing their finance and a very high to nearly the whole Khula book defaulted in their obligations.</li> <li>• The Khula Credit Guarantee scheme has the final say on the interest rate.</li> </ul>
<b>THERE IS UNCERTAINTY THAT THE CLAIMS WILL BE PAID</b>
<ul style="list-style-type: none"> <li>• Poor management of the Khula Credit Guarantee scheme.</li> <li>• The rules around the Khula Credit Guarantee scheme are onerous and banks had to comply strictly in order to make a claim.</li> <li>• Reliability is doubtful.</li> </ul>

The participants were then asked their view based on options provided in a structured question on who should be responsible for the loan assessment/approval process. The results follow in Figures 5-67 - 5-70.

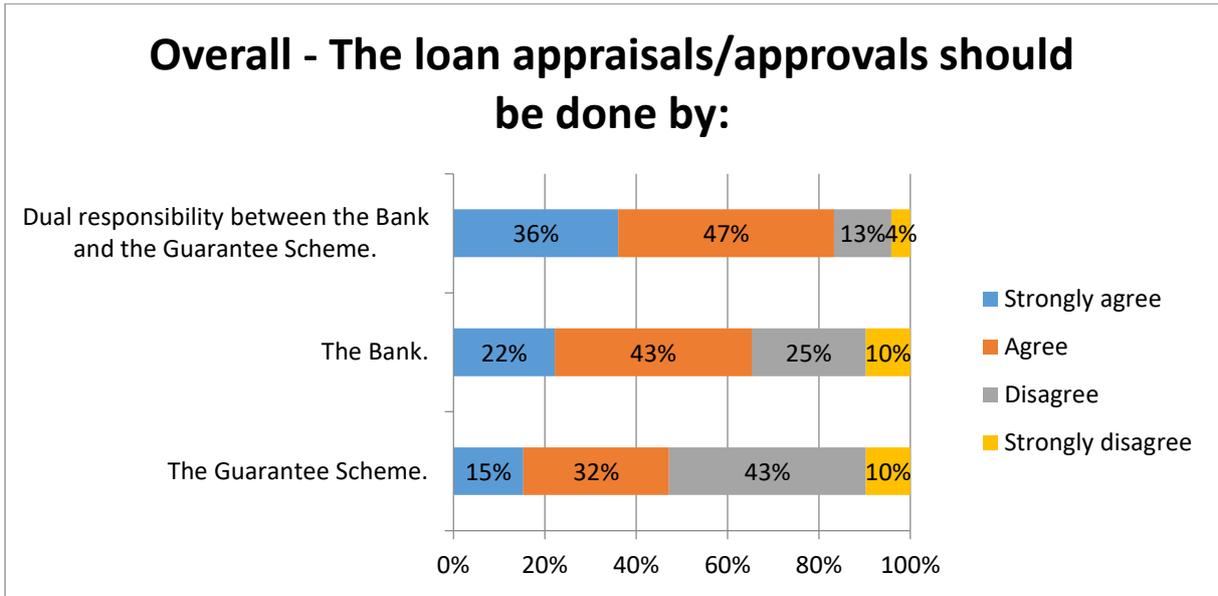


Figure 5-67: Overall: Loan appraisals/approvals

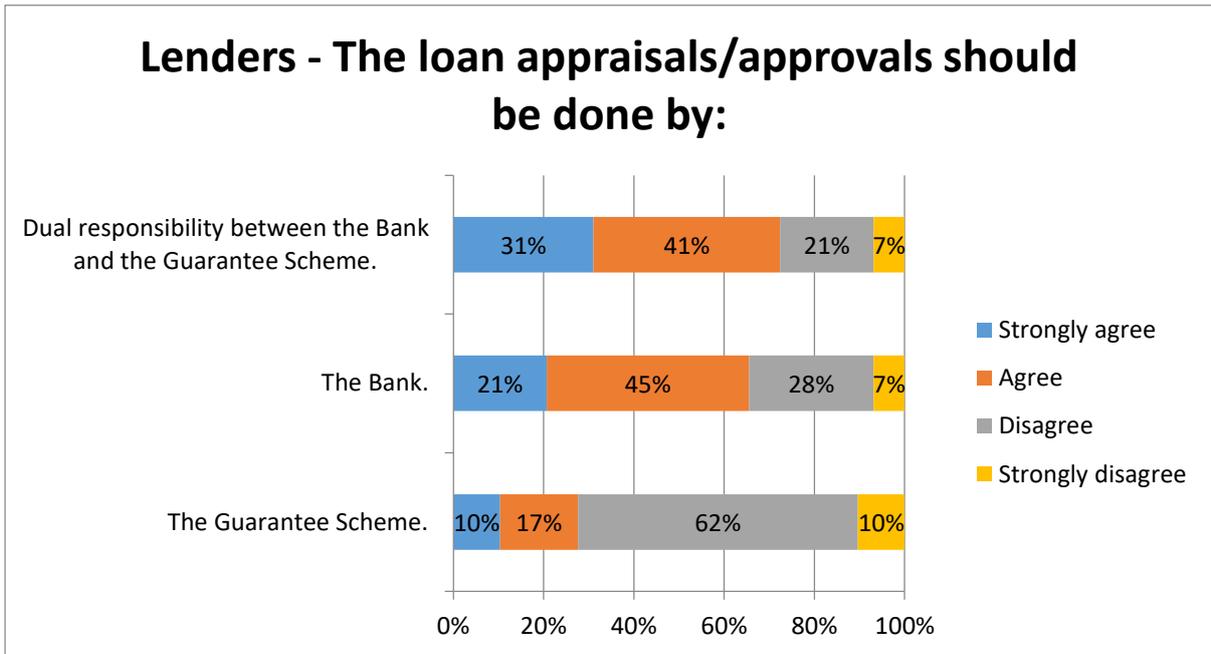


Figure 5-68: Lenders: Loan appraisals/approvals

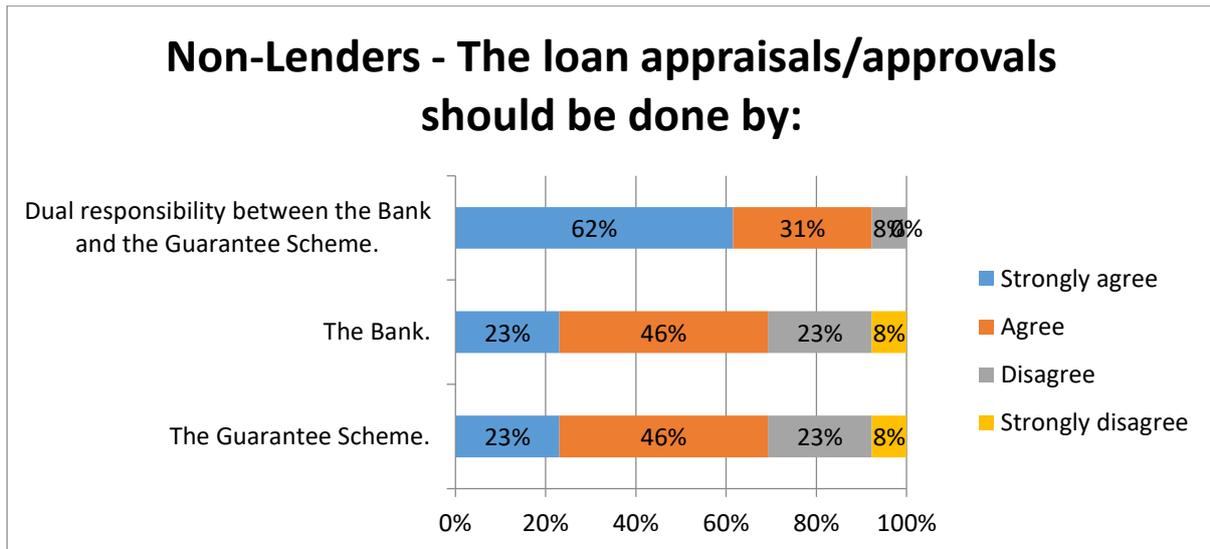


Figure 5-69: Non-lenders: Loan appraisals/approvals

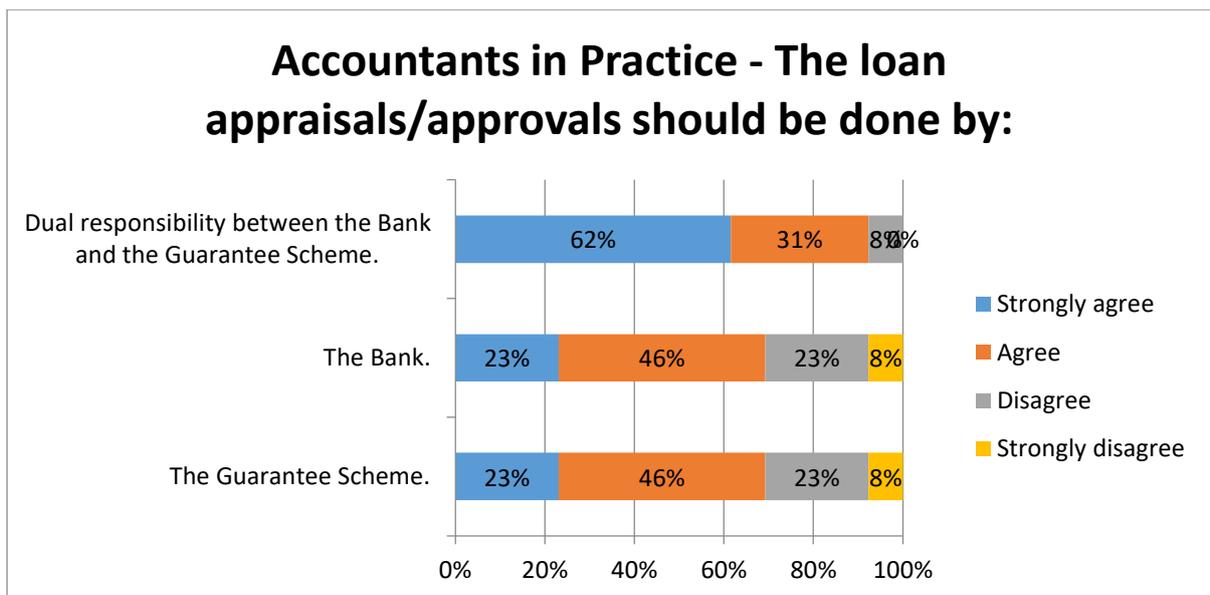


Figure 5-70: Accountants in practice: Loan appraisals/approvals

Overall the participants agreed that the loan appraisal/approval should be a dual responsibility between the Bank and the Guarantee Scheme (83%). The lenders, however, do not seem to be in favour of the Guarantee Scheme making the decisions for approval.

During the literature study, it was emphasized that banks incur increased administration costs by having to undertake the full investigation and appraisal of loan applications and that there is apparently no consensus internationally on who should take responsibility for this function. The results from this empirical study show that there is a strong consensus that the

assessment of applications should be a joint responsibility between the Bank and the Credit Guarantee Scheme.

The participants were then asked in an open-ended question about any other options of who could be responsible for the approval of applications. The only other recommendation made was that a special board/advisory committee should be set up specifically for the purpose of making the decisions on applications.

The participants were then asked in a structured question whether it would be a requirement for the owners to contribute towards the business by way of cash or equipment if the business has a viable business plan, given that the guarantee is granted. The results follow in Figure 5-71.

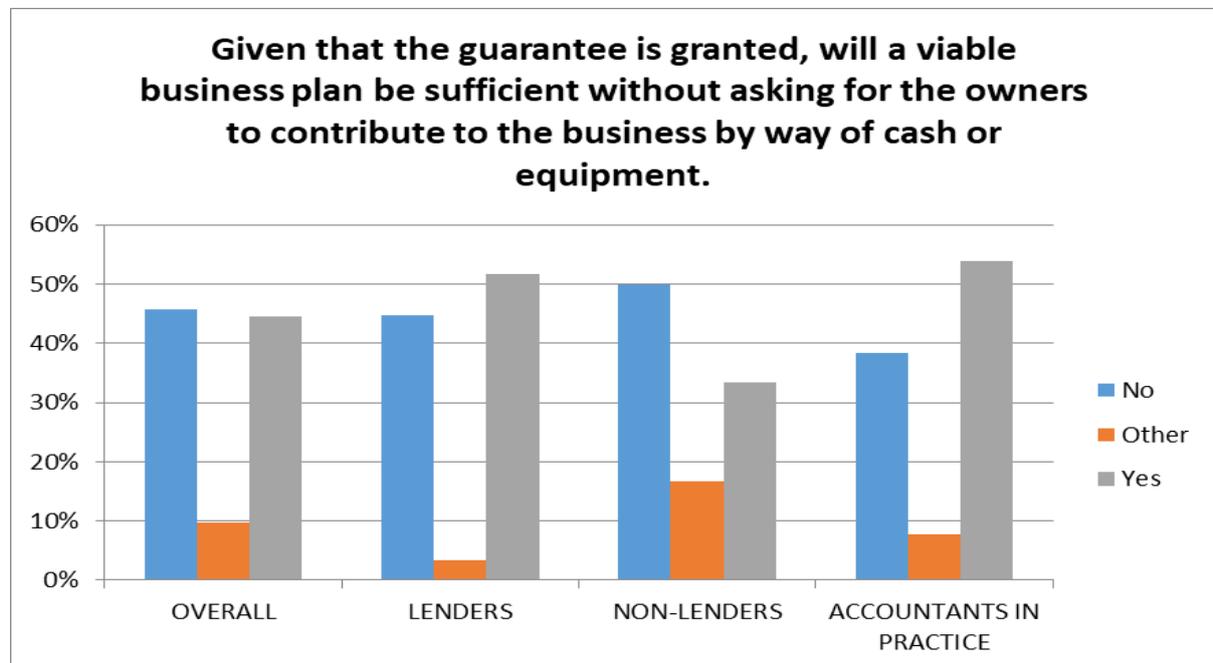


Figure 5-71: Viable business plan and Guarantee – Owners contribution

Overall the majority of participants felt that it would not be sufficient for only a viable business plan to be provided, without asking for the owners to contribute to the business by way of cash or equipment.

The participants were then asked in a structured question on what percentage the owner's contribution should be. The results follow in Figure 5-72.

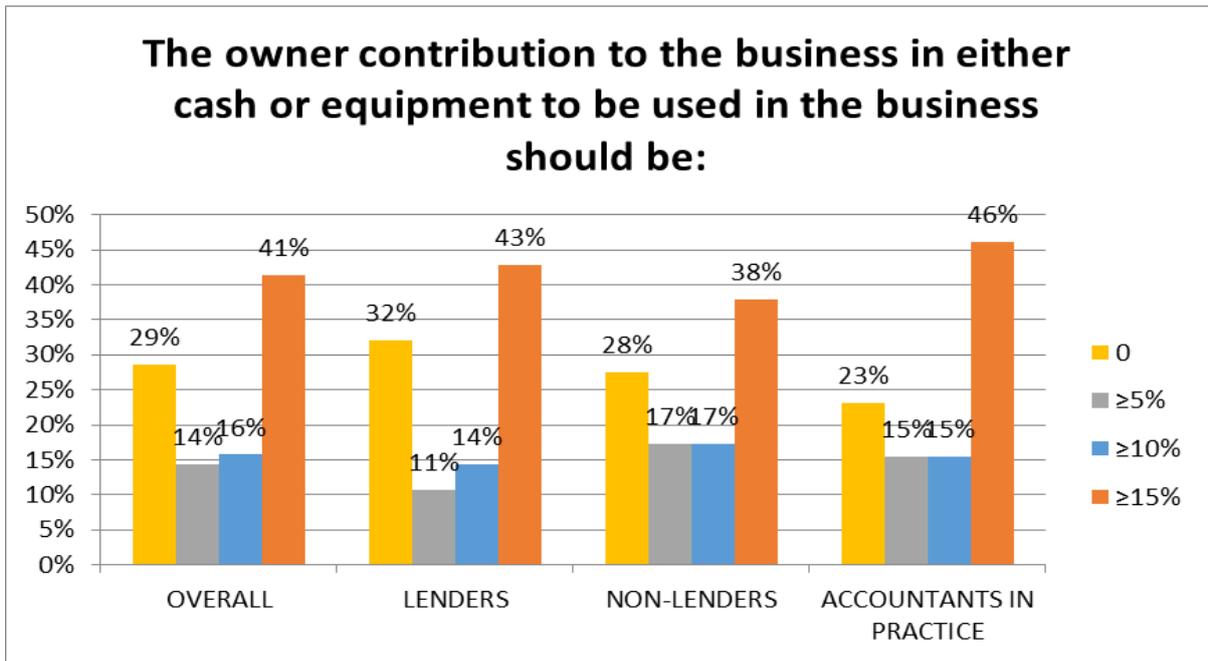


Figure 5-72: Percentage owner contribution to the business

Overall the consensus is that the owner contribution to the business in either cash or equipment to be used in the business should be 15% or higher.

The participants were then asked in a structured question on what percentage the Bank and Guarantee Scheme should be responsible for in the event of a default by the customer. The results follow in Figure 5-73.

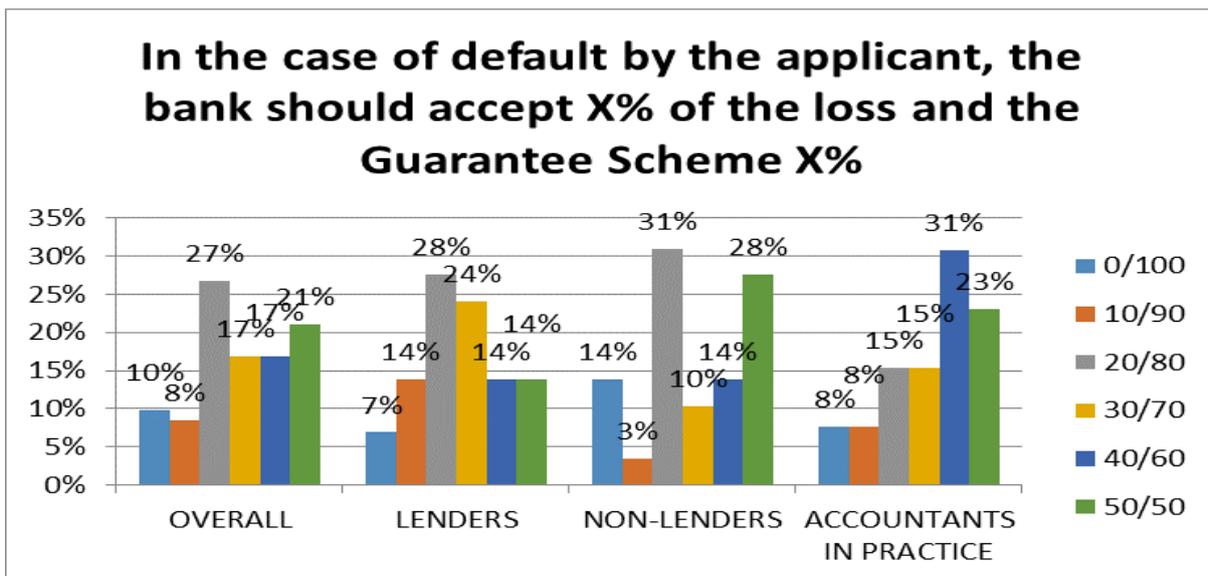


Figure 5-73: In the case of default by the customer, the Bank should accept X% of the loss and the Guarantee Scheme X%

Overall the consensus is that in the case of default by the customer, the bank should accept 20% of the loss and the Guarantee Scheme 80% of the loss. Only the accountants in practice did not seem to agree with this percentage, as this population seemed to feel that the banks should accept a loss of 40% and the Guarantee Scheme 60%.

The above concludes the empirical results for the questionnaire survey. The empirical results for the analysis conducted to determine which variables may contribute towards the development of a scorecard follow.

## **5.5 Empirical Study B**

The second part of the empirical study was to gain an insight into what variables could be used towards the development of a scorecard for commercial lending which will aid to determine the probability of default, using the existing commercial data of credit providers. In order to perform the analysis, a sample was taken of customers who qualified for the Khula Credit Guarantee Scheme. The files of 100 non-defaulting accounts and 100 files of defaulting accounts were used, based on a random sample. A checklist with pre-determined variables was identified along with an outcome field (defaulted or not). The checklist exercise was done at the premises of the Small Enterprise Finance Agency (SEFA) after signing a non-disclosure agreement. A statistical analysis was then conducted to determine whether there is a relationship between the variables identified and the likelihood of default.

### **5.5.1 Data analysis**

As explained above, the aim of the analysis was to identify whether there are any variables which may contribute to the probability of default, using the existing commercial data of credit providers. The intention was, therefore, to determine whether there is a relationship between the identified variables and the likelihood of default, where these variables could potentially be used towards the development of a scorecard to predict the probability of default. It must, however, be noted that there is legislation governing certain variables that cannot be used towards decision-making as they could be considered discriminatory, for example "gender". This needs to be considered before utilizing any of the recommended variables from the study.

A sample was taken of business customers who qualified for the Khula Credit Guarantee Scheme. 100 non-defaulters and 100 defaulters were sampled. This was done manually at the premises of SEFA using a checklist which was developed covering the variables to be considered as listed in Table 5-37.

The following variables were considered along with an outcome field (defaulted or not):

Table 5-37: Variables considered

<b>Variables considered</b>
• Amount of owner contribution as a % of total bank facility.
• Provided security: yes or no.
• Security (first class) as a % of total bank facility.
• Security (second class) as a % of total bank facility.
• Total securities as a % of total bank facility.
• Net worth of owner/s: positive or zero.
• Net worth of owner/s as a % of total bank facility.
• Legal status.
• Area.
• Sector.
• Job creation.
• Age of business.
• Number of owners.
• Gender.
• Experience in this industry.
• Purpose of facility.
• Owns a home.
• Total bank facility as a % of turnover (actual or projected).
• Bank facility as % of total capital required (Bank facilities + owner's contribution).

The results of the analysis conducted follow below.

### **5.5.2 Results**

Variables that were not found to be statistically significant were rejected as potential variables for a propensity to default scorecard. Of the 19 variables considered, 10 variables were found to have a statistically significant impact as listed in Table 5-38.

Table 5-38: Variables with a statistically significant impact

<b>Variables with a statistically significant impact</b>
• Amount of own contribution as a % of total bank facility.
• Net worth of owner/s: positive or zero.
• Legal status.
• Area.
• Age of business.
• Gender.
• Experience in this industry.
• Purpose of facility.
• Owns a home.
• Bank facility as % of total capital required (Bank facilities + owner’s contribution).

Note that the variables “Bank facility as % of total capital required (Bank facilities + owner’s contribution)” and “Amount of own contribution as a % of total bank facility” are continuous variables, whilst the other eight are categorical.

The analysis of the categorical variables was conducted as follows:

For the Categorical variables, Cross-tabulation was used to see if there is an association between two categorical variables. Cross-tabulation is a statistical tool used to analyze categorical data, allowing for the comparison of the relationship between two or more categories in order to understand how they are related to each other (Momeni, Pincus & Libien, 2018).

The chi-square test determines whether there is a statistically significant association between the variables, and Phi determines whether there is a practical significant association between the groups (Momeni *et al.*, 2018).

As this research does not consist of a random sample, and the aim is only to identify if the variables have an association with default status, p-values are not relevant, but are reported for completeness. Emphasis will therefore be placed on the interpretation of the Phi-value as effect size which gives the importance of the effect in practice, as this is in line with the objective. The interpretation of the Phi-values is as follows (Cohen, 1988:25):

Table 5-39: Phi and effect

Phi	Effect
0.1	Small
0.3	Medium
0.5	Large

A value below 0.1 is considered as “small” and means that the variable shows no practical significant association with default status. An association between 0.1 and 0.3 is considered as “medium” and means that the variable has a practically visible association with default status, whilst a value above 0.3 is classified as “large” and is considered to have a practical significant association with default status (Cohen, 1988:25). Based on the results of the crosstab analysis of the eight Categorical variables with default status, three came out with large associations or effects and five had a medium association’s effect. The results follow.

Table 5-40: Results summary of Chi-square and Cramer’s V tests

Variable	Chi-Square	Phi			Finding
	P-value	V	Significance (P-value)	Association	
Experience in this industry	.000	.562	.000	Large	The more experience the owners/members/directors have in the industry, the less likely the business will default.
Purpose of facility	.000	.480	.000	Large	Starting a new business and Buying a franchise are more likely to default.
Age of business	.000	.441	.000	Large	The older the business, the less likely to default.
Area	.008	.322	.008	Medium	The area is likely to have an impact on default.
Gender	.000	.279	.000	Medium	Males are more likely to default. Females are less likely to default.
Legal status	.025	.216	.025	Medium	A sole proprietor is more likely to default. A company is less likely to default.
Net worth (no on scale)	.022	.162	.022	Medium	If the owners/members/directors have a negative net worth (assets-liabilities), the business is more likely to default.

Variable	Chi-Square	Phi			Finding
	P-value	V	Significance (P-value)	Association	
					If the owners/members/directors have a positive net worth (assets-liabilities), the business is less likely to default.
Owns a home	.004	.201	.004	Medium	If the owners/members/directors do not own a home, the applicant is more likely to default. If the owners/members/directors own a home, the business is less likely to default.

## 5.6 Conclusion

The chapter covered the research methodology approach and presented the findings of the empirical studies A and B. The results from the empirical study were utilized towards the value-based decision framework for small business lending which follows in Chapter 6. A summary of results follows for each empirical study A and B respectively.

### Empirical Study A

Empirical Study A comprised of a self-administered, structured questionnaire which comprised of 112 items and included mainly close-ended questions but also open-ended questions.

The results were positive with 323 “usable” questionnaires received. The total of 323 were made up of the following, per research population category: Lenders 89 (27.6%); Non-lenders 161 (49.8%); and Accountants in practice 73 (22.6%).

The participant demographic data reflects the gender to be predominantly male (69%), average age 42, average number of years in current position of 9 years, with the majority having a post graduate degree (37%), followed by a degree (29%), majority work in the Credit department (28%), followed by “Accountants in practice” (23%). The division at work of the research participants is mainly in the small business lending space (32%), followed by micro finance (24%).

The questionnaire was split into four sections. The salient findings based on the results from the closed-ended questions are summarised below under the headings of the four sections.

For further elaboration and additional information from the open-ended questions, the relevant Tables in the above Chapter is to be referenced.

### **Section 1: Banks existing proposition for small businesses**

The aim of this section was to determine the participants view on the current small business proposition and practices applied by banks when lending to small businesses.

The results revealed that although banks understand the needs of small businesses, and provide clear lending criteria, the banks do not provide suitable credit products to meet the needs of the small businesses.

Based on the existing Credit Policy of the banks, the overall figures reflect that the participants agreed that banks do have different lending criteria based on the age and size of a business, and the banks do take into consideration the lifecycle stages of a business. However, the accountants in practice did not seem to agree that the banks take into consideration the lifecycle stages of the business.

The top five challenges for banks when lending to small businesses was identified as (in ranking order): inability to provide collateral security, inability to provide adequate proof of income, insufficient experience of bank staff when dealing with small business applications, high default rates, and high administration costs.

### **Section 2: Credit Policy for small business lending**

This section covered the views of the participants on what an appropriate credit policy should be for small business lending.

Acceptable proof of income in ranking order: financial statements/management accounts, business bank account statements, cash flow statement, proof of contract, income tax return (business), projected cash flow statement, owner's bank account statements, sales invoices, income tax return (owners), and purchase receipts. The only exception was that the accountants in practice did not seem to agree with the acceptance of purchase receipts as proof of income.

With regards to the credit decision process the participants view was that there must be direct contact by the applicant with the decision maker, furthermore, the participants agreed that there must be a visit to the business premises by either the bank official interviewing the applicant (87%) or the credit manager (80%). It was also agreed that the applicant should

have the opportunity to present the business case directly with the decision maker and in the event that the application should be declined, have the opportunity to discuss the reason for decline directly with the decision maker.

The highest ranking three most significant micro-economic (firm-based) factors identified: viability of business idea (demonstrated in a business plan), realistic envisaged growth, and the business experience of the owners.

The highest ranking three most significant macro-economic factors identified: impact of the economic conditions of the industry in which the business operates, sufficient potential customers to meet sales targets, and whether any suppliers have a specific impact on the operations of the business.

Overall the respondents agreed (90%) that financial ratios should carry different weightings. The ratios/key measures provided to the participants were all considered important, namely; Activity (Turnover/Efficiency) ratios, Ability to pay short-term debt within 12 months, Profitability (sustainability) ratios, Liquidity ratios, and the Ability to repay long-term debt.

Other salient points to be taken into consideration for the credit policy:

- Minimum period that the business must be operational: between 6 and 12 months.
- Overdraft granted should be 20% of the projected annual turnover of the business.
- Allow start-up businesses to not pay any capital in the first year of being granted a loan.
- Where security is requested, it should be between 26% and 50% of the total credit granted.
- Credit decisions should be a combination of automated (for example; credit scoring) and subjective lending.
- The subjective credit lending decisions should be done at the Branch as opposed to Head Office; and
- Alternative sources of financing: finance equipment by taking a lien over the asset; provide an initial small amount, and on successful repayment, grant a higher loan value (step-up-approach); factoring: the bank buys the existing debtors book of the business.

### **Section 3: Regulation: National Credit Act (NCA)**

The section covered specifically how the NCA Regulation may influence small business lending.

The results revealed that 96% of the participants are aware of the NCA. With regards to the influence of the NCA, the participants felt that whilst the NCA successfully protected the rights of the consumer (76%), small businesses have less access to credit as a result of the NCA (65%), and 62% agreed that the NCA does not allow for more credit to be advanced to businesses.

One of the reasons for less access to credit for small businesses is that small business lending has become more expensive for banks since the implementation of the NCA according to the participants (68%).

### **Section 4: Government Khula Credit Guarantee Scheme**

This section covered the Khula Credit Guarantee Scheme aimed at promoting the growth of access to finance for SMMEs in South Africa.

The results revealed that only 34% of the participants are aware of the Khula Credit Guarantee Scheme. The challenges for the banks to utilize the Khula Credit Guarantee Scheme were identified as follows (in ranking order): red tape in the claims process when a customer defaults (83%), high cost for the bank in the claims process when a customer defaults (75%), and the Guarantee Scheme dictates the maximum interest rate that can be charged (74%).

### **Empirical Study B**

The purpose of conducting empirical study B was to identify any variables which may contribute towards identifying risk when lending to small businesses.

The empirical results revealed that the following variables are considered to have a practical significant association with default status:

- Experience in the industry: The more experience the owners/members/directors have in the industry, the less likely the business will default.
- Purpose of facility: Starting a new business and buying a franchise are more likely to default.
- Age of business: The older the business, the less likely to default.

- Area: The area can play a role in the likelihood of default.
- Gender: Males are more likely to default. Females are less likely to default.
- Legal status: A sole proprietor is more likely to default. A company is less likely to default.
- Net worth: If the owners/members/directors have a negative net worth (assets-liabilities), the business is more likely to default. If the owners/members/directors have a positive net worth (assets-liabilities), the business is less likely to default; and
- Owns a home: If the owners/members/directors do not own a home, the business is more likely to default. If the owners/members/directors own a home, the business is less likely to default.

The above summarizes the results for Empirical Study A and B. It is once again re-iterated that there are regulations preventing certain variables from being utilized, for example, to prevent discrimination.

# **CHAPTER 6: VALUE-BASED DECISION FRAMEWORK FOR SMALL BUSINESS LENDING IN SOUTH AFRICA: CONCLUSIONS AND RECOMMENDATIONS**

## **6.1 Introduction**

This study comprises of six chapters. The chapters are listed below together with the objectives that were to be met for each chapter in order to meet the main objective of the study. The Chapter titles and objectives are as follows:

Chapter 1: Credit for small businesses: An orientation

Chapter one provided the background to the study and set the scene for the research objective.

Chapter 2: Access to credit for small businesses: A small business owner's perspective.

Through a literature review, the aim was to address the following objectives:

- To obtain a general profile of small businesses in South Africa.
- To identify the challenges faced by small businesses in South Africa, specifically from a credit access perspective; and
- To identify the prominent reasons for the failure of small businesses in South Africa.

Chapter 3: Access to credit for small businesses: A credit provider's perspective.

Through a literature review, the aim was to address the following objectives:

- To identify the basis upon which banks typically grant credit to small businesses; and
- To identify what the challenges are for banks to provide credit to small businesses.

Chapter 4: Influence of regulation and Government initiatives on small business lending.

Through a literature review, the aim was to address the following objectives:

- To determine the influence of the National Credit Act (NCA) on small business lending; and

- To determine the influence of the Khula Credit Guarantee Scheme on small business lending.

Chapter 5: Research methodology and empirical results.

Chapter 6: Value-based decision framework for small business lending in South Africa. Conclusions and recommendations.

This is the concluding chapter which provides a summary of the key findings of each objective. This is followed by the proposed value-based decision framework for small business lending in South Africa, which is based on the results of the empirical research conducted and concludes with recommendations for further research.

It is important to note that the aim of the proposed framework for small business lending is by no means to “re-invent the wheel”, as banks have been lending to businesses for many decades. However, it can be argued that banks have not accommodated for the change in the market as the typical small business customer profile today more than likely differs significantly from the typical small business customer profile of many years back. The banks’ credit policies, however, have arguably not been adequately amended to accommodate the current market. The purpose of the lending framework is, therefore, to aid credit providers to take the existing vast experience that banks already have in this area of lending and benefit from new insights for a more feasible and practical credit policy for small business lending.

The key findings for each objective are summarized below, however, it is important to note that some of the objectives and findings are combined together for practicality, and hence may not follow the sequence as they are listed under each chapter above.

## **6.2 Objective summary results**

### **6.2.1 Research objective: To obtain a general profile of small businesses in South Africa.**

Small businesses in South Africa encompass a very broad range of business which includes formally registered and informal businesses. One of the main variables used to distinguish whether a business operates in the formal economy or in the informal economy is whether the business is registered for VAT. In 2015, VAT registration was legally required for businesses with a turnover of >R1 million (SARS, 2015).

There is uncertainty about the size of the small business market in South Africa due to businesses which may not be registered which makes record-keeping difficult (Ladzani & Netswera, 2009). It was identified that there are various reasons for business owners not wanting to register the business. Schneider and Klinglmair (2004) noted that the main reasons for becoming informal in the formal economy are due to direct and indirect taxation, and government regulations.

The National Small Business (NSB) Act (102 of 1996) defines SMMEs as a separate and distinct business entity, including cooperative enterprises, sole proprietorships, partnerships, close corporations, and non-governmental organisations, managed by one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or sub-sector of the economy (Government Gazette of the Republic of South Africa, 1996; Dlova, 2017).

The National Small Business Act (102 of 1996) (as amended) further categorizes businesses in South Africa into distinct groups, namely; survivalist, micro, very small, small, and medium, hence the use of the term “SMME” for small, medium and micro-enterprises (Mago & Toro, 2013). An analysis of both the South African and international definitions of SMMEs shows that there is agreement on what constitutes an SMME in terms of the number of employees. For the purpose of this study, the definition of a small business is based on the number of employees from 0-50. Survivalist enterprises were also excluded for the purpose of this study.

Based on this definition, small businesses are therefore mainly made up of small (includes very small) and micro-enterprises, where a basic profile for each category is provided in Table 6.1 below.

Table 6-1: Small and Micro-enterprises in South Africa

	<b>Micro-enterprises</b>	<b>Very small enterprises</b>	<b>Small enterprises</b>
Ownership	Mainly owned by one owner.	Mainly owned by one owner.	Usually owner-managed or directly controlled by an owner.
Employees	0-5	0-10 0-20 (mining, electricity, manufacturing and construction sectors).	5-50
Trade in formal/informal economy	Mainly operating in the informal economy.	Mainly operating in the formal economy.	Mainly operating in the formal economy.

Premises	Mainly home based.	Largely home based.	Business or industrial premises.
Examples of business activity	Spaza shops, minibus taxis, household industries, renting out rooms.	Retail, car mechanics, gate manufacturers.	Construction, manufacturing, retailing, and professional services.
Access to technology	Limited or no access to technology.	Mainly have access to technology.	Have access to technology.

A further breakdown was provided for the small businesses operating in the formal economy and the informal economy.

Table 6-2: Formal and informal small businesses in South Africa (2015)

2015	Formal	Informal
Numbers	670,000	1.5 million
Employment status	69% of owners are employers, 31% employ only themselves.	20% of owners are employers, 80% employ only themselves.
Average monthly income	R8000 – R12000pm.	R2000 – R4000pm.
Majority ownership by race	49% owned by black people.	94% owned by black people.
Ownership by gender	Women 24%, Men 76%.	Women 40%, Men 60%.
Main geographic distribution	Gauteng, Western Cape & KwaZulu Natal.	Limpopo and Mpumalanga.
Primary industries	Retail, financial, construction, and business services.	Trade and accommodation sector.
Education levels	Degree or diploma 15%. Matric 38%. Do not have matric 47%.	Degree or diploma 5%. Matric 25%. Do not have matric 70%.

### 6.2.2 Research objective: To identify the basis upon which banks typically grant credit to small businesses

A literature review was conducted to identify how banks typically grant credit to small businesses. In summary, the banks typically apply the credit policy in order to determine the creditworthiness of a borrower. Using a combination of both qualitative and quantitative measures, credit applications are assessed to estimate the probability of default. Default is the failure to pay interest or principal on a credit obligation when due. Default occurs when a debtor is unable to meet the legal obligation of debt repayment.

In order to ensure some guidance and uniformity in the credit granting process, the banks typically use the 5Cs of credit as a framework in the credit policy. The 5Cs refer to "character,"

"capacity," "capital," "collateral," and "condition". Character involves both qualitative and quantitative aspects to be considered; capacity, capital, and collateral are based on quantitative aspects; and condition is more macro-economic conditions that may impact on the business. A brief will be provided on each of the 5Cs of credit below.

### **Character/Personal attributes of the borrower**

Under “character” the banks look at the applicant’s “willingness” to make repayments in full and on time by considering qualitative character aspects such as honesty and integrity. This is normally the first step in the credit assessment process, as it would not matter if the applicant has the “ability” to repay, however, has no intention to repay the bank or is not as phased as most customers if the debt does not get repaid, for example, due to unforeseen circumstances. The ‘honesty’ and ‘integrity’ of a person is however difficult to determine at face value during an interview with an applicant.

The general belief by banks is that if an applicant has paid his/her debt timeously in the past, the chances are that the applicant will pay the newly applied debt in a similar manner. Banks, therefore, look at quantitative measures such as the past credit history by drawing credit bureau enquiries on the applicant and bank statements to obtain a view of how the applicant conducts his/her accounts. Another aspect which the bank focuses on is the “stability” factors such as the age of the business, the period at current address, and the knowledge, skill and business experience of the owners/members/directors.

### **Capacity**

Once the bank has relative comfort in the applicant’s “willingness” to repay, the next step is to look at the applicants “ability” to repay the credit amount applied for. To determine capacity, one of the key measures is to look at the monthly income and expenditure of the business and calculate the debt-to-income ratio, after including the monthly installments of the credit applied for to the existing debt. The ratio should be within the acceptable norm, where a lower ratio indicates a higher probability of repayment.

The bank must have comfort that the cash flow (income less expenses) is somewhat predictable and will be sufficient to cover the repayments of the credit applied for, throughout the term of the loan. A strong cash flow from the normal activities of the business mitigates the probability to default. In order to determine this, the bank will look at the past track record of cash flow, and also look at the projections going forward, to determine if the projections are realistic based on the past performance. This all forms part of the affordability assessment

process where the bank typically asks for financial information from the applicant such as financial statements for three years, projected cash flow statements and bank account statements. During the affordability assessment process, the financial statements are analyzed to determine the overall financial soundness of the business and key ratios are calculated and compared to industry norms. A trend analysis is also done to identify any trends. The results will indicate whether the cash flow is relatively stable, improving, or deteriorating.

### **Capital assets of the business**

Under “capacity” the means of repayment by way of cash flow was determined. This is derived mainly from the Income Statement provided for the business. For the “capital” requirements the bank will assess the Balance Sheet of the business to determine the capital assets of the business, the owner’s equity, and retained earnings in the business.

The owner’s equity is the capital contribution that the owners/members/directors have invested in the business. A larger contribution by the owners is an indication of a lower probability of default. This also indicates that the owners are serious about the business as they believe in the business. Retained earnings are also a positive indicator as it shows that the owners are putting back money into the business as opposed to depleting all the profits. A high capital value in the business indicates a higher probability that the business can stand volatility. Capital assets of the business may include funds held in deposit accounts, and machinery and equipment used in environments such as factories.

### **Condition**

In order to cover all the aspects of credit risk, it is important for the bank to understand the external macro-economic conditions that may impact the business. In order to determine this, the bank normally requests the applicant to provide a business plan to gauge a better understanding of the business, and what external factors could impact the business. External factors could include any market conditions, industry-specific or local economic conditions which may affect the operations of the business. For example, the construction industry may be influenced by changes in Government policies on immigration, interest rates, and taxation. If the business deals with international trade, the impact of any change in the currency rates in the near future will also need to be taken into consideration.

## **Collateral**

The bank will always ask the applicant how the loan amount will be repaid in the unfortunate event that the business is unable to repay the loan. For this reason, the bank normally requests for collateral in the form of assets to be ceded to the bank to secure the loan. A realistic bank value is placed on the assets which allows for easy liquidation in the event that the borrower defaults. If the owner of the business has nothing to lose if the business fails, the owners can simply walk away from any obligations, leaving the bank to suffer the loss. The reason for taking collateral is therefore twofold, firstly to serve as a second form of income to repay the debt in the event of default by the borrower, and secondly to ensure the commitment of the owner/s to the success of the business.

The above provides a summary of the assessment process typically followed by commercial banks for small business lending. The tools used in the small business lending process were also explored during the literature review, including credit scoring models. Overall the chapter covered the process from credit application to the decision process, which sufficiently covers the process of how banks grant credit to small businesses.

### **6.2.3 Research objective: Access to credit for small businesses: Challenges faced by banks and small business owners**

The objectives were split as follows:

- By means of a literature review: identify the challenges faced by small businesses in South Africa, specifically from a financial perspective; and identify what the challenges are for banks to provide credit to small businesses. The results are summarised in Table 6.3; and
- By means of an empirical study: identify what the challenges are to provide credit to small businesses. The results are summarised in Table 6.3.

Table 6-3: Access to credit for small businesses: Challenges faced by banks and small business owners

CHALLENGES FACED BY SMALL BUSINESS OWNERS	CHALLENGES FACED BY CREDIT MANAGERS
<b>Character/Capabilities (owners)</b>	
<ul style="list-style-type: none"> <li>• Lack of financial planning skills.</li> <li>• Lack of business management skills/experience.</li> <li>• Lack of specific industry knowledge.</li> </ul>	<ul style="list-style-type: none"> <li>• Lack of knowledge in working capital management.</li> <li>• Lack of knowledge in accounting.</li> <li>• Insufficient experience in the current field of business.</li> <li>• Insufficient management skills to ensure the viability of the business.</li> <li>• Owner operates the business on his/her own.</li> <li>• Inability to explain financial problems professionally.</li> </ul>
<b>Capacity</b>	
<ul style="list-style-type: none"> <li>• Insufficient capital.</li> <li>• Lack of accurate and reliable information.</li> <li>• Inadequate financial record keeping.</li> <li>• Lack of timely payment from Government on contracts.</li> </ul>	<ul style="list-style-type: none"> <li>• Insufficient or incomplete information on the credit application given to the bank.</li> <li>• No formal financial statements or proof of income.</li> <li>• None or limited credit histories with commercial banks.</li> <li>• No proper business plan.</li> <li>• High debt-to-equity ratios.</li> <li>• No other source of income to support the application.</li> </ul>
<b>Condition</b>	
<ul style="list-style-type: none"> <li>• Insufficient demand for products or services.</li> <li>• Poor market access.</li> <li>• Lack of bargaining power with suppliers and customers.</li> <li>• Lack of knowledge of competitors.</li> <li>• High crime and theft.</li> <li>• Regulatory requirements.</li> <li>• High interest rates.</li> </ul>	<ul style="list-style-type: none"> <li>• There is no way of knowing that the funds will be applied for the purpose that the credit was granted.</li> <li>• Macro-economic factors that may pose a threat to the industry in which the applicants business operates. For example; competition, macro instability, high interest rates, and exchange rate risk.</li> </ul>
<b>Capital</b>	
<ul style="list-style-type: none"> <li>• Unable to provide an equity contribution.</li> </ul>	<ul style="list-style-type: none"> <li>• Insufficient personal financial contribution as compared to the loan requested.</li> </ul>
<b>Collateral</b>	
<ul style="list-style-type: none"> <li>• Unable to provide collateral security.</li> </ul>	<ul style="list-style-type: none"> <li>• Lack of adequate collateral (in the form of immovable property or valuable movables) that banks require as security in the event of default.</li> </ul>

The above provides the challenges from a small business owner’s perspective and the challenges faced by credit managers when assessing small business credit applications. What was also highlighted during the literature review is that banks generally prefer to operate in areas of familiarity and where the higher profit margins will be obtained, which is the larger businesses. It was noted during the literature review that it costs the same, if not more, to assess a small loan value in comparison to a large loan value, however, the profit margin is higher for the larger loan. The perceived credit risks are also higher for small business than large businesses. There is, therefore, very little incentive for banks to provide credit to small businesses. The top five challenges (in ranking order) for banks to provide credit to small businesses based on the empirical results are listed in Table 6-4.

Table 6-4: Challenges for banks

<b>CHALLENGES FOR BANKS</b>
<ul style="list-style-type: none"> <li>• Inability to provide collateral security.</li> <li>• Inability to provide adequate proof of income.</li> <li>• Insufficient experience of bank staff when dealing with small business applications.</li> <li>• High default rates.</li> <li>• High administration costs.</li> </ul>

#### **6.2.4 Research objective: To identify the prominent reasons for the failure of small businesses in South Africa.**

The literature review revealed the following prominent reasons for the failure of small businesses in South Africa as listed in Table 6-5:

Table 6-5: Prominent reasons for the failure of small businesses in South Africa

<b>Prominent reasons for the failure of small businesses in South Africa</b>
<ul style="list-style-type: none"> <li>• Limited or no access to credit.</li> <li>• Limited or lack of education and skills.</li> <li>• Many are necessity driven.</li> <li>• The high cost of credit.</li> <li>• Tax, administrative and legislation robust requirements.</li> <li>• Poor access to markets.</li> <li>• Poor demand for products offered.</li> <li>• Limited logistical infrastructure.</li> </ul>

According to Table 6-5, many of the small businesses are established due to necessity, and Table 6-2 revealed that the majority of small business owners have a lower level of education than matric. It was also clear from the literature review that small businesses, specifically start-ups, have no or limited access to formal finance. All of these factors are rated as a high potential for business failure according to the literature review.

**6.2.5 Research objective: To identify what a suitable credit policy may be for small business lending.**

From the results of the empirical research (questionnaire results), there was valuable input provided from the participants on what a suitable credit policy may be for small business lending. The following can be considered by credit providers for the credit policy for small business lending. It is important to note that this section is to be utilized to supplement the existing policies by banks, so it by no means covers “all” the detailed requirements. It provides new insights into what is considered important and what could be done differently to improve on the current policies by banks.

Table 6-6: Credit Policy

<b>MINIMUM PERIOD THAT THE BUSINESS MUST BE IN EXISTENCE</b>
<ul style="list-style-type: none"> <li>• A minimum period of between 6 months and 12 months.</li> </ul>
<b>PROOF OF INCOME</b>
<p>The results revealed that the following are ranked as the most important proof of income to be obtained (in ranking order):</p> <ul style="list-style-type: none"> <li>• Financial statements/Management accounts.</li> <li>• Business bank account statements.</li> <li>• Cash flow statement.</li> </ul>
<b>MICRO-ECONOMIC (FIRM-BASED) FACTORS</b>
<p>The following are considered the top five (in ranking order) firm-based factors to be considered during the credit application assessment process:</p> <ul style="list-style-type: none"> <li>• The viability of the business idea (demonstrated in a business plan).</li> <li>• Realistic envisaged growth.</li> <li>• Business experience of owners/members.</li> <li>• Business credit history with the bank.</li> <li>• Qualifications of owners/members.</li> </ul>
<b>MACRO-ECONOMIC FACTORS</b>

The following are considered the top five (in ranking order) macro-economic factors to be considered during the credit application assessment process:

- Impact of the economic conditions of the industry in which the business operates.
- Whether the business has sufficient potential customers to meet the sales targets.
- Whether any suppliers have a specific impact on the operations of the business.
- Whether sufficient research has been done on the competitors of the business.
- Consumer's ability to influence the selling price.

### **FINANCIAL RATIOS**

The financial ratios should carry different weightings. The ratios to be considered are listed below, in the order of importance:

- Activity (turnover) ratios: Inventory turnover ratio; Average collection period (accounts receivable turnover ratio); Total assets turnover ratio; Average sales period (turnover in days).
- Ability to pay short-term debt within 12 months: (Debt service coverage ratio (DSCR)/Debt coverage ratio (DCR)). DSCR is calculated as net operating income as a multiple of debt obligations due within one year.
- Profitability ratios: Gross/Operating profit margin (Coverage ratio); Net profit margin; Return on Equity (ROE); Times interest earned; Return on total assets; Return on common shareholders' equity; Return on investment (ROI).
- Liquidity ratios: Current Ratio/Working Capital Ratio; Quick (Acid Test) ratio.
- Ability to repay long-term debt: Leverage Capital Structure Ratio/Debt to equity/Solvency/Gearing ratio; Debt to asset ratio; Long-term debt ratio; Long-term debt to total capitalization ratio; Debt to tangible net worth ratio; Times interest earned.

Other salient points to be taken into consideration for the Credit Policy:

- Overdraft granted should be 20% of the projected annual turnover of the business.
- Allow start-up businesses to not pay any capital in the first year of being granted a loan.
- Where security is requested, it should be between 26% and 50% of the total credit granted.
- Credit decisions should be a combination of automated (for example, credit scoring) and subjective lending.
- The subjective credit lending decisions should be done at the Branch as opposed to Head Office; and
- Alternative sources of financing: finance equipment by taking a lien over the asset; provide an initial small amount, and on successful repayment, grant a higher loan value (step-up-approach); factoring: the bank buys the existing debtors book of the business.

The above provides a summary of the results from the structured questions from the questionnaire. There were further insights gained from the open-ended questions which will be utilized towards the design of a credit lending decision framework for small businesses.

**6.2.6 Research objective: To identify any variables which may contribute towards identifying risk when lending to small businesses.**

The empirical results revealed that the following variables are considered to have a practical significant association with default status. The results follow in Table 6-7.

Table 6-7: Variables which are considered to have a practical significant association with a default status

Variable	Finding
Experience in the industry	The more experience the owners/members/directors have in the industry, the less likely the business will default.
Purpose of facility	Starting a new business and Buying a franchise are more likely to default.
Age of business	The older the business, the less likely to default.
Area	The area can play a role in the likelihood of default.
Gender	Males are more likely to default. Females are less likely to default.
Legal status	A sole proprietor is more likely to default. A company is less likely to default.
Net worth	If the owners/members/directors have a negative net worth (assets-liabilities), the business is more likely to default. If the owners/members/directors have a positive net worth (assets-liabilities), the business is less likely to default.
Owens a home	If the owners/members/directors do not own a home, the business is more likely to default. If the owners/members/directors own a home, the business is less likely to default.

**6.2.7 Research objective: To determine the influence of the National Credit Act (NCA) on small business lending.**

Based on the interpretation of the NCA, it was determined that the NCA applies to all start-up businesses, sole proprietors, and juristic persons/companies (includes partnerships and unincorporated associations) where the annual turnover or net asset value at the time that the credit agreement is concluded is  $\leq$  R1 million. From the previous chapters, it was ascertained that the majority of the small businesses are sole proprietors, and the NCA regulations apply to a sole proprietor, therefore, an assumption can be made that the NCA applies to most small businesses. Based on the turnover and asset value threshold, it is further assumed that most juristic persons/companies will be excluded from the ambits of the NCA.

For the consumer, there are clear benefits, such as the protection provided to consumers; however, the pitfall for the consumer is the reduction in credit access due to the stricter credit

policies applied by banks. The capped fees and rates that the banks may charge (whilst beneficial to the customer) may also deter banks from lending to small businesses as it makes it difficult to price for the perceived risk.

Moreover, Regulation 4 of the affordability assessment regulations stipulates the income requirements; where a self-employed person is expected to either provide financial statements for three months or three months bank statements. This effectively means that an individual/business which has a fantastic business idea or invention cannot get funding from a credit provider to set-up or establish this business. Family and friends may not have the funds available to assist as it could require large funds to establish, but with the potential of being a hugely successful business. So from this perspective, the NCA is prohibiting new upcoming entrepreneurs with inventions and business ideas from obtaining credit to establish businesses.

There are also areas of the NCA which seem very “grey” which allows for too much misinterpretation and even possible manipulation. For example, if a company applies for an overdraft facility, and at the time of the application, the turnover and/or asset value is  $\leq$  R1 million, the NCA will apply. However, if the company applies for an increase in the overdraft facility at a later stage, and at this point the turnover is now, for example, in excess of R1 million, it would seem that the NCA now no longer applies to this applicant, even though the NCA did apply at the time when the first overdraft facility amount was granted. This could create some confusion for banks from an interpretation and implementation perspective.

Moreover, a sole proprietor that has assets in excess of R1 million and/or turnover that is in excess of R1 million at the time of his/her credit application, could be advised to simply go register a Company, with the result that the credit application no longer falls within the ambit of the NCA.

The other issue is that there may be “loopholes” where funds are being granted by entities and no interest is being charged. For example, an entity provides a business with “funds”, for example, R1 million based on the point of sale (POS) card machine turnover of the business, with a percentage of the turnover as the daily repayment. The funds provided to the businesses are typically referred to as merchant cash advances. It would appear that the amount repaid to the entity is significantly higher when compared to “interest” charged if the applicant applied for credit at a bank. These alternative avenues to access funds may be creating a situation where businesses may find themselves caught in a “debt trap”. So whilst the NCA managed to work out the “Loan Sharks”, providing protection to the salaried

individual, the means of alternative funding to small businesses, effectively at a very high cost, is becoming more prominent.

Furthermore, from a credit bureau reporting perspective, there is no indication that the NCA promotes the submission of data on SMMEs to credit bureaus, which makes it more difficult for credit providers to do thorough risk assessments.

Based on what has been highlighted above, an assumption can be made that there is a lot of grey areas and complexity and this makes it difficult for banks to comply. What also came out from the study is that due to the “grey” areas and complexity, banks prefer to stay on “safe grounds”, rather adding more requirements to ensure compliance, which makes it even more difficult for small business owners to qualify for credit.

From a business owner perspective, the business owner should also have an in-depth understanding of the NCA. Business owners may have the perception that as long as the business does not provide credit, and that all debtor accounts are payable within 30 days, that the NCA does not apply to their business. However, if the business charges its customers fees, charges, or interest for late payment in the event of incidental agreements, with certain conditions, this falls within the ambits of the NCA, and the result may be that the business is non-compliant with the relevant section of the NCA. This adds additional skills that upcoming entrepreneurs and existing small business owners need to have. Not only is an accounting background beneficial, but the business owners must now also be expected to have some form of legal and compliance knowledge, to understand the requirements and implications of the NCA.

The overall conclusions drawn are that whilst the NCA certainly is a necessity, and certainly has had a significant positive influence in many areas, it did not seem to achieve what was intended from a small business perspective. This is disappointing considering that the initial intention of how the NCA came about was to regulate the sector and provide a platform for the development of SMMEs; however, the influence of the NCA seems to be having an opposite effect. This was confirmed in the empirical results which concluded that small businesses have less access to credit since the implementation of the NCA.

In summary, the results of the empirical research revealed the following salient points. Firstly, it was positive to note that 96% of the participants are aware of the NCA. When delving into the influence of the NCA, the results revealed that although the participants felt that the NCA successfully protected the rights of the consumer (76%), the participants felt that small

businesses have less access to credit as a result of the NCA (65%), and 62% agreed that the NCA does not allow for more credit to be advanced to businesses.

One of the reasons for less access to credit for small businesses is that small business lending has become more expensive for banks since the implementation of the NCA according to participants (68%). The reasons provided by the participants for the higher cost to the bank were predominantly due to the detailed documentation requirements, increased administration, the increase in collections costs, additional resources required in order to comply, additional staff training, and system change implementations. What was also prominent is that fewer small businesses will qualify due to the stricter affordability requirements. It is therefore recommended that the NCA regulation specific to small businesses should be reviewed to provide more clarity and with an “enabling” approach, to allow for more access to credit for small businesses.

#### **6.2.8 Research objective: To determine the influence of the Khula Credit Guarantee Scheme on small business lending.**

The primary aim of the Khula Credit Guarantee Scheme was to increase the access to credit to the previously disadvantaged, specifically smaller businesses. However, considering the requirements based on the literature review, a summation can be made that very few smaller businesses are going to qualify. In the event where a customer defaults, the Guarantee Scheme requires for banks to complete the full collections process, even to the point of taking judgment before claiming on the guarantee. To take judgment requires of the customer to have some valuable assets in order to make it feasible, as taking judgment is a very costly and lengthy process. The point that is made is that it may be unlikely that the smaller businesses will have sufficient valuable assets for resell, to make the full late stage collections process feasible for banks. Based on this, it can be argued that the Khula Credit Guarantee Scheme has been catering more for the affluent businesses and not the smaller businesses. It is understandable then that the empirical results revealed that the Khula Credit Guarantee Scheme did not prove to provide “additionality”, as it caters more for the business segment that the banks would have provided credit to anyway.

Furthermore, the empirical results revealed that only 34% of the participants are aware of the Khula Credit Guarantee Scheme. The challenges for the banks to utilize the Khula Credit Guarantee Scheme were identified as follows (in ranking order):

- Red tape in the claims process when a customer defaults (83%).
- High cost for the bank in the claims process when a customer defaults (75%); and

- The Guarantee Scheme dictates the maximum interest rate that can be charged (74%).

“Other” challenges during the open-ended questions revealed the following additional challenges:

- High administration fees.
- The bank does not have control; and
- There is uncertainty on whether the claims will be paid.

The above empirical results are very much in line with the literature review as it was highlighted that banks are no longer in favour of making use of the Khula Credit Guarantee Scheme due to the maintenance, high transaction costs, and the concern that the bank does not have control over the guaranteed funds. The Small Enterprise Finance Agency (SEFA) since took over the Khula Credit Guarantee Scheme and is trying to ignite the interest of banks to utilize the Guarantee. Previously the “Individual retail selective model” was used and more recently the “Portfolio model” was offered to banks. Other than the “portfolio” offering, the only difference between the Individual model and the Portfolio model from an administration perspective is that the credit provider is solely responsible for the credit assessment; it does not go through a second credit assessment at Khula, as per the Individual model. A one-pager approval is sent to Khula for each credit application approved by the credit provider.

In the event of default by the customer, the collections process for the Portfolio model, however, remains the same as that of the Individual model. Furthermore, if any security held by the bank is realised during the collections process, the proceeds must be split between the bank and Khula. The same applies to any money collected by the bank thereafter. The administration fees also apply to the Portfolio model. It is not surprising then based on the literature, that the report by the Inter-American Development Bank revealed that both the Individual retail selective model and the Portfolio model have proven not to be effective in increasing lending to SMMEs, as no “additionality” was demonstrated. The high transaction cost to the bank to make use of these models and the concern of non-payment by the Credit Guarantee Schemes to cover such arrangements also contribute to the ineffectiveness of these models, according to the report.

What has proven to be more effective abroad is the “Intermediary Wholesale model”, however, this is more aimed for Non-Governmental Organizations (NGOs). This could be tested in the South African market, for smaller value loans and for start-up businesses with more relaxed regulation governing the credit. Once the start-ups are operational for an identified period, the business can be referred to commercial banks for further lending.

For the more established small businesses and/or for larger value loan sizes, a Securitization Model is recommended. The tranching of the liabilities in a typical securitization scheme allows those investors who are willing to take a higher risk in exchange for a higher return, to take up these tranches. The proposed model will be explained below.

### 6.3 Proposed Bank Guarantee Securitization Model

The Securitization Model proposed for Government to guarantee a portion of the small business lending by the banks would operate as follows:

- The Government would be required to invest equity funds in a Small Business Guarantee Holding Trust Fund. Each bank participating in the Guarantee Scheme would hold a separate Trust Fund under the Guarantee Scheme Holding Trust Fund.
- The bank and Government are to agree on the following:
  - The definition of a “small business” (target population).
  - The expected return on equity (ROE) target for the banks small business book; and
  - The threshold point where the Government guarantee will no longer apply and the bank will be responsible for that portion of the bad book if the threshold limit is exceeded.

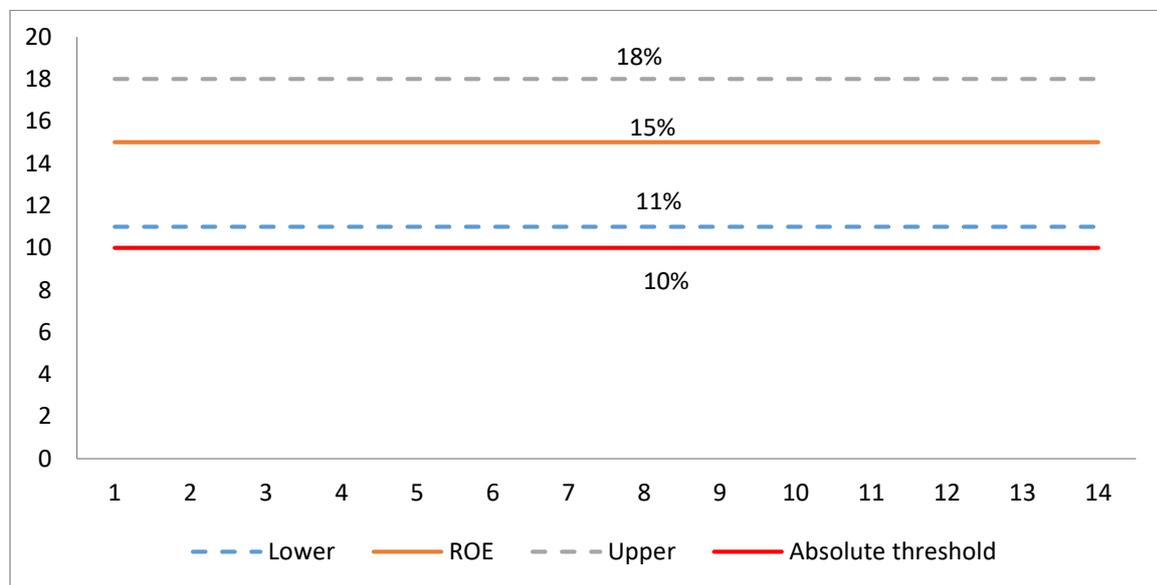


Figure 6-1: Example of an application of the Bank Guarantee Securitization Model

To illustrate how the proposed securitization model will work, reference is made to Figure 6-1 (hypothetical figures are used). Where:

- The agreed expected ROE for the bank small business book is 15% (solid orange line).

- If the actual bank ROE achieved is 18% (green dotted line), the bank is to re-invest the difference of 3% back into the Trust Fund.
- If the actual bank ROE achieved is 11% (blue dotted line), the bank can claim the difference of 4% (absolute differential amount) from the Trust Fund; and
- Should the ROE achieved drop below the threshold limit set, in this instance 10% (solid red line) the bank can claim a maximum amount of 5% (absolute differential value), thereafter the bank will be responsible for the bad debt amount.

Benefits of this model include the following:

- This model is applied on a portfolio level, not on an individual accounts basis. This will reduce the overall administration cost and improve on the turnaround time of applications.
  - It is less labour intensive.
  - No fees are payable to the Guarantee Scheme.
  - No passing of customer information to an external party; and
  - No duplication of effort (between the bank and the Guarantee Scheme).
- The bank is solely responsible for determining the credit risk of the portfolio booked.
- The bank determines the collection process to be followed.
- No sharing of the proceeds of securities realised in the collections process, or distribution of payments collected.
- It allows for an absolute threshold limit to be set high enough to reduce the risk of arbitrage. The aim is to deter banks from booking high-risk business without proper assessment, knowing that the risk is covered by the proposed model.
- The bank will no longer have the concern that a claim may not be paid by the Credit Guarantee Scheme; and
- Considering that the banks need to protect the depositor's funds, by agreeing on a minimum ROE for the banks small business book, this is a more practical solution.

The above concludes the key findings from each chapter. Table 6.8 provides a summary of the achievement of the research objectives:

Table 6-8: Achievement of research objectives

SECONDARY OBJECTIVES AS PRESENTED IN CHAPTER 1	CHAPTER ADDRESSING THE OBJECTIVE	APPLICATION IN VALUE-BASED DECISION FRAMEWORK
To obtain a general profile of small businesses in South Africa.	Chapter 2 2.2 A general profile of small businesses in South Africa. Tables 2-1, 2-2	Phase 1
To identify the challenges faced by small businesses in South Africa, specifically from a credit access perspective.	Chapter 2 Tables 2-4 to 2-6	Phase 1 to Phase 3
To identify the prominent reasons for the failure of small businesses in South Africa.	Chapter 2 Table 2-7	Phase 1 to Phase 3
To identify the basis upon which banks typically grant credit to small businesses.	Chapter 3 3.6 Credit application lifecycle stages Tables 3-1 to 3-12	Phase 1 to Phase 3
To identify what the challenges are for banks to provide credit to small businesses.	Chapter 3 Table 3-14	Phase 1 to Phase 3
To determine the influence of the National Credit Act (NCA) on small business lending.	Chapter 4 4.4 The National Credit Act Tables 4-2 to 4-5	Phase 3
To determine the influence of the Khula Credit Guarantee Scheme on small business lending.	Chapter 4 4.5 Khula Credit Guarantee Scheme	Phase 3
Identify what the challenges are to provide credit to small businesses.	Chapter 5 Empirical Study A Figure 5-5 Tables 5-8, 5-9	Phase 1

Identify what a suitable credit policy may be for small business lending.	Chapter 5 Empirical Study A Tables 5-11 to 5-27 Figures: 5-19, 5-27, 5-31, 5-35, 5-39, 5-43, 5-47, 5-48, 5-50, 5-51, 5-52	Phase 1 Table 5-14 Tables 5-27 to 5-30 Figures 5-48, 5-49 Phase 2 Figure 5-50 Table 5-10 Phase 3 Figures 5-11, 5-12, 5-19, 5-22, 5-23, 5-27, 5-28, 5-31, 5-39, 5-40, 5-52, 5-72 Tables 4-3, 5-10, 5-15
Identify any variables which may contribute towards identifying credit risk when lending to small businesses.	Chapter 5 Empirical Study A and B Tables 5-38, 5-40	Phase 3
To determine the influence of the NCA on small business lending.	Chapter 5 Empirical Study A Tables 5-31 to 5-34 Figures 5-53 to 5-54	Phase 1 to 3
To determine the influence of the Khula Credit Guarantee Scheme on small business lending.	Chapter 5 Empirical Study A Figures 5-71 to 5-73 Figures 5-58 to 5-59 Figures 5-63 Tables 5-36, 5-67	Phase 3

Below a value-based decision framework for small business lending is proposed which was developed based on the empirical results, after consideration of the challenges and gaps in small business lending.

#### **6.4 Value-based Decision Framework for Small Business Lending**

The proposed framework is detailed below. For the process flow chart mapping the framework, refer to Addendum B. It is important to note that all the additional services proposed in the

framework that fall outside of the current offerings traditionally provided by banks, is to be paid for and provided by Government.

It is proposed that the specialized outlets that are established to focus specifically on small businesses have a welcoming name such as “Small Business Community Centre” (SBCC). Furthermore the name “credit manager” should be replaced with a title that is less “daunting” for an applicant, for example, “Small Business Champion” (SBC). The qualified accountants whom are to be based in the SBCC are to be referred to as Small Business Accountants (SBA). These are the titles that will be referred to throughout the framework. The framework comprises a combined approach of an automated and subjective process. Applicants should be provided the option to apply at the banks “Small Business Community Centre”, or at the applicants nearest branch or online. Cubicles can also be provided for the applicants to apply online at a branch, at the Small Business Community Centre, and with joint venture options where the bank arranges to install the “self-help service” cubicles at outlets such as Shoprite Checkers.

The framework is split into various “phases” with the intention to save time, cost and resources for the customer and the bank. For example, a small business customer may be asked to provide financial statements, a projected cash flow statement, and a business plan, which the small business customer pays out of his own expense, only for the application for credit to be ultimately declined by the bank. Worse still, in many cases, the applicant walks away not knowing what to improve on, or change, in order to re-apply for credit. The aim is towards a value-based decision framework, which will benefit the customer, the bank, promote small business growth, and ultimately benefit the economy in South Africa.

#### **6.4.1 Phase 1**

### **PHASE 1**

The applicant is to apply online, at a branch outlet or at an SBCC. The following information is to be captured directly into the bank’s application system:

- The period that the business is operational; the value of loan/credit required, the purpose of the loan, business trade (what does the business do – description of product or service offered).
- Name, surname and identity number of the owners/members/directors and banking account details.
- Consent to the bank to do the required checks, for example:

- Credit bureau checks.
- To do online checks with SARS and the Council (this is if this access is authorized by SARS and the Council through an agreement with the bank).
- Fraud prevention services.
- To draw online bank statements.
- Consent to participate in a basic psychometric and aptitude test.
- Confirmation of consent from the spouse (where applicable) to enter into a credit agreement based on matrimonial law. For example, where the applicant is a sole proprietor and is married in community of property.
- Any previous formal employment and experience detail.  
If yes, to provide reasons for leaving formal employment; drop-down list can include:
  - To start my own business.
  - A business opportunity arose.
  - I was retrenched.
  - Retired.
  - Other.
- Highest qualification; drop-down list can include:
  - I have not completed matric.
  - Matric.
  - Diploma of three years.
  - Degree.
  - Post-graduate.

At this point, the system will draw the required information on the owners and any business to which the owners are linked based on the identification numbers provided from the Credit Bureaus (credit history, adverse information and credit scores) and Fraud Prevention Services. The applicant should have a view of the trades reflected on the credit bureaus, and must be enabled to provide an online signature/voice recording to confirm the information (debt and repayments with credit providers) which is to be taken into consideration for affordability purposes.

From the information accessed, and based on the in-house rules of the credit provider, the system must make the following decision at this point:

- Green – continue to phase 2.
- Red – system decline.
  - Refer to Table 6-9 below for the automated outright decline rules at phase 1.

- The system is to provide the most dominant reason for the decline, and access to a decline letter which the customer may print, which must meet the requirements of the NCA regulation. The system is to provide the contact details of the SBCC, should the customer require any further information. It is also recommended that a “call me back” click on button/or an online assistance option be provided which the applicant can click on for assistance at any point in the application process.
- Amber – refer the application for manual review.
  - This must be in the event of “borderline cases” (based on a combined score), or where the owners/members/directors have any adverse credit information/unsatisfactory credit history AND the owner/member/director was retrenched by a previous employer.

For the applications which are referred for manual review (amber), a SBC must interview the applicant and determine the reason for the unsatisfactory credit bureau record/credit history of the applicant and make a decision. For example, if it is due to a reason beyond the control of the applicant, such as retrenchment from a previous employer, and depending on the extent of the “unsatisfactory” record, the SBC can either allow the application to continue, or advise the applicant that the bank cannot assist with finance at this stage, providing an explanation, and where possible advise of other options (decline process to be covered later in the chapter).

Table 6-9: Automated outright decline rules at phase 1

<b>Automated outright decline rules at phase 1</b>
<ul style="list-style-type: none"> <li>● Age of business &lt; 6 months.</li> <li>● The applicant is not authorized to apply for credit for the business (separate legal entity).</li> <li>● Consent was not provided where required, for example, to do the required checks.</li> <li>● Business practice is illegal/not ethical.</li> <li>● Purpose of loan is unacceptable.</li> <li>● Compliance/Regulatory rules, for example, the owner is under debt administration/sequestration, under the legal age, or the business is insolvent.</li> <li>● Record of fraud.</li> <li>● Criminal checks unsatisfactory.</li> <li>● Unsatisfactory conduct of account/s.</li> <li>● Unsatisfactory credit history.</li> <li>● Unsatisfactory credit bureau results.</li> <li>● Tax owing/ Council debt owing (where online access is available).</li> </ul>

In-house checks are to be done on the conduct of accounts – using online bank statements of the owners and the business. Where the applicant banks at the bank where credit is applied for, the process can be automated to check the conduct of accounts. Conduct of accounts will include annual turnover; highest, lowest and average balance on accounts; dishonors, returned debit orders; excesses on accounts; deposit information; spending patterns; and so on.

#### 6.4.2 Phase 2

### PHASE 2

If the applicant passes the requirements of Phase 1, the applicant can automatically continue to Phase 2 (if there was no referral for manual review).

Phase 2 will involve the following:

- A basic psychometric test to determine:
  - The willingness of the owner/s to repay the loan:
    - Any indication of deceit with regards to the repayment of the credit applied for.
    - The level of ownership in the event of non-repayment, for example, whether it makes a difference to the applicant if listed on the credit bureau in the event of bad debt.
  - The level of the owner's ambition, drive, and commitment to the business.
- Depending on the qualification of the applicant, a basic aptitude test is to be conducted to determine the level of mathematical, accounting, and management abilities which can be deemed the minimum requirement to manage any type of business.
- The system is to determine a separate score for the psychometric and aptitude test (if applicable), and a combined score.
- If the applicant meets the minimum criteria of the psychometric/aptitude test, the system is to allow the application to continue to phase 3.
- If the applicant passed the aptitude test but failed the psychometric test:
  - And has no past credit history or an average credit history, the application for credit should be declined.
  - If the applicant has an excellent past credit history (minimum two years), the application should be allowed to continue in the process (based on the combined score, which also includes the score for past credit history).

- If the applicant failed both the aptitude and psychometric test, the application should be declined.
  - Depending on the combined total score, where the applicant has a past excellent credit history (minimum two years), these applications can be referred for manual review. The system is to advise the applicant that a bank employee will contact the applicant.
- If the applicant passed the psychometric test but failed the aptitude test, these applications can be referred for manual review.
  - Based on an in-depth interview with the applicant and at the discretion of the SBC (based on the business feasibility/growth potential), the applicant should be referred to attend a Government funded short training course based on the areas identified where development may be required. The recommended training programs are listed in Table 6-10 below.

Table 6-10: Training Programmes

<b>TRAINING PROGRAMMES</b>
<b>Financial</b>
<p>Basic accounting/bookkeeping/financial management training:</p> <ul style="list-style-type: none"> <li>• Building a good credit record.</li> <li>• To recognize the difference between sales (turnover) and profit.</li> <li>• Mark-up percentage on the sale of goods to ensure profitability.</li> <li>• Cash flow budgets, personal overspending, stock control, debtor book collection.</li> <li>• To compile and manage accounting records.</li> <li>• Taxation and VAT issues.</li> </ul> <p>On a more advanced level:</p> <ul style="list-style-type: none"> <li>• Drafting of business plans/budgets/forecasts/projections.</li> <li>• Cash flow management, costing, record keeping, cash management, cash flow planning, ratio analysis, credit risk, financials.</li> </ul>

## Non-financial

Basic skills to manage the business:

- Identify the target market/how to get customers/market a business.
- Daily operations management of a business.
- HR management.
- Time and priority management.
- IT and computing solutions.

Dealing with required legislation:

- Registration requirements.
- National Credit Act.
- Company regulation.
- CCMA.

On a more advanced level:

- Marketing and research.
- Business Cycles.
- Risk management.
- Industry trends and analysis.
- Relevant events in economics, markets, politics.

Once the applicant successfully completes the identified training programmes, the applicant is advised to return to the SBCC with the achieved certificates, to apply for credit. The SBCC is to keep track of the training programme candidates.

### 6.4.3 Phase 3

## PHASE 3

For the applications that continue to phase 3:

#### 6.4.3.1 Business in existence $\geq$ 2 years

Company/Close Corporation/Partnership with annual turnover/assets > R1m

- For existing excellent conduct of personal and business cheque accounts and overall excellent credit history, the SBC is to conduct an interview with the applicant to determine the following:
  - How will the business generate sufficient revenue to repay the loan?

- Obtain the following as proof of income:
  - Business bank statements (for six months).
  - Point of sale (POS) income statements (where available).
  - Proof of signed contracts (where applicable).
- Do the owners/members/directors meet the minimum owner's contribution/owners' equity of 15%?
- Do the owners/members/directors have a positive net worth? (Statement of assets and liabilities and Income and Expenditure Statement to be completed).
  - Verify the assets as far as possible, for example, for fixed property owned, confirm with a deeds office search (if the applicant does not have a home loan at the current bank).
- If the above is in order, the SBC is to do an onsite visit to the business (within discretion):
  - To verify the existence of the business, premises, assets, and buildings (where applicable).
  - Speak to neighbouring businesses, other business associates and key personnel of the business to obtain "general" information.
- If the SBC is satisfied with the above results; the business exists, seems feasible, the owner/s have a positive personal net worth position, and seem to have the necessary drive, dedication and skill levels, excellent conduct of existing accounts, and good credit history, the SBC must continue with the following:
  - Minimum of 15% owner's equity (owners' contribution) requirements must be met.
  - Finalize the credit application on the system – includes obtaining all the required signatures, meeting all the regulatory requirements such as the Financial Intelligence Centre Act (FICA), and all the supporting documentation such as Company registration documentation.
  - Where the business is a separate legal entity: Suretyships by the directors/members must be obtained, the cession of member's/shareholders loans, and cession of book debts (where applicable).
- Grant a maximum overdraft of 20% of annual turnover as working capital (set a rand maximum limit according to risk appetite), and within discretion arrange for a percentage of the turnover as a monthly repayment (reduction plan on overdraft facility).
- The SBC is to approve the credit amount within his/her mandate.

- If the applicant requires in excess of the 20% turnover or exceeds the maximum unsecured threshold amount (set as per risk appetite), in addition to the above requirements, obtain:
  - The Company income tax return for the business for a minimum period of two years and compare it to the bank statement transactions for a minimum period of two years. If the applicant banks at the current bank where the application is made, the turnover will reflect on a single enquiry drawn, also showing the conduct of the account, highest and lowest balance, and so on.
- If the Company income tax return and the bank statement turnover reflect a similar financial position, the SBC is to approve the credit amount within his/her mandate.
- If the Company income tax return and the bank statement do not show a similar financial position, or if the value applied for is in excess of a certain rand value:
  - Obtain full financial statements for a minimum period of two years (three years where available), projected cash flow statement, business plan, and debtors age analysis (where applicable) for assessment.
  - If the applicant does not have financial statements, the applicant must be referred to the SBA at the SBCC to draft the required financial statements.
  - The financial statement information is to be captured onto the system by a credit analyst (at a branch outlet or at the SBCC center). The SBA based at the SBCC must be able to access this information from any entry point, for example, from a branch outlet.
  - Financial ratio information is to be calculated by the system and compared to industry norms. Any outliers must be flagged so that the SBA can review these, and contact the applicant to discuss if required. Any outliers must be motivated if it is warranted. If successful, these applications are to be approved within the credit mandate of the SBC, or referred to a higher mandate (the approval process will be discussed in more detail below).

#### 6.4.3.2 Business in existence for 6 months - < 2 years

The online application is to continue for these applicants from Phase 2, marking with an “X”, whether the following required information is available:

REQUIREMENTS FOR THE OWNERS/MEMBERS/DIRECTORS:	Y	N
CV (for any previous employment) (online template to be available for completion).		
Personal statement of assets and liabilities (online Annexure to be available for completion).		

<b>REQUIREMENTS FOR THE OWNERS/MEMBERS/DIRECTORS:</b>	<b>Y</b>	<b>N</b>
Income and expenditure statement (this is to determine any other income earnings, and to provide an indication of the monthly drawings amount required from the business) (online Annexure to be available for completion).		
Rates and taxes certificate (if there is any property owned).		
Income tax statement.		
Bank statements.		
<b>REQUIREMENTS FOR THE BUSINESS:</b>	<b>Y</b>	<b>N</b>
Business registration documentation (if applicable).		
Bank statements (for a minimum period of 6 months).		
Financial statements/management accounts drafted by an accountant/auditor.		
Business plan.		
Projected cash flow statement (for 12 months).		
Point of sale machine (POS) income statement (if applicable).		
Signed contracts/Letters of intent (where applicable).		
Tax clearance certificate/Company Income tax return/VAT return.		
Rates and taxes certificate (where the business is a separate legal entity and owns property).		
Debtors age analysis (if applicable).		

➤ **If the applicant ticks “Y” in the financial statements/management accounts from an accountant/auditor field:**

- The system is to advise the applicant to call at the nearest branch of the bank or at the SBCC, together with the required information. A GPS locator is to advise the applicant of the detail of the nearest branch and contact detail. The bank official at the branch or SBC at the SBCC can draw the completed online application information from the system using the applicant’s identity number.
- The bank official is to confirm the pre-populated information on the system, obtained from the credit bureaus (for example; business registration information, business address, contact detail, and demographic information of all the owners/members/directors) and the information completed online by the applicant. Once the documentation is obtained, the bank official must verify the accountant/auditor information that drafted the financial statements, assist the applicant to complete the outstanding information required on the credit application, and continue with the credit assessment process.

➤ **If the applicant ticks “N” in the financial statements/management accounts from an accountant/auditor field:**

- The system is to advise the applicant to call at the nearest SBCC.
- The SBC is to conduct an in-depth interview with the applicant.
- The SBC is to conduct an on-site visit to the business premises (on discretion).
- If the business has the potential for growth and seems feasible, using the below guidelines:
  - The business should show the potential to break-even and produce a positive cash flow within a reasonable period (depending on industry type).
  - After break-even, the business should have the potential to have a Return on Investment (ROI) of a minimum of 10%, but ideally >16% year-on-year.
  - The business must have the ability to create job opportunities.

Other requirements:

- The business must comply with tax return requirements and all required legal requirements.
- Must be able to meet the minimum owner's equity (owner's contribution) requirements.
- After paying expenses, the surplus is to be re-invested into the business.

Obtain the following as proof of income:

- Business bank statements (for the period that the business is operational – minimum six months).
- Personal income tax statements/Company income tax return (where available – this must be compared to the bank statements and show a similar financial position).
- Point of Sale Income Statements (POS) (where applicable).
- Proof of signed contracts (where applicable).
- Where the business is in existence for > one year, and:
  - The required overdraft does not exceed 20% of turnover, and
  - The owners/members/directors net worth shows a favourable positive financial position, and
  - Company tax return and bank statement turnover for one year show a similar financial position, and
  - There is a minimum of 30% tangible collateral security provided, and/or proof of a secured government signed contract. For example, a family member can

sign surety and cede tangible security if the applicant is unable to provide security.

- In the absence of the minimum required security, and/or the owners do not show a positive financial position – the Government credit guarantee is to cover for a portion of the risk.
  - The SBC is to approve the amount within his/her mandate.
- Where the required credit amount exceeds 20% of the turnover (for example, for business expansion), and/or the credit amount requested exceeds the rand value threshold set by the bank:
- The applicant meets all the above minimum requirements; however, the applicant cannot provide financial statements and a business plan.
  - The SBC is to introduce the applicant to the SBA (registered accountant) at the SBCC to draft the required documentation, which should include:
    - Financial statements/Management accounts.
      - Income Statement and Balance Sheet.
      - Cash flow statement.
    - Business plan.
    - Projections.
      - Financial/Cash flow forecast.
      - Income and Expenditure statement.

Where the business is in existence between 6 months – 1 year, or for businesses existing > 1 year where there are any shortcomings during any phase above, the shortcoming must be addressed before the application continues, or it must be made a condition of grant, using Table 6-11 below as a guideline.

Table 6-11: Options to reduce credit risk

<b>Where the business owner/s:</b>	<b>The condition of grant:</b>
Lack experience in the specific industry.	<ul style="list-style-type: none"> <li>• A successful business owner in a similar industry to be appointed as a mentor, or</li> <li>• Partner the business with a complementary venture that already exists.</li> </ul>
Lack any tangible security which may be required, and/or There is insufficient owner's contribution.	<ul style="list-style-type: none"> <li>• Government to guarantee a portion of the credit amount – directly via a Service Level Agreement (SLA) with the bank or via the Securitization Model proposed, or</li> <li>• Look at the pool of investors that the SBCC has established that are willing investors to provide surety in</li> </ul>

Where the business owner/s:	The condition of grant:
	<p>return for a stake in the business (should the applicant be in agreement to this avenue).</p> <ul style="list-style-type: none"> <li>• Social investors on the internet.</li> <li>• Provide exposure to communities seeking new investment opportunities.</li> </ul>
Do not have an adequate marketing strategy in place for the business.	<ul style="list-style-type: none"> <li>• Applicant must be assisted with a website for the business, and guidance on how to promote the business offering. This service must be provided at the SBCC.</li> </ul>
Are unable to demonstrate repayment ability through financial statements.	<ul style="list-style-type: none"> <li>• Put a cap on the maximum loan amount equal to the forecasted value of the business after year two. Work on an average income over a two year period, and/or</li> <li>• Provide working capital in stages based on actual performance/once certain milestones/targets are met. As the set targets are reached, provide the next credit progress payment, and/or</li> <li>• Cash flow securitization using the point of sale (POS) machines to determine how much money the business generates and also how much it can pay back, and/or</li> <li>• Business to provide proof of signed contract(s) to warrant the amount that it wants to borrow.</li> </ul>
Do not qualify for the full amount applied for.	<ul style="list-style-type: none"> <li>• Assess whether the business model can be adjusted/re-structured to apply a different implementation strategy with an initial smaller credit amount. Usually, a change in the business model means a much more efficient and profitable approach, for less money.</li> <li>• However, if there is no prospect to adjust the current business model to accommodate the smaller credit facility, the application must be declined. By providing insufficient working capital, the business would be undercapitalized and most likely be set up for failure.</li> </ul>
For start-ups.	<ul style="list-style-type: none"> <li>• Staggered finance: Provide only the working capital that is necessary upfront and then make progress payments, linked to goals (once certain deliverables are met, for example, to obtain proof of an order, overdraft to be repaid once this is finalized. The next amount is to be considered, and so on), and/or</li> <li>• Make payments on the business' behalf where appropriate, for example, suppliers. The owner is to supply a pro-forma invoice to the bank for payment, and/or</li> <li>• The bank could make arrangements with suppliers to cover the goods costs and issue these goods in phases; the customer has to repay each "phase" as the money is received from the end user. If the customer fails to pay then the bank can stop the supply of goods.</li> </ul>

Table 6-12: Other support services that could be offered at the SBCC

<b>SBCC: ADDITIONAL SUPPORT SERVICES</b>
<ul style="list-style-type: none"> <li>• Internet café for small business owners.</li> </ul>
<ul style="list-style-type: none"> <li>• Business idea showcasing.</li> <li>• In order to attract potential investors, the SBCC is to allocate a section of the SBCC for the showcasing of business ideas/proposals by entrepreneurs/small businesses, which can be screened and then aired on specific television channels for viewing, available on a site on the internet, and to be screened in-house within branches (visible whilst waiting in queues/waiting rooms in private bank/business bank).</li> </ul>
<ul style="list-style-type: none"> <li>• Business registration practitioners to be established within the SBCC.</li> </ul>
<ul style="list-style-type: none"> <li>• VAT/Tax practitioners.</li> </ul>
<ul style="list-style-type: none"> <li>• Business compliance advice on relevant regulations.</li> </ul>
<ul style="list-style-type: none"> <li>• Insurance advice and services such as key man insurance.</li> </ul>

For all credit applications, the SBC must ensure that credit applications are accurately completed, all regulatory requirements are met, all supporting documentation is obtained, required security is obtained, and all the required signatures are in place.

#### **6.4.3.3 Approval process**

- The SBC is to approve the applications for credit within an approved allocated mandate amount, considering the highest combined exposure (HCE) of the application (a director of company A may have signed a suretyship for Company B, for example, so the exposure of Company A and Company B must be totaled, including all the personal exposures of all the owners/members/directors).
- Where the credit application (based on the HCE) exceeds the mandate of the SB Champion:
  - The SBCC outlet manager is to approve the applications within his/her mandate, together with the SBC (two to sign).
- Where the credit application exceeds the mandate of the SBCC manager:
  - These applications are to be referred to the “small business credit assessment panel” for approval. The panel members should include the SBC which was involved with the application, the outlet manager of the SBCC and an independent finance professional (SAICA/SAIPA/SAIBA) who is contracted in for this purpose. The SBA is to sit in on the panel approvals should any questions be raised on financial positions which require clarity.
- Depending on the value of the credit applied for, and the specialist field of the business industry, specialist advisory members should be available on a panel to be called upon to attend the scheduled approval meeting. Recommendations for special advisory committee members are listed in Table 6-13.

Table 6-13: Special advisory committee members

<b>SPECIAL ADVISORY COMMITTEE MEMBERS</b>
<ul style="list-style-type: none"> <li>• Subject matter specialist/market analyst in the industry of the business that is also a specialist of the geographic area of the proposed business. It could be a local business member.</li> <li>• Technical expert (in that particular field).</li> <li>• Depending on the type of business, experts in the following fields could be called in: Legal/Compliance, Statistician/ Actuary, Product, Fraud, Entrepreneurial/SMME, Business development/New business/Commercial, Risk, Agriculture, Information technology.</li> <li>• Community leader; Business coach; Business Angels.</li> <li>• Representatives from: A credit bureau; business incubator/accelerator; Small Business Chamber/body or Chambers of Commerce.</li> </ul>

#### 6.4.3.4 Decline procedure

Should the application not be successful at any stage during the process, the applicant should be advised on the reason for the decline. Table 6-14 provides guidance on the decline procedure.

Table 6-14: Decline procedure

<b>DECLINED APPLICATIONS</b>
<ul style="list-style-type: none"> <li>• Declining an application should involve a consultation process.</li> <li>• Assist the applicant to understand why the application was unsuccessful and provide guidance on what can be improved on in order to improve the likelihood of qualifying for credit in the future.</li> <li>• Depending on the reason for the decline, guidance could include:             <ul style="list-style-type: none"> <li>○ Constructive feedback with implementable suggestions.</li> <li>○ How to build the required creditworthiness.</li> <li>○ Highlight the gaps in their business model.</li> <li>○ Suggested changes to the business plan for future review.</li> <li>○ Guide the applicant to an external firm which specializes in advising how to structure the business to qualify in future.</li> <li>○ Advice on other options such as Incubators/Business accelerators/ Private equity/Venture capitalists/Crowd funding.</li> </ul> </li> <li>• Create a wealth creation learning facility to educate small business owners and advise on the period of re-assessment.</li> </ul>

#### 6.4.4 Aftercare management

##### 6.4.4.1 Business in existence ≥ 2 years

Company/Close Corporation/Partnership with annual turnover/assets > R1m

- Depending on the credit facility amount (threshold can be set by the bank), there should not be an annual review of an account requiring the applicant to bring in financial statements in the following instances:
  - The applicant has not requested for an increased facility.
  - Where the security position is in good standing.
  - The conduct of the account is satisfactory.

There should be system triggers on the business cheque account to alert for early warning signs of any financial distress, for example, where the turnover is not increasing or where there is a drop in turnover by an identified percentage, excesses on the account, and returned debit orders. Based on these triggers, the SBC is to contact the customer and arrange for a visit at the business premises, to discuss the conduct of the account and request for financial statements for a full review of the account if required.

#### **6.4.4.2 Business in existence for 6 months - < 2 years**

And any Company/Close Corporation/Partnership with annual turnover/assets <R1m (irrespective of the age of the business).

Table 6-15: After support services for start-ups

<b>AFTER SUPPORT SERVICES FOR START-UPS</b>
<p>Relationship management is required and strict monitoring of the financial behaviour of the business:</p> <ul style="list-style-type: none"> <li>• The SB accountant is to obtain monthly/quarterly management accounts and cash flow statements to monitor the business progress. A comparison must be made to the initial projections.</li> <li>• This must be continued until such time as the accountant is comfortable with the progress of the business; thereafter the account management must become more automated.</li> <li>• Set up financial performance triggers on the business accounts to indicate signs of financial difficulty.</li> <li>• Focus on the debt ratio.</li> <li>• Regular interaction with the business owner/s. Visits to the business. On a monthly basis initially, thereafter quarterly.</li> <li>• Reduce the overdraft/credit amount as and when necessary, for example, on completion of a contract or project.</li> </ul>

The guidelines in Table 6-15 are dependent on the value of the credit facility/in the absence of an allocated mentor/security position, and so on. Although it would be ideal for all start-ups, there is a high cost involved.

There must, however, be some form of aftercare support, specifically for start-ups. Business owners need to know that guidance will be available if required and that the bank will not

immediately “pull the plug” on the business should the business owner admit to experiencing some hurdles. It is typically the norm for the banks to return paper and “call-up” the credit facility where there is a concern that the business is in financial distress. This could mean cutting off suppliers of the business and also the cash flow of the business, which will more than likely lead to the business shutting down.

Where a business shows signs of financial distress, there should be a consultation process by the SBA and SBC with the business owner, to determine what the issues are and what measures could be implemented to overcome the difficult time. The difficult period could be a temporary hurdle which with the right guidance and support from the bank could be overcome, and thereafter the business may flourish. It is therefore important for banks to try and assist in difficult times where there is a good chance that the business can recover from the downturn. If the banks instead are quick to call-up the facilities, specifically due to the perceived high risk of the smaller businesses and start-ups, it will defeat the objective of looking at ways to grant more credit to promote small business growth, if the businesses are going to be “shut down” as a result of withdrawing the credit with the slightest “red flag” seen by the bank.

#### **6.4.5 SBCC Outlets**

##### **6.4.5.1 Image and positioning**

The SBCC outlets should be situated in areas where there is high small business activity. The outlets should have a different “look and feel” to the traditional bank branches, with a more laid back, welcoming image.

##### **6.4.5.2 SBCC Employees**

The employees employed at the SBCC should ideally have the following qualities/skill/education:

- Friendly, patient, humble and personable.
- Previous experience in owning and operating a business (preferable).
- Accounting qualification.
- Experience in commercial lending of a minimum period of five years.
- A diverse group of employees covering the prominent languages in the Region.

#### **6.4.6 Rewards Programme**

The rewards programme for the employees of the SBCC should be based on a team effort and not be based on an individual reward system. It must be considered that an individual carrying a credit granting mandate cannot have a sales target as this is considered a conflict of interest. The overall annual bonus reward scheme, however, should be based on all the employees meeting the SBCC allocated:

- Budget.
- Sales target.
- Total book bad debt ratio not to exceed an agreed percentage.

#### **6.5 Conclusion**

The previous chapters provided the main issues and provided interim recommendations. A framework for small business lending was then, as the main contribution of the study, provided for banks as a guideline. The guideline includes traditional banking methods but also includes new innovations and different methods which can be implemented towards a value-based decision framework. The “value-based” term implies not only towards a more profitable solution to lending for the bank but also a credit offering to the small business customer, which ultimately enables the development, growth, and expansion of small businesses in South Africa. For the bank, the framework removes certain tasks in the lending process or combines the task to be performed by “one” person as opposed to multiple people (duplicating efforts) during the traditional lending process, hence reducing cost.

An example of this is where an accountant (paid for by Government) based at the Small Business Community Centre (SBCC) drafts the financial statements/projections/business plan for a potential small business customer, there is then no need for a credit manager to analyze and interpret these financial statements/projections and look at the feasibility of the business plan. This saves on cost and time from the credit manager and at the same time, the small business applicant has financial statements, a business plan, and projections in order to apply for credit, which may not have been affordable for the applicant. Furthermore, if the applicant applies directly at the SBCC, or online during the first phases it also cuts out the cost of the portfolio manager at the branch interviewing the customer and the analyst cost of preparing the application for approval.

By splitting the application process into phases and combining an automated and manual approach also assists in reducing cost to the bank, and potentially saving on time and cost to

the applicant. Other than from a cost perspective, the framework provides an alternative means of assisting small business owners which may never have had the opportunity for qualifying for credit following the traditional methods. At this point, a quote from a research participant is so relevant, which states “Assist when the small businesses need help (provide the umbrella when it's raining, not when the sun is shining)”. Basically, this would require a change of ‘mind-set’ that it is not always about the profits, implement a caring approach, and the profits will follow. If the “passion” is there, the banks can make it work.

The framework, however, encourages a collaborative approach combining the efforts of banks and the Government. The Government already has most of the recommended development programs in place to develop and assist businesses; however, it may be argued that these are not being utilized to the extent that they could be. By providing these Government solutions within the SBCC, the Government efforts can be more visible and optimized.

It is important to note that it was not possible or practical to test the proposed Value-Based Decision Framework for Small Business Lending due to the following; time constraints, and the fact that sufficient data is required over a reasonable period in order to determine the impact on the non-performing loan book of the relevant bank. The proposed framework was, however, discussed with a panel of banking officials in the small business lending space and/or responsible for the small business loan centres. The perception was positive, with great interest, where assistance was requested for consultation for testing the implementation. Furthermore, the proposed framework was discussed with the Chairman of a Government SMME forum and the CEO of SAIBA and similar to the banking officials there was a positive response, and further feedback was requested on completion of the study. There was also contact made from senior officials (Chief executive officers, Managing director) in the finance field who expressed interest in the study and proposed framework, requesting for the completed study and framework to be communicated.

## **6.6 Recommendations for further research**

It is recommended that the proposed Value-Based Decision Framework for Small Business Lending be tested. Furthermore, considering the limitations of this study, which excludes certain segments of the SMMEs in South Africa, as the focus was only on small businesses, further research can be conducted to expand from these ideas to also utilize in other segments of business lending. Furthermore, more research can be conducted on the development of a scorecard for businesses in South Africa, accommodating the different segments in the SMME customer base.

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# ADDENDUM A: QUESTIONNAIRE

Access to credit for small businesses in South Africa: A value based inv... <http://fluidsurveys.com/s/Access-to-credit-MB/print/?token=eJxIjUE...>



## Access to credit for small businesses in South Africa: A value based investigation

### Page 1

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Good day

I am a PHD student at North West University. My topic for the study is "Access to credit for small businesses in South Africa: A value based investigation".

For the purposes of my study, a small business is defined as a business with 50 employees or less, and a start-up is defined as a business in existence for less than 24 months. The survivalist market has been excluded from my study. Please keep this in mind when completing the questionnaire.

My objective is to ultimately design a framework for small business lending. In order to achieve this, I require your valuable input by completing the attached questionnaire, which should take you no longer than 30 minutes to complete. Your response will be completely anonymous.

The results of the questionnaires, once approved by the University, will be distributed to the various banks which participated in the completion of the questionnaire.

I look forward to receiving your valuable contribution to assist me to complete my study. Should you have any concerns or queries, you are welcome to contact me at [mariasurveysa@gmail.com](mailto:mariasurveysa@gmail.com)

Kind Regards  
Maria Burger

### Page 2

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Please provide the following biographical information:

**AGE (in years):**

**GENDER:**

- Male  
 Female

**NUMBER OF YEARS IN CURRENT POSITION:**

**HIGHEST QUALIFICATION:**

- LESS THAN GRADE 12  
 MATRIC  
 DIPLOMA  
 DEGREE  
 POST GRADUATE  
 OTHER (please specify)

**DEPARTMENT:**

- CREDIT
- SALES
- FINANCE
- ACCOUNTING
- AUDIT
- GOVERNMENT
- OTHER (please specify)
- ACCOUNTANTS IN PRACTICE

**DIVISION:**

- MICRO FINANCE
- SMALL BUSINESS
- MEDIUM BUSINESS
- HOME LOANS
- VEHICLE & ASSET FINANCE
- ADVISORY
- ASSURANCE
- OTHER (please specify)

**JOB CATEGORY:**

- CREDIT MANAGER
- CREDIT GRANTOR/OFFICER
- CREDIT ANALYST
- PORTFOLIO MANAGER/PRIVATE BANKER
- CONSULTANT
- ACCOUNTANT
- OTHER (please specify)

**The aim of this questionnaire:**

Section 1: The aim of section 1 is to determine your view on the current small business proposition and practices applied by banks when lending to small businesses.

Section 2: In this section you are encouraged to assist in the design of a credit policy for small business lending, based on your opinion of what the methodology could be to reduce the credit risk to the bank, and by doing so, allow more access to credit for small businesses.

Section 3: Covers specifically NCA Regulation impacting on small business lending.

Section 4: Covers the Khula Credit Guarantee Scheme aimed at promoting the growth of access to finance for SMMEs in SA.

'Out of the box' thinking is encouraged whilst answering the questionnaire, to look at innovative, creative and sensible ways to lend to small businesses.

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**SECTION 1  
BANKS EXISTING PROPOSITION FOR SMALL BUSINESSES**

**PART A:**

Based on the **existing** product offering and proposition to small businesses by banks, taking a view from your current or past experience, please provide your input on the following statements: *(Please choose the appropriate bullet) where (1 = Strongly agree, 2 = Agree, 3 = Disagree, 4 = Strongly disagree).*

**The banks:**

	1	2	3	4
A1 Understand the needs of small businesses.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
A2 Provide clear lending criteria requirements to small business owners.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

	1	2	3	4
A3 Provide suitable credit products to meet the needs of small businesses.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

A4 Please provide your view on what alternative credit products could be provided by banks to small businesses:

Type here

**Bank credit policy:**

	1	2	3	4
A5.1 Has different lending criteria based on the age of the business (start-ups, and businesses that are longer in existence).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
A5.2 Has different lending criteria based on the size of the business (small and larger businesses).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
A5.3 Takes into consideration the lifecycle stages of the business.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

**Challenges for small business lending:**

	1	2	3	4
A6.1 Unnecessary discrimination against small businesses.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
A6.2 Inability to provide adequate proof of income.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
A6.3 Inability to provide collateral/security.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
A6.4 High default rates.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
A6.5 Insufficient staff to approve credit.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
A6.6 Insufficient experience of bank staff in dealing with small business applications.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
A6.7 High administrative costs.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
A6.8 Difficult to collect the outstanding amount owing to the bank (in instances where the customer defaults).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
A6.9 Branches of the bank are not in areas where there is high small business activity.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

A6.10 Other challenges for the bank to lend to small businesses are the following:

Type here

A6.11Based on your view of these challenges, what could be the starting point for banks

to overcome these challenges? Please specify below:

Type here

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**SECTION 2  
CREDIT POLICY FOR SMALL BUSINESS LENDING**

**PART B:**

Please provide *your view* on what a *proposed* small business lending *credit policy could include* to enable quality small business lending. (Please choose the appropriate bullet) where (1 = Strongly agree, 2 = Agree, 3 = Disagree, 4 = Strongly disagree).

**The following should be accepted as proof of income for small business lending:**

	1	2	3	4
B1.1 Financial Statements and/or Management accounts (Balance Sheet & Income Statement).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B1.2 Cash flow statement.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B1.3 Projected cash flow statement.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B1.4 Personal (owner/s) account bank statements.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B1.5 Business account bank statements.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B1.6 Sales invoices.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B1.7 Purchase receipts.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B1.8 Proof of contract.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B1.9 Income tax return (owner/s).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B1.10 Income tax return (business).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

B1.11 Other, please specify other proof of income types that could be accepted as proof of income for small business lending:

Type here

**B2** How can start-up businesses with a viable business idea, that are not able to provide proof of income, be assisted with finance? Please specify:

Type here

**B3** List what tools in your view are appropriate to evaluate small business applications (e.g. credit scoring models):

Type here

**B4** Choose the most appropriate option. Credit decisions should be:

- Automated
- Subjective
- Combination of the two

**B5** Please advise on how a combined approach (automated decision process together with a subjective decision (by individual/s)) can be implemented:

Type here

**B6** Choose the most appropriate option. Subjective decisions should be done at:

- Head office
- The branch

**Page 5**

	1	2	3	4
<b>B7</b> A credit manager could be responsible for the end-to-end lending process (starting with a visit to the business premises, the assessment process, and the credit decision).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
<b>B8</b> The credit decision should be done by a special advisory committee (e.g. a credit manager, technological expert & economist).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

**B9** What other members could be part of a special advisory committee? Please specify below:

Type here

	1	2	3	4
B10 The credit decision makers could be rewarded with monetary incentives (for an identified target of approvals based on good quality lending).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B11 Small business applicant/s should have the opportunity to present the business case to the credit decision makers/committee.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B12 The bank official who interviews the business applicant should visit the business premises.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B13 The bank credit manager (decision maker) should visit the business premises.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B14 The applicant should not have any direct contact with the credit decision maker/s.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

**MICRO ECONOMIC FACTORS that should be taken into consideration for small business lending assessment:**

	1	2	3	4
B15.1 Viability of business idea (demonstrated in a business plan).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B15.2 Realistic envisaged growth.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B15.3 Projections are in line with past performance.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B15.4 Business experience of owners/members.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B15.5 Qualifications of owners/members.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B15.6 The financial strength of the owners (by obtaining a statement of assets and liabilities of each member/owner).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B15.7 Owner's financial contribution to the business.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B15.8 Clear credit bureau report of owners/members.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B15.9 Clear credit bureau of the business.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B15.10 Owners/members personal credit history with the bank.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B15.11 Business credit history with the bank.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

B15.12 Other, please specify below:

Type here

B16 What is your interpretation of a viable and sustainable business idea?

Type here

**MACRO ECONOMIC FACTORS: The following macro economic factors should be taken into consideration when assessing a small business credit application:**

	1	2	3	4
B17.1 Impact of the economic conditions of the industry in which the business operates.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B17.2 Sufficient potential customers to meet the sales targets.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B17.3 Whether any suppliers have a specific impact on the operations of the business.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B17.4 Whether sufficient research has been done on the competitors of the business.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B17.5 Consumers' ability to influence selling price.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

B17.6 Other, please specify:

Type here

B18 Please list sectors you consider high risk when lending to small businesses (e.g. manufacturing, retailing). Please specify:

Type here

**Page 6**

The following financial ratios/key measures add value when assessing the credit risk of the business application:

	1	2	3	4
B19.1 Liquidity measures (the liquidity of a business is measured by its ability to meet its short-term debt obligations as they fall due).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B19.2 Activity ratios (assess the speed with which current accounts i.e. inventory, debtors and creditors are converted into cash in the business).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B19.3 The ability of the business to repay short term debt (which is due within 12 months).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

	1	2	3	4
B19.4 The ability of the business to repay long term debt (which is due after 12 months).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
B19.5 Analysing the profitability of the business (the profitability of a business can be assessed relative to sales, assets or equity i.e. owners' contribution to financing the business).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

B19.6 The following ratios/key measures should also be taken into consideration for small business lending:

Type here

	1	2	3	4
B20 Financial ratios/measures could carry different weightings (where some ratios are considered more important than others).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

B21 Working capital finance should be the following % of projected annual turnover:

- |                           |                            |
|---------------------------|----------------------------|
| <input type="radio"/> 5%  | <input type="radio"/> 20%  |
| <input type="radio"/> 10% | <input type="radio"/> 25%  |
| <input type="radio"/> 15% | <input type="radio"/> ≥30% |

B22 The period that a small business must be operational to qualify for credit (in months):

- |                            |                            |
|----------------------------|----------------------------|
| <input type="radio"/> ≤ 6  | <input type="radio"/> ≤ 36 |
| <input type="radio"/> ≤ 12 | <input type="radio"/> ≤ 48 |
| <input type="radio"/> ≤ 24 | <input type="radio"/> ≤ 60 |

B23 No tangible collateral security is required if the applicant has a viable business idea (in a business plan for a start- up business).

- Strongly agree
- Agree
- Disagree
- Strongly disagree

**B24** If you disagree to the statement in the previous question, indicate the% security required to total credit granted.

- ≤15%
- ≤25%
- ≤50%
- ≤75%
- ≤100%

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**B25** What can be done to assist the business with credit, instead of declining the application, if an applicant with a viable business idea cannot provide tangible security? Please specify:

Type here

	1	2	3	4
<b>B26</b> The bank should assist small businesses to build up a credit history by providing an initial small value loan to the applicant, and on successful repayment of the loan, grant a higher value loan (apply a step-up value approach).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

The bank could provide the following alternative sources of financing to small businesses:

	1	2	3	4
<b>B27.1</b> Finance equipment for the business, taking a lien over the assets.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
<b>B27.2</b> Provide a factoring option, where the bank buys the existing debtors book (accounts receivable) of the business.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
<b>B27.3</b> Buy into viable businesses by becoming equity holders.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

**B27.4** Other alternative sources of financing for small businesses could include the following:

Type here

	1	2	3	4
<b>B28</b> Start- up businesses should not have to pay any capital	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

	1	2	3	4
portion of a loan during the 1st year of operations (only pay the interest).				
B29 Applicants should have the opportunity to discuss the reason for decline with the decision maker/s that declined the application.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

B30 What could the bank do to assist the business instead of declining the application, where an applicant does not qualify for the full amount applied for?

Type here

B31 There may be a risk in over-lending where an excessive amount may be granted to the business. (E.g. where the business cannot continue to pay if there is a significant change in the market). What in your view can be done to prevent over-lending to the business?

Type here

	1	2	3	4
B32 A central credit bureau, specifically for businesses, would add value to assess the risk of small business lending.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

B33 What data could be stored at this small business credit bureau (e.g. data from registered credit providers, informal lenders such as pawn shops):

Type here

	1	2	3	4
B34 Access to membership data would add value to assessing the risk of the small business application (e.g. with the Liquor Board).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

B35 What membership data could add value in assessing the risk of small businesses:

Type here

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B36 Please list any other innovative ideas on how to improve the lending criteria for small

businesses:

B37 The bank could mitigate credit risk by providing the following support to business owners (e.g. provide training in certain business aspects). Please specify:

	1	2	3	4
B38 There should be a separate small business division in a bank (from application to approval).	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

B39 There should be a separate bank in SA, specifically for small business lending.

- Strongly agree
- Agree
- Disagree
- Strongly disagree

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B40 Please motivate why you feel there should be a bank specifically for small business:

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B41 The following strategies can be implemented to attract small business customers to the bank to apply for credit, (based on the argument that some small business owners may see the banks as a last resort to obtain credit to start-up a business or obtain working capital).

Type here
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### SECTION 3 REGULATION: NATIONAL CREDIT ACT (NCA)

#### PART C:

The National Credit Act, 2005 (that came into effect on 1 June 2007) aims to ensure the regulation of credit granting practices. Please provide your view on the effect of the NCA in general, and on small business lending. (Please choose the appropriate bullet) where (1 = Strongly agree, 2 = Agree, 3 = Disagree, 4 = Strongly disagree).

C1 I am aware of the NCA.

- Yes  
 No

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	1	2	3	4
C2 The NCA allows for more credit to be advanced to businesses.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
C3 The NCA successfully protects the right of the consumer.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

C4 List below any positive impacts that the NCA has had on small business lending, from a banking perspective:

Type here

	1	2	3	4
C5 Small businesses have less access to credit as a result of the NCA.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

C6 Please provide your view on the reason/s for less access to credit below:

Type here

	1	2	3	4
C7 Small business lending has become more expensive for banks since the implementation of the NCA.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

C8 Please list below any negative impacts that the NCA has had on small business lending from a bank perspective:

Type here

C9 NCA regulation could be changed in the following ways, to enhance small business lending:

Type here

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C10 List any other regulation that could be changed or implemented to promote the access of credit for small businesses:

Type here

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### SECTION 4 GOVERNMENT KHULA CREDIT GUARANTEE SCHEME

**PART D:**

The purpose of the Government Khula Credit Guarantee Scheme is to assist banks in lending to small businesses by guaranteeing a portion of the risk should the applicant default. Please provide your view on the effect of Khula Credit Guarantee Scheme on small business lending. *(Please choose the appropriate bullet) where (1 = Strongly agree, 2 = Agree, 3 = Disagree, 4 = Strongly disagree).*

D1 I am aware of the Khula Credit Guarantee Scheme.

- Yes
- No

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	1	2	3	4
D2 The Khula Guarantee Scheme is assisting to increase access to credit for small businesses.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

The biggest challenges for the banks to participate in the Khula Guarantee Scheme are the following:

	1	2	3	4
D3.1 The Guarantee Scheme dictates the maximum interest rate that can be charged.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
D3.2 Red tape in the claims process when a customer defaults.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
D3.3 High cost for the bank in the claims process when a customer defaults.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

D3.4 Other challenges for the bank in participating in the Credit Guarantee Scheme:

Type here

	1	2	3	4
D4 Credit applications that are approved under the Khula Credit Guarantee scheme would have been approved anyway.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

The loan appraisals/approvals should be done by:

	1	2	3	4
D5.1 The Bank.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
D5.2 The Guarantee Scheme.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
D5.3 Dual responsibility between the Bank and the Guarantee Scheme.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

D5.4 Other, please specify below:

D6 Given that the guarantee is granted, will a viable business plan be sufficient without asking for the owners to contribute to the business by way of cash or equipment.

- Yes
- No
- Other, please specify...

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D7 If "no", the owner contribution to the business in either cash or equipment to be used in the business should be:

- 0
- $\geq 5\%$
- $\geq 10\%$
- $\geq 15\%$

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D8 In the case of default by the applicant, the bank should accept X% of the loss and the Guarantee Scheme X%.

- 0/100
- 10/90
- 20/80
- 30/70
- 40/60
- 50/50

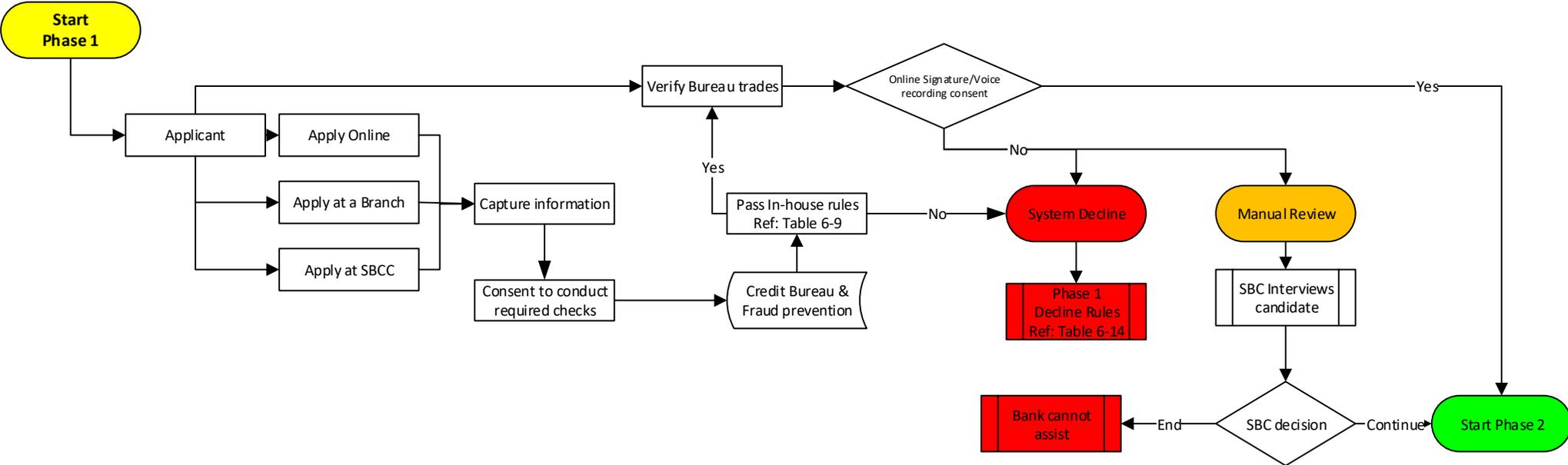
**Thank you for your participation.**

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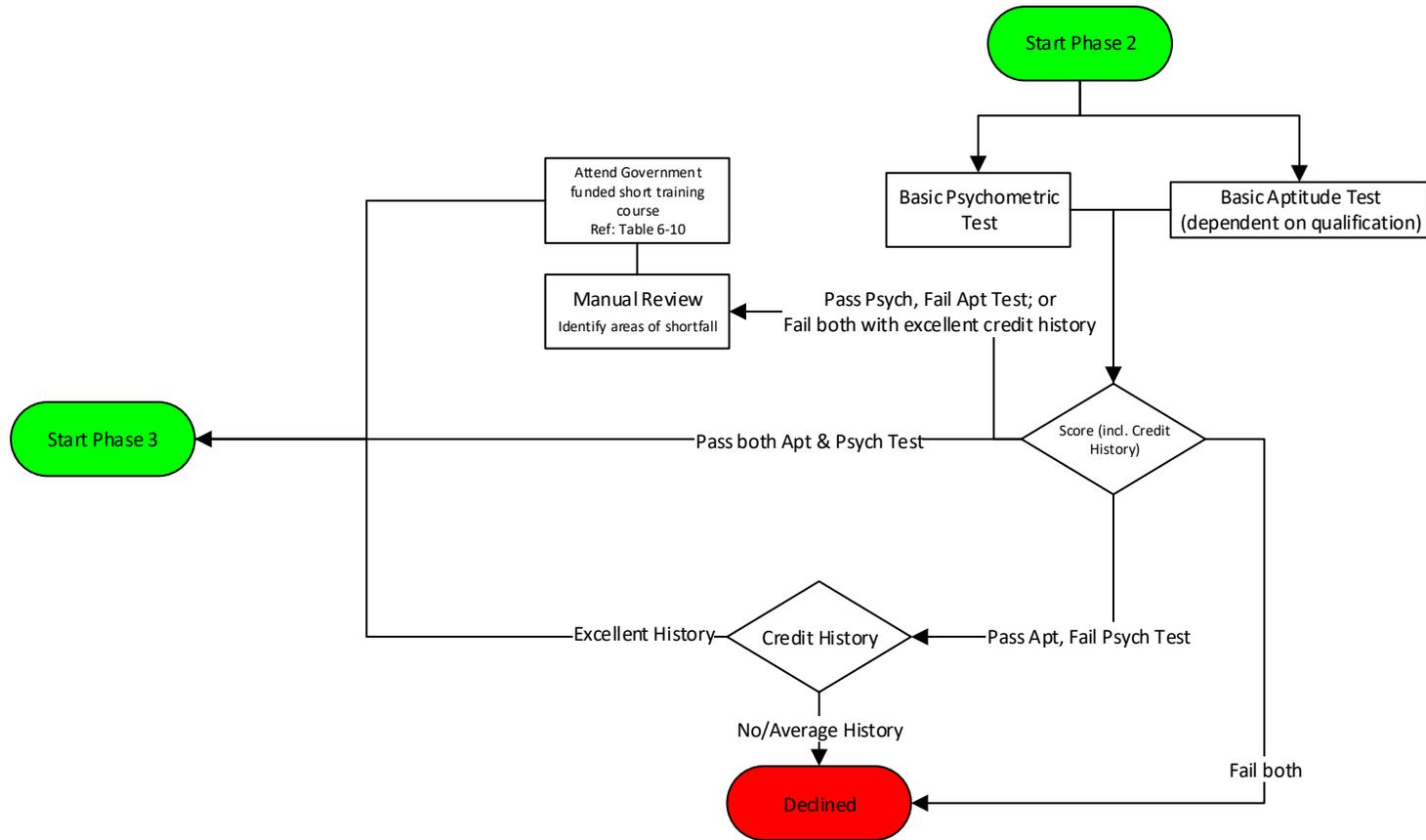


# ADDENDUM B: VALUE-BASED DECISION FRAMEWORK FOR SMALL BUSINESS LENDING

## PHASE 1



## PHASE 2



# PHASE 3

