

# The National Credit Act: Will it increase access to credit for small and micro enterprises?

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## 1 INTRODUCTION

South Africa faces a number of critical challenges, most notably poverty, unemployment and income inequality. The concept of the country having two economies – the first being ‘an advanced, sophisticated economy, based on skilled labour, which is becoming more globally competitive’ and the second being ‘a mainly informal, marginalised and unskilled economy, populated by the unemployed and those unemployable in the formal sector’ – nicely captures the structural consequences of these problems.<sup>2</sup> Certainly, this deep division is a long way from government’s vision of a ‘prosperous, equitable, stable and democratic society [and]...of decent work and living standards for all’.<sup>3</sup>

The promotion of the small, medium and micro enterprise (SMME) sector has long been advocated by government as a way of accelerating job creation and poverty alleviation, and thereby assisting in bridging the inequality gap.<sup>4</sup> This has resulted in a number of policies and programmes that have sought to remove obstacles to SMME development as well as stimulate their growth. Access to finance has been identified as one of the most important factors that hamper SMMEs’ potential to succeed.<sup>5</sup>

SMMEs, however, have proved to be a difficult target for policy-makers, not least because what is good for medium-sized enterprises is not necessarily good for micro enterprises. This is evident in the case of access to credit. While access to credit is a challenge for SMMEs in general, micro and small enterprises

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- 2 The Presidency *Towards a Ten Year Review* p 97 as cited in DBSA *Overcoming underdevelopment in South Africa’s second economy, 2005 Development Report* p 35 and ‘Approaches to poverty reduction and economic development VII: transform the second economy’ 2004 26(4) *ANC Today* 1.
- 3 *ANC Umrabulo* 2 p1
- 4 Small, medium and micro enterprises are a diverse group of enterprises. They are defined in the National Small Business Act 102 of 1996 according to a number of criteria. There is general consensus that the different size categories of SMMEs serve different purposes: while micro and small enterprises are generally associated with poverty alleviation, medium enterprises have been identified as the major vehicle for employment generation.
- 5 Other factors include access to markets, management and technical skills, technology and finance.

(MSEs)<sup>6</sup> experience this problem more acutely than established medium-sized enterprises.<sup>7</sup> MSEs can be defined as owner-driven and owner-managed enterprises with less than 50 employees,<sup>8</sup> usually initiated out of necessity due to a lack of better choices for work,<sup>9</sup> that exist along a continuum of varying degrees of formality.<sup>10</sup> Another defining feature of MSEs is that most are 'unbanked', that is they cannot access credit from the mainstream financial sector: commercial banks, large investment houses and commercial credit providers.<sup>11</sup>

MSEs are unbanked for a number of reasons. The main reason is that most financial institutions are reluctant to lend to MSEs because of the high cost of servicing loans to such firms relative to the size of the loan.<sup>12</sup> It is generally accepted that the cost of servicing a loan is the same regardless of the amount involved.<sup>13</sup> The transaction cost per Rand lent is therefore much higher for small loans than for larger loans, making smaller loans less profitable.<sup>14</sup> Furthermore, interest regulations may limit the loan sizes from which credit providers can legally recover these costs and make a profit.<sup>15</sup> Because smaller loans are relatively more costly it appears that banks are not willing to enter the SMME market below a threshold of R250 000.<sup>16</sup> This has created a gap in credit provision for smaller loans.

Risk factors also hinder lending to MSEs. Risk assessment, which is highly standardised in formal financial institutions and based on the credit histories of potential borrowers, rules out many small and micro entrepreneurs because they lack documented credit histories.<sup>17</sup> In addition, formal financial

- 6 Angela Motsa and Associates *SMME finance sector background paper: a review of key documents on SMME finance 1994-2004* (2004) Paper commissioned by Finmark Trust p 6.
- 7 Berry A, Von Blotnitz M, Cassim R, Kesper A, Rajaratnam B, Van Seventer D E *The Economics of SMMEs in South Africa* (2002) paper for Trade and Industrial Policy Strategies p 4; Angela Motsa (fn 6 above) 16; Ligthelm A 'Informal trading through home-based micro-enterprise: the role of spaza shops' 2005 22(2) *Development Southern Africa* 199 211.
- 8 This is the threshold that defines a small business for all sectors in the National Small Enterprise Act 102 of 1996.
- 9 Angela Motsa (fn 6 above) 6.
- 10 Formality relates to the extent to which economic activities of an enterprise comply with legal regulations. An enterprise is 'informal' to the extent that its operations do not comply with legal regulations – either because they do not apply to the enterprise or due to non-compliance with applicable regulations. It is possible for an enterprise to comply with some legal regulations and not comply with others. Thus, 'formality and informality do not constitute a dichotomy, but a continuum.': Reinecke, G and White, S *Policies for small enterprises: Creating the right environment for good jobs* (2004) p 52.
- 11 Schoombie A 'South African banks and the unbanked: progress and prospects', Paper presented at the Biennial Conference of the Economic Society of South Africa, Somerset West, 2003 p 5.
- 12 The costs include those of screening potential borrowers in order to determine risk and default and of creating and implementing incentives and enforcement mechanisms to ensure repayment.
- 13 Berry *et al* (fn 7 above) 72.
- 14 Schoombie (fn 11) 5.
- 15 *Ibid.*
- 16 There are some indications that R 100 000 is the minimum level at which banks are willing to enter the SMME market. However, the few alternative financial institutions that exclusively target unbanked MSEs indicate that banks largely ignore the market below R250 000. In addition, Khula also indicates the need to focus on the market for loans below R250 000. While the R10 000 to R100 000 range is a critical gap in the provision of credit, R250 000 will be used as a guideline to identify the unbanked MSE market. Submission by Small Enterprise Foundation and other developmental credit providers at the Public Hearings on the National Credit Bill on 08/08/2005.
- 17 Jaffer J 'Microfinance and the mechanics of solidarity lending: Improving access to credit through innovations in contract structure' 1999 9 *J. Transnational law and policy* 183; Angela Motsa (fn 6 above) 16-17.

institutions determine that most micro and small entrepreneurs do not have sufficient experience and lack adequate managerial skills to ensure the viability of the enterprise.<sup>18</sup> Finally, the majority of micro and small entrepreneurs lack the conventional collateral (in the form of immovable property or valuable movables) that formal financial institutions require as security in the event of default.<sup>19</sup>

In South Africa an added twist is that the majority of MSEs are black-owned. Historically, private sector financial institutions such as banks and investment houses have been racially and economically exclusive.<sup>20</sup> Until recently, very few alternative institutions existed to serve the needs of less affluent, black entrepreneurs. Furthermore, it is arguable that given the legacy of apartheid the risk factors relating to credit histories, managerial expertise and collateral affect black entrepreneurs more than their white counterparts.<sup>21</sup> This is another reason why MSEs have greater difficulty in accessing credit from the formal financial sector<sup>22</sup> than more established medium-sized enterprises, many of which are white-owned.<sup>23</sup>

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. This framework has proved woefully inadequate to the task of regulating the sector, compounding some of the problems outlined above and failing to provide a platform for the development of SMMEs. It became increasingly evident to policy-makers and stakeholders during the 1990s that a new regulatory framework was needed. Such a framework would have multiple goals given the diversity of the credit industry, but a key aim would have to be the radical improvement of access to credit for SMMEs.

Government's response was the National Credit Act.<sup>24</sup> The statute comprehensively overhauls the regulatory system for the credit industry and promises to have far-reaching consequences for most businesses and many individuals. The bulk of its provisions indicate that the Act's main objectives are to regulate the commercial aspects of credit provision and to protect vulnerable borrowers, but it does provide some innovations in respect of access to credit for SMMEs. The question is whether it has done enough with regard to the latter to make a significant impact on SMME development and thereby make inroads into the unemployment, poverty and income inequality that underpin the deep schism in the South African economy.

18 Interviews with staff of financial institutions and NGO credit providers.

19 Schoombie (fn 11 above); Schoombie A 'Getting South African Banks to serve micro-entrepreneurs: An analysis of policy options' *Development Southern Africa* 17(5) 2000 751 p 762; Angela Motsa (fn 6 above) 16; Berry *et al* (fn 7 above) 96.

20 For a more detailed discussion of the history of the financial sector in relation to SMME finance, see Meagher P and Wilkinson B 'Filling the Gap in South Africa's Small and Micro Credit Market: An analysis of major policy, legal and regulatory issues' (2001) Report submitted to the MFRC p 4 ff and Porteous D 'Is Cinderella finally coming to the ball? SA micro finance in broad perspective' Undated draft at [www.finmark.co.za](http://www.finmark.co.za) 3.

21 Berry *et al* (fn 7 above) 74.

22 Berry *et al* (fn 7 above) 79; Angela Motsa (fn 6 above) 11, 15-16.

23 Berry *et al* (fn 7 above) 74.

24 34 of 2005.

This article provides a critical analysis of the National Credit Act and the extent to which it is able to provide for and maintain a sustainable basis for SMME development. It is based upon an examination of the statute itself, the Bill that preceded it and the subsequent Parliamentary Portfolio Committee hearings, as well as interviews with key players in the credit industry.<sup>25</sup> While it is still very early days given that the Act has only recently been promulgated, the article seeks to draw some conclusions regarding the likely impact of the NCA on credit provision for unbanked micro and small enterprises. Given the fact that the analysis concentrates on the changes as against the previous regime, and is not a full-scale economic analysis, the conclusions drawn are tentative.

The starting point for the enquiry is a brief examination of the regulation of credit under the Usury Act<sup>26</sup> and its exemptions of 1992 and 1999 respectively. The next section outlines the moves to reform the credit industry, from the formulation of the National Credit Bill to the Parliamentary Portfolio hearings on the Bill. The section thereafter focuses on the main provisions of the National Credit Act as well as the key provisions dealing with a special category of credit agreements known as developmental credit agreements. The final section discusses the extent to which the Act will promote the provision of credit to MSEs.

## 2 THE PRIOR REGULATORY FRAMEWORK

The Usury Act, introduced in 1968, prescribed interest rate ceilings for loans. The prescribed rates applied to loans irrespective of their purpose and it was an offence to charge interest in excess of the stipulated ceiling. The aim of the statute was to protect individuals from credit providers that charged excessive rates of interest.<sup>27</sup>

The Act, however, had a perverse consequence in that the maximum interest rates it allowed did not off-set the transaction costs of providing smaller loans. Large financial institutions therefore had no incentives to serve the lower end of the market. Certain lobby groups criticised the Act on this ground, arguing that the interest rate limitations were not conducive to the provision of loans to emergent small enterprises.<sup>28</sup> The Law Review Project<sup>29</sup>

25 The research upon which this article is based was conducted under the auspices of the Labour and Enterprise Policy Research Group at the University of Cape Town as well as for postgraduate qualifications. The authors are grateful for the insights and contributions of the following people who provided interviews: Mr Stephen Curry, Western Cape Regional Manager of the Umsobomvu Youth Fund; Ms Adri Du Toit, Legal Advisor, Casidra (Pty) Ltd; Mr Opar Ledwaba General Operations Manager, Free State Development Corporation; Mr Patrick Mabueta, Country Manager, Oikocredit Co-operative South Africa; Mr David Mandell, Branch Manager, Eastern Cape Development Corporation; Mr N Naidoo, Manager, Khethani Business Finance Ltd; Mr Hadle Peterson, Chief Financial Officer, Business Finance Agency; Mr George Watson, Managing Director, New Business Finance (Pty) Ltd; Mr Mateo Zanetik, Financial Advisor, Small Enterprise Foundation; and Mr Lusizo Zulu, Divisions Manager: Finance and Administration in Financial Services, Ithala Development Corporation. The interviews were conducted telephonically using semi-structured questionnaires between August and October 2006.

26 73 of 1968.

27 Schoombie (fn 20) 755.

28 *Ibid.*

29 The Law Review Project is a NGO that was established to formulate, propose and promote legislative change with the aim of promoting economic development.

submitted proposals to the Minister of Trade to make small loans more viable for financial institutions in order to encourage loans for small enterprises.<sup>30</sup>

As a result of the proposals, in 1992 the Minister granted an exemption to the interest limitations set in terms of the Usury Act.<sup>31</sup> The exemption applied to 'micro-loans', defined as loans of less than R6 000 granted for periods shorter than 36 months. The aim of the exemption was to allow credit providers to charge unlimited interest for micro loans so that they would be able to recover the full costs of the loan and make a profit, thus making the MSE credit market more attractive and 'spur[ing] growth in lending to micro, small and medium enterprises'.<sup>32</sup>

The 1992 exemption, however, was not restricted to loans advanced for SMME development. Instead, it applied to all loans falling within the prescribed monetary and time limit, irrespective of their purpose. The objective to develop SMMEs was therefore conditioned by a broader policy approach termed the 'market development' approach, that is, that government should limit its role to creating the right conditions to allow the market for SMME micro-credit to grow rather than intervene more directly by prescribing how the market should allocate credit.<sup>33</sup>

The exemption was problematic for a number of reasons. The choice of the R6 000 ceiling was inappropriate because it was well below the minimum amount that credit providers could viably lend within the interest rate limitations. In other words, there were good grounds for setting the ceiling much higher. The prescribed threshold meant that loans below R6 000 could attract unlimited interest irrespective of their purpose, while SMME development loans between R6 000 and about R50 000<sup>34</sup> were still subject to the Usury Act restrictions and therefore unviable for credit providers. Thus, by imposing too low a ceiling, the exemption did not apply to the full range of loans that SMMEs, and particularly MSEs, required.<sup>35</sup> A critical gap in credit provision therefore remained.

A second problematic aspect of the exemption was that it did not take account of the purpose of the loan: any loan below R6 000 could attract the benefit of the exemption, whether or not its purpose was to finance an SMME. The exemption therefore failed to provide any incentive to specifically extend micro loans to SMMEs. This shortcoming created perverse incentives for entry into the micro credit industry,<sup>36</sup> with commercial lenders and furniture retailers soon dominating the market, lending predominantly

30 Schoombie (fn 11 above) 5.

31 Government Notice No. 3451 of 1992.

32 Schoombie (fn 20 above) 755; Coetzee G K ; Druschel K A; Cook L D; Brislin N W; Meagher J P; Roland N W ; Pearson R V 'The Evolution of the South African microfinance sector from 1992 to 2004: the Micro Finance Regulatory Council' (2005) Report prepared for ECI Africa and Iris Centre at the University of Maryland p 13.

33 Coetzee *et al* (fn 34 above) 14.

34 Arguably the minimum that commercial credit providers could profitably lend within the interest rate stipulations that existed at that time.

35 Treasury Department 'SMEs access to finance in South Africa' [www.treasury.gov.za](http://www.treasury.gov.za) 171.

36 *Ibid.*

to salaried workers for consumption purposes.<sup>37</sup> These lenders concentrated on the borrower's ability to repay and not on the purpose of the loan.<sup>38</sup> As a result, the exemption facilitated the growth of a micro credit industry that had little interest in developmental finance.<sup>39</sup>

A third problem was that the exemption did not impose any checks on the conduct of micro lenders. Save for prohibitions on deposit-taking and on investments from non-family members, micro lenders were largely left to their own devices.<sup>40</sup> In the absence of regulations, micro lenders exploited desperate and vulnerable borrowers and significantly contributed to their over-indebtedness. This situation was exacerbated when the state granted lenders access codes to its salary system to enable them to deduct instalments directly from civil servants' salaries.<sup>41</sup> Large private sector employers soon followed suit.<sup>42</sup> These measures reduced the risk of lending and lowered collection costs, opening a Pandora's Box of unsecured lending to salaried employees.<sup>43</sup> Again, the emphasis was on consumption lending rather than on lending to advance developmental objectives.

The undesirable situation caused the Minister of Trade and Industry to threaten to revoke the 1992 exemption and subsequently to announce his intention of raising the exemption ceiling to R50 000. The Minister's threat sparked a five-year debate between stakeholders, with some interest groups demanding tighter regulation of the industry to protect vulnerable salaried workers and micro lenders arguing for preservation of the *status quo*.<sup>44</sup> The controversy ended with the publication of a revised exemption to the Usury Act in 1999, which lifted the exemption ceiling on loans to R10 000.<sup>45</sup> The need to raise the threshold was tempered by a countervailing need to protect consumption borrowers from over-exposure to credit, with the result that it remained well below the level that would have significantly impacted on lending to SMMEs and did not close the gap in credit provision.<sup>46</sup> Importantly, the rationale behind the new ceiling indicated a shift in the purpose and orientation of the exemption from development towards consumer protection.

The 1999 exemption, however, did introduce some positive changes. Importantly, it provided a regulatory system for the micro credit industry. The exemption from the interest rate limits set in terms of the Usury Act applied only if the micro lender complied with the conditions stipulated in the exemption. In order to enforce compliance, the exemption designated the Micro Finance Regulatory Council (MFRC) as the regulatory body for the industry.<sup>47</sup> Lenders providing micro loans had to register with the MFRC and comply with its

37 Meagher and Wilkinson (fn 21 above) 5.

38 *Ibid.*

39 Porteous (fn 21 above) 4; Treasury Department (fn 37 above) 171.

40 Meagher and Wilkinson (fn 21) 5.

41 Porteous (fn 21 above) 3.

42 *Ibid.*

43 *Ibid.*

44 Coetzee *et al* (fn 34 above) 13; Schoombie (fn 20 above) 756.

45 Meagher and Wilkinson (fn 21 above) 6.

46 Schoombie (fn 20 above) 756.

47 The MFRC was a government-funded, non-profit institution established in terms of section 21 of the Companies Act. Its mission was to promote the sustainable growth of the micro-credit industry and to ensure the protection of consumer rights.

rules. Its main functions were to investigate compliance with the MFRC Rules and the 1999 exemption notice, to investigate and discipline unregistered lenders, to publish industry-related information and to initiate research on relevant issues.<sup>48</sup> In addition, it had to maintain the National Loans Register, the purpose of which was to record all transactions by registered micro lenders.<sup>49</sup>

At this stage there was broad consensus that the focus of regulating micro credit had shifted from SMME promotion to the protection of borrowers from lenders' exploitative practices, such as the over-extension of credit,<sup>50</sup> illegal collection methods and improper inducements.<sup>51</sup> In line with this shift it is apparent that the MFRC paid little attention to SMME lending. A factor that probably played its part in this change of emphasis was government's promotion of wholesale credit provision through the establishment of Khula Enterprise Finance Limited. The objective of Khula was to provide wholesale credit to retail financial institutions that would lend this on exclusively to SMMEs.<sup>52</sup>

Commercial banks' reaction to the two exemptions deserves special attention. Although initially reluctant to enter the micro loan market, they gradually changed their policies and either opened separate micro loan divisions or entered partnerships with and acquired stakes in existing commercial micro lenders.<sup>53</sup> Since then the major banks have disbursed loans worth billions of Rand through their micro loan divisions or subsidiaries, but the bulk of these loans have been advanced to low-income salaried workers for consumption purposes.<sup>54</sup>

On a more positive note, a number of non-governmental organisations (NGOs) were established to provide loans to small enterprises after the transition to democracy. Many of them served the lower end of the market, namely survivalist and micro entrepreneurs. They restricted their focus to loans below R10 000 in order to benefit from the exemption and achieve full cost recovery, but were critical of the low and restrictive ceiling within which

48 *Ibid.*

49 The National Loans Register gave lenders information on existing micro loans and the creditworthiness of potential borrowers. From 1 July 2002 it became compulsory for lenders to submit information relating to micro loans to the register and to inquire into a potential borrower's credit before lending: [www.mfrc.co.za](http://www.mfrc.co.za).

50 In June 2000 the government withdrew payroll deduction facilities for civil servants on unsecured loans, which had a serious impact on the micro credit industry: Angela Motsa (fn 6 above) 21. This was in response to rising over-indebtedness amongst civil servants, who made up a significant portion of borrowers. In the absence of stable collection alternatives, many lenders were unable to collect arrears and suffered huge losses, and this directly and indirectly caused two of the biggest bank collapses (Saambou and Unibank) two years later: Porteous (fn 21 above) 6.

51 Coetzee *et al* (fn 34 above) 14.

52 *Ibid.* Wholesale level intervention involves a wholesale or apex financial institution providing wholesale credit to retail credit providers who in turn on-lend to borrowers. Khula Enterprise Finance Limited was established in 1996 in terms of the National Small Enterprise Act.

53 For a detailed discussion of the banks' participation in the micro credit industry, see Schoombie (fn 11 above) 5-9 and Schoombie (fn 20 above) 756-7.

54 Schoombie (fn 11) 8. Standard Bank initiated a micro enterprise pilot project in four black townships in 1993. However, it terminated the project in 1996 on the grounds that the R6 000 ceiling was too low. It also cited the relatively high wage and security costs and the negative image that would be gained from charging full costs and therefore high interest rates. The latter concern was shared by most of the other large banks: Schoombie (fn 20 above) 756-7. ABSA's micro loans division NuBank made a commitment of 10% of its loan book to micro enterprises in the initial stages: Schoombie (fn 11 above) 8.

they were forced to operate.<sup>55</sup> The upper limit on their lending had the result that the growth of many of their clients' enterprises was stunted at the critical stage when they were beginning to excel and gain capacity.<sup>56</sup>

The general consensus is that the exemptions made micro loans more lucrative and increased consumption-oriented micro-lending but did not significantly increase access to credit for SMMEs, nor for MSEs in particular.<sup>57</sup> While a number of NGOs entered into the industry to provide micro loans to MSEs under the exemptions, they constituted a tiny part of the industry. In the period 2004 to 2005 only 4% of the R17 billion worth of micro loans disbursed had been used to finance small enterprises.<sup>58</sup>

### 3 CHANGING THE REGULATORY FRAMEWORK FOR CREDIT

In 2002 the Department of Trade and Industry (DTI) established a Technical Committee to review the consumer credit legislation and submit recommendations for a new regulatory framework. Their research and efforts culminated in a report submitted to the Minister in October 2003.<sup>59</sup> The report identified a number of areas for policy and regulatory reform, and after careful consideration the DTI drafted the *Consumer Credit Policy Framework*.<sup>60</sup> This document subsequently led to the drafting of the National Credit Bill, which was published for public comment in early 2005.

The National Credit Bill was an attempt to consolidate the different aspects of the loan industry covered by the Usury Act and the Credit Agreements Act<sup>61</sup> under a single piece of legislation. It therefore aimed to regulate all aspects of the credit agreement, defined as a credit facility, a credit transaction, a credit guarantee, or any combination of these which were entered into between a natural person and a credit provider. In line with this aim the Bill sought to:

- improve transparency;
- prohibit unfair contractual terms and practices;
- prohibit anti-competitive practices;
- curb reckless credit extension;
- provide measures to assist over-indebted consumers;
- regulate information acquired, held and reported by credit bureaux;
- create a central register of debt obligations; and
- establish a Credit Regulator and Credit Tribunal for effective enforcement.

The Bill also created two special categories of credit agreements, namely developmental credit agreements and public interest credit agreements. The former focused on, amongst other things, the SMME sector.

55 Submission by Small Enterprise Foundation (fn 16 above).

56 Submission by Small Enterprise Foundation (fn 16 above).

57 Schoombie (fn 20 above) 755, Coetzee *et al* (fn 34 above) 14.

58 MFRC Fact Sheet accessed at [www.mfrc.co.za](http://www.mfrc.co.za).

59 The result was the *Credit Law Review (2003)* published by the DTI.

60 *Consumer Credit Law Reform: Policy framework for Consumer Credit* (2004), published by the DTI.

61 75 of 1980.



## THE NATIONAL CREDIT ACT

On 5 August 2005 the Department of Trade and Industry's Portfolio Committee began public hearings on the National Credit Bill. Because of its wide scope and potentially far-reaching consequences, the Bill received a lot of publicity and was hotly debated. Submissions were made by a large number of bodies and individuals, including public interest groups, academics, political parties, legal practitioners, banks, credit providers, retail outlets, telecommunications companies and the infamous credit bureaux. The public hearings stretched over two weeks to accommodate the large volume of submissions.

Many credit providers such as banks and retailers objected to a number of the provisions on the grounds that they imposed costly and burdensome obligations on them. These included the duties to conduct investigations to prevent reckless lending and to send monthly statements to borrowers. Retailers also complained that the five-day cooling off period afforded to those who bought goods on credit was prejudicial to them. The most emotive topic, however, related to the role of credit bureaux in providing information to credit providers and the (sometimes unwarranted) blacklisting of borrowers. The respective roles of and interaction between the National Credit Regulator and the National Credit Tribunal were also scrutinised. In addition, some stakeholders were concerned about the cost of and exercise of choice in obtaining credit insurance.

As noted above, the Bill made reference to a special category of credit agreements termed developmental credit agreements. These were defined as credit agreements entered into for the purpose of small business development, education and low-income housing. Remarkably, the provisions relating to developmental credit agreements received almost no attention during the course of the public hearings, with only one submission being made in relation to them.<sup>62</sup> The latter submission raised concerns about the proposed interest rate limits that would apply to developmental credit and appealed for special consideration to be given to the high cost of credit associated with lending small amounts to low income groups. In addition, the submission argued that developmental credit providers should be exempted from the requirement to register their credit agreements on the proposed National Credit Register, or alternatively, they should be exempted from having to provide the addresses of their clients where this information was not available.

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<sup>62</sup> The submission was made by credit providers that were providing micro loans for small business development and low-income housing in terms of the 1999 exemption. The group was represented by the Small Enterprise Foundation, one of the leading micro enterprise credit providers in South Africa.

A number of amendments were made to the Bill after the public hearings and it was finally gazetted as law in March 2006, although its commencement will take place in stages.<sup>63</sup>

## 4 THE NATIONAL CREDIT ACT

### 4.1 General Provisions

The National Credit Act aims 'to promote and advance the social and economic welfare of South Africans, promote a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry'.<sup>64</sup> The Act emphasises the needs of South Africans who have historically been unable to access credit under sustainable conditions.<sup>65</sup> It also aims to promote a responsible credit market and balance the countervailing rights of consumers and credit providers.<sup>66</sup> It further regulates consumer credit information and reporting; over-indebtedness and reckless lending; debt enforcement and dispute resolution.<sup>67</sup>

The Act applies only to 'credit agreements between parties dealing at arm's length'<sup>68</sup> and excludes certain transactions from its ambit.<sup>69</sup> Section 8 defines credit agreements as credit facilities, credit transactions and credit guarantees. Loans for money will fall under the scope of credit transactions or credit facilities and are therefore subject to the Act.

The Act establishes the National Credit Regulator (NCR) to regulate the credit industry and realise its objectives. In terms of the Act, the NCR assumed the assets and liabilities of the MFRC and also took over its employees, including the CEO (who was extensively involved in the drafting of the Act).<sup>70</sup>

63 In terms of *Government Gazette* 28824 of 11 May 2006:

- Sections 1-11 (definitions, interpretation, application and purpose), 12-25 (establishment of the NCR and its functions), 35-38 (administration matters), 39-59 (consumer credit industry regulation), 69 (National Credit Registry), 73 (verification, review and removal of consumer credit information), 134-152 (dispute settlement other than debt enforcement), 153-162 (enforcement of the Act), 164-170 (miscellaneous matters), 171-173 (Ministerial regulations, conflicts with other legislation, repeal and short title and commencement), Schedule 1-3 (rules concerning conflicting legislation, amendment of laws and transitional provisions): came into operation on 1 June 2006;
- Sections 26-34 (National Consumer Tribunal), 67 (conflicting legislation), 68 (right to confidential treatment), 70 (credit bureaux information) and 72 (right to access and challenge credit records and information) came into operation on 1 September 2006; and
- Sections 60-66 (consumer credit policy), 71 (removal of judgments), 74-88 (credit marketing practices, recklessness and over-indebtedness), 89-123 (unlawful credit agreements; disclosure; consumer liability for interest, charges and fees; statements of account; alteration of credit agreements; rescission and termination of credit agreements), 124-133 (collection, repayment, surrender and debt enforcement) and 163 (agents): came into operation on 1 June 2007.

64 Section 3 of the Act.

65 *Ibid.*

66 *Ibid.*

67 *Ibid.*

68 *Ibid.*

69 Section 8(2) of the Act excludes the following transactions from the definition: insurance policies extended solely to maintain the payment of premiums on an insurance policy; leases of immovable property, and transactions between stokvels and their members. Section 4 of the Act excludes the application of the Act to certain credit agreements.

70 Item 8 of Schedule 3 to the Act.

## THE NATIONAL CREDIT ACT

One important function of the NCR is the registration and regulation of role players in the credit industry.<sup>71</sup> A person (natural or juristic) who is a credit provider in terms of at least 100 credit agreements or who is owed a total principal debt exceeding a minimum prescribed amount, is obliged to register with the NCR.<sup>72</sup> Registered credit providers must comply with the conditions of registration and the provisions of the Act. Sections 15 and 55 provide the NCR with wide-ranging powers to ensure compliance.<sup>73</sup> The NCR must monitor and investigate the conduct of credit providers and must also establish mechanisms to enable the public to make complaints and must conduct informal dispute resolution. The NCR may issue compliance notices against non-compliant credit providers and may refer contraventions of the Act for prosecution.

In addition, section 69 of the Act requires the NCR to establish and maintain a national register of outstanding credit agreements. A registered credit provider will be obliged to record every credit agreement it enters into on the National Credit Register.<sup>74</sup> It will also have to record details of each transaction, the details of the consumer involved and particulars relating to the termination or satisfaction of the credit agreement.<sup>75</sup> Previously, credit providers only had to comply with similar registration requirements in respect of micro loans granted in terms of the 1999 Exemption; no register was kept for other credit agreements. In the absence of unfavourable information listed with the credit bureaux or full disclosure by a potential borrower, credit providers were unable to establish the full debt exposure of potential borrowers before advancing them credit.

In the long-term the registration requirement will probably have some impact on lending to unbanked MSEs. One objection by large banks and commercial credit providers to lending to (particularly emergent) entrepreneurs has been that they do not have a credit history as information relating to their debt exposure and repayment profiles is not readily available.<sup>76</sup> They also claim that it is more expensive to perform a credit assessment of such an enterprise or entrepreneur.<sup>77</sup> The new Act should overcome these barriers by ensuring that a small enterprise's (or entrepreneur's) credit history will be available to a potential credit provider. As all registered credit providers will be required to record their agreements and will have access to the information on the Register, they will share the costs and benefits of using the Register. However, this information will only be generated where micro and small entrepreneurs obtain credit from formal, registered credit providers.

Another section of the Act could have ramifications for SMME credit. In the event that a potential borrower, in this context an entrepreneur, lacks a credit history or is blacklisted, and lacks sufficient security for a loan, a credit provider may have recourse to section 106 of the Act. This section states that

71 Section 14 of the Act.

72 Section 41(1) of the Act.

73 Section 15 read with section 55 of the Act.

74 Section 69(2) of the Act.

75 Section 69(2) read with section 69(3) of the Act.

76 Treasury Department (note 37) p 174.

77 *Ibid.*

a credit provider is entitled to require a borrower to take out a credit life insurance policy for the duration of a credit agreement. This will enable a credit provider to be compensated for the outstanding amount in the event that the borrower defaults. The borrower will have a choice as to whether to take out a policy provided by the credit provider or by any other insurer. While it is impossible to speculate about the extent to which SMME credit providers will make use of this provision, it would certainly provide greater security with certain clients. However, the high risk involved will increase the insurance premiums and consequently the cost of credit for entrepreneurs required to take out credit insurance.

#### 4.2 Developmental Credit Agreements

Besides the above more general provisions that will have an impact on SMME credit, and MSE loans in particular, the Act retains the special category of credit agreements – known as developmental credit agreements – introduced in the Bill.<sup>78</sup> An agreement, irrespective of its form, type or category is a development agreement if it is in respect of education, low income housing or the development of a small business as defined in the National Small Enterprise Act.<sup>79</sup> Loans to SMMEs therefore qualify as developmental credit agreements.

Developmental credit agreements are accorded special treatment in three ways. First, the Act imposes a duty on the National Credit Regulator to take measures to increase the provision of developmental credit for entrepreneurs. Second, developmental credit providers may be entitled to statutory exceptions from the Act, provided they undergo supplementary registration.<sup>80</sup> Third, the Regulations in terms of the Act make special provision for interest rates that may be charged in respect of SMME loans. Each instance of special treatment is discussed in more detail below.

Section 13 of the Act provides that an accessible credit market must cater for *inter alia* the needs of historically disadvantaged and low income persons and communities. The section also requires the NCR to monitor and report to the Minister on access to credit by SMMEs. This shows that they are a group requiring special attention as far as access to credit is concerned. Thus, section 13 requires the NCR to take measures to encourage the provision of SMME credit agreements.

<sup>78</sup> S 10(1) of the Act.

<sup>79</sup> The Minister may prescribe any other purposes for these agreements. A non-profit credit agreement between a credit co-operative and its member qualifies as a development agreement if the principal amount is less than R15 000.

<sup>80</sup> In terms of section 41 the requirements for supplementary registration are:

- the credit provider must be a close corporation, credit co-operative, trust, statutory entity, mutual bank or bank;
- the credit provider must be registered with the South African Revenue Service;
- the credit provider is not managed or controlled by a disqualified person;
- the credit provider has sufficient resources or the capacity to acquire the necessary resources to effectively perform its functions;
- the credit provider has an adequate administrative system or a plan to develop such a system to justify exemption from certain provisions of the Act.

The NCR may use a number of its general powers to fulfil its responsibility to increase SMME access to credit. It may conduct research, audits and investigations to establish and investigate demographic patterns, socio-economic trends, the promotion of black economic empowerment, and the needs of previously disadvantaged, low income communities in the credit market.<sup>81</sup> It must also establish and maintain relations with other regulatory authorities.<sup>82</sup> In discharging this responsibility it may initiate dialogue and liaise with any regulatory authority that may have an interest in or a role to play with regard to SMME credit.

Because the NCR has only recently been established, its role in encouraging greater SMME credit provision and the measures that it will take are yet to be seen. However, there is a question mark over its functioning in this regard. The public hearings indicate that developmental credit agreements were not a matter of urgency or even priority; technical commercial provisions and consumer protection attracted most of the attention. In addition, the National Credit Regulator took over its core staff and functions from the MFRC, which paid very little attention to SMME credit during its existence. It is therefore unlikely that the NCR will (particularly during the initial stages) commit significant resources towards efforts to increase SMME access to finance.

The second instance of special treatment is that section 41 requires credit providers wishing to extend developmental credit to undertake supplementary registration in order to qualify for 'statutory exceptions from this Act'. Applicants for supplementary registration must show that they have 'adequate' administrative procedures to justify the application of the statutory exceptions. The only reference to a possible 'statutory exception' for developmental credit providers in the Act itself is 69(6), which provides that the Minister may provide 'alternative requirements' with respect to the registration of details of developmental credit agreements on the National Credit Register.<sup>83</sup> The Bill that was debated in Parliament in August 2005 did not contain this provision. It was arguably added as a concession to the demands of developmental credit providers during the course of the public hearings.<sup>84</sup>

Developmental credit providers raised concerns that compliance with the requirement to record credit agreements on the National Credit Register might be too costly and would adversely affect their sustainability.<sup>85</sup> They also proposed that in recognition of their methodologies<sup>86</sup> and their empowerment agenda, the Act should exempt the non-collateralised loans from the reporting requirements.<sup>87</sup> They argued that at the very least they should be exempted from providing the addresses of their clients, as many of their clients living in townships cannot furnish proof of their addresses.<sup>88</sup>

81 S 16 of the Act.

82 S 17 of the Act.

83 S 69(6) of the Act.

84 These were developmental credit providers providing loans for less than R10 000 for micro enterprise and housing at the lowest end of the market.

85 Submission by Small Enterprise Foundation (fn 16 above).

86 They normally do not require collateral and do repossess clients' assets if they are unable to repay a loan.

87 Submission by Small Enterprise Foundation (fn 16 above).

88 *Ibid.*

It is unclear what is envisaged by the phrase 'alternative requirements', and thus far no regulations have been made in this regard. However, it is an issue that needs to be approached cautiously. While acknowledging the potential harm of burdensome reporting requirements, the wholesale exclusion of developmental credit providers from the requirements could be counter-productive. For example, excluding reporting in respect of non-collateralised loans could lead to an inaccurate calculation of an enterprise's or an entrepreneur's credit exposure, thereby prejudicing other potential credit providers. This would perpetuate the absence of credit information regarding micro and small entrepreneurs and raise the risk of lending to SMMEs, with the result that they will continue to be marginalised from the mainstream credit industry. The availability of information relating to *all* borrowers is therefore critical for ensuring that credit providers are not discouraged from lending to certain categories of borrowers on the basis of insufficient information.

Another possible exception (although not specifically mentioned in the Act or the Regulations) for developmental credit providers relates to credit providers' marketing practices. The Act prohibits all credit providers from using certain marketing practices which may prejudice borrowers and potential borrowers, for instance, visiting borrowers and potential borrowers in their homes. Developmental credit providers – particularly those serving rural clients – lobbied for an exemption from this particular prohibition as many visit rural clients that cannot afford to travel to the credit providers' offices in order to make their products accessible. Such visits also enable the development credit providers to assess the home-based businesses. The exemption was expected at the end of 2006 but to date has not been granted. Given the socially desirable purpose of developmental credit agreements and the low risk of the abuse in this context, there is no reason why the exemption should not be granted by the Minister.

The third way in which the Act affords SMMEs special treatment is through interest rate ceilings. The approach adopted in the Act departs from the previous regime in that interest rate ceilings are determined on the basis of the types of credit agreements and not the size of the loan. The Regulations provide that loans made for *inter alia* SMME development shall attract the highest interest that may be charged in terms of the Act, irrespective of the loan size.<sup>89</sup> Based on the current repurchase rate, the actual rate at which developmental credit providers will be allowed to charge is 36% per annum. The primary reason for allowing developmental credit providers to recover the maximum possible interest is to facilitate full cost recovery in light of the higher risks involved and the unconventional methodologies that they may use, for instance not requiring collateral. A related reason is to encourage developmental credit lending.

<sup>89</sup> Regulations in terms of the National Credit Act 34 of 2005 *Government Gazette* 28864 of 2006, Item 42(1): maximum interest for SMME development, low income housing and unsecured credit agreements shall be [(Repurchase Rate x 2.2) + 20%] per year; for mortgages [(Repurchase Rate x 2.2) + 5%] for credit facilities and for credit facilities and all other credit agreements [(Repurchase Rate x 2.2) + 10%].

It is difficult to predict with any certainty the effect that the interest rate ceiling will have on SMME lending. Furthermore, given that the industry is undergoing a transition from one regulatory regime to another, it is probable that there will be different impacts according to whether SMME credit providers are exclusively lending amounts below R10 000 (and who previously fell under the 1999 Exemption), or are providing loans below and above R10 000. It is also probable that the ceiling will impact differently on credit providers that have not previously provided credit to SMMEs.

One would assume that MSE credit providers that exclusively provided loans below R10 000 and charged interest in the region of, for example, 80% per annum under the 1999 exemption will be adversely affected by the new interest rate limitation. However, the representative of one such developmental credit provider argued that the ceiling of 36% will not impact on these institutions because the Act introduces initiation fees and monthly administration fees that will enable these institutions to recover the costs of credit provision.<sup>90</sup> In other words, the latter fees will off-set the reduction in the interest they are able to charge. The downside is that while these fees in conjunction with interest will encourage full cost recovery for smaller loans, they are less transparent and make it difficult for the borrower to determine the true cost of the loan. They may therefore be used by 'less scrupulous credit providers to try to hide the true cost of credit',<sup>91</sup> thereby directly contradicting one of the objectives of the Act.<sup>92</sup> This is why developmental credit providers advancing loans below R10 000 proposed that the Minister should rather set realistic interest rate ceilings and exclude such fees for developmental credit agreements.<sup>93</sup>

On the other hand, the combination of interest and fees may have a positive impact on developmental credit providers that restricted themselves to loans of less than R10 000. The new dispensation attempts to enable developmental credit providers to recover their full costs for loans to SMMEs below and above R10 000. This will remove the need to restrict themselves to loans below R10 000 and should enable these developmental credit providers to offer a wider range of loan sizes to meet their clients' needs.<sup>94</sup> So, they should be able to 'scale up' their loan products, which will go some way towards filling the gap in the provision of credit to unbanked MSEs.

Some SMME credit providers did not restrict their loan sizes to R10 000, providing loans below and above this amount. Furthermore, these credit providers did not make use of the 1999 exemption and charged interest below the Usury Act ceiling of 20% in respect of all their credit agreements. They will therefore be able to charge more interest under the new Regulations. However, interviews with a range of these credit providers indicate that they will not increase the interest they charge because they can operate satisfactorily at the existing rate. The market would also exert downward pressure on

90 These charges are applicable to all credit agreements.

91 Although the NCA requires that the full cost of the credit is disclosed to the borrower.

92 Submission by Small Enterprise Foundation (fn 16 above).

93 *Ibid.*

94 *Ibid.*



rates: the director of a commercial MSE credit provider stated that any institution that charged interest in the region of 30% would be 'pricing itself out of the market'. It is therefore unlikely that the changes in the interest regime will have any impact on the product range, choice of clients, or level of MSE lending of such credit providers.

The higher rate of interest attached to developmental credit agreements, however, will be unlikely to attract commercial (i.e. non-developmental) financial institutions into this market. The rate of interest charged is only one factor when considering whether to provide credit to SMMEs. The availability of collateral or other security, the viability of the enterprise, and the management capabilities of the entrepreneur are also important factors; all of which will be seen as barriers by commercial lenders. Furthermore, SMME credit providers indicate that their work is not just a money-making enterprise, but requires sound knowledge of the nature of SMMEs and commitment to providing the necessary advice and support to ensure their success. Commercial lenders that do not have experience of working with SMMEs or share such a commitment will not be attracted to the SMME market. Where there are new entrants it is likely that they will focus on lending to medium-sized enterprises rather than to 'more risky' MSEs.

## 5 THE IMPLICATIONS OF THE NEW ACT FOR UNBANKED MSEs

This article has outlined the shortcomings of the previous regime, particularly with regard to lending to SMMEs: the limitations in respect of the ceilings on loans; the unintended consequence of creating a predominantly consumption-driven micro credit industry; and the emergence of numerous undesirable practices such as reckless lending and over-indebtedness. The question is whether the National Credit Act addresses these problems and will facilitate a significant expansion in lending to unbanked MSEs? And a bigger question is whether the Act will, in this regard, have an impact on poverty, unemployment and income inequality? In this section we make some tentative points regarding the Act's likely impact on unbanked MSEs.

The National Credit Act clearly attempts to chart a new direction for the regulation of SMME credit provision. The recognition of developmental agreements as a particular category of credit agreements that receive special treatment is a commendable step. The Act, furthermore, identifies SMMEs as a group requiring the NCR's special attention when carrying out its duty to create an accessible credit market. Special treatment and concessions for developmental credit agreements will only be granted to credit providers who demonstrate their commitment to economic development and who are registered as developmental credit providers. This will prevent abuse of these benefits and advantages by credit providers that are not development-oriented, as was the case under the Usury Act Exemptions.

However, the effect of the new interest regulations on the SMME credit market is yet to be seen. As noted above, higher interest rates alone are unlikely to entice existing commercial credit providers to enter the SMME mar-



ket, let alone to lend to MSEs. The new interest rates are also unlikely to have much effect on SMME credit providers who provided loans above R10 000 as they are currently operating optimally at rates below the new maximum rate. Where there is likely to be an impact is on credit providers that provided loans below R10 000 to MSEs in terms of the 1999 Exemption. The new dispensation will free these credit providers from the R10 000 limit and enable them to expand their product range and increase their financial support to MSE clients. This will increase the availability of loans and contribute towards closing the current gap in credit provision to MSEs. But it is arguable that this will not be enough to entirely fill the gap in credit provision to MSEs. The Act should have provided more incentives for the commercial credit providers to lower the limit at which they lend to SMMEs, thereby narrowing the gap.

The Act attempts to address problems with risk assessment by requiring all registered credit providers to share information relating to their clients and credit agreements on the National Credit Register. The developmental credit providers asked to be exempted from entering information on the register, and there is provision for 'alternative arrangements' for them in the Act. It is not known at this point what these arrangements will be but the wholesale exemption of developmental credit providers runs the risk of being counter-productive. The use of the Register by all credit providers will increase the availability of information and enable them to assess the creditworthiness of entrepreneurs. Placing developmental credit providers outside this system will merely entrench their marginalisation. While the ability of credit providers to resort to credit insurance in terms of the new Act could temper the adverse consequences of the above, this will increase the cost of credit to the entrepreneur. Again, it does not appear that these provisions will encourage non-SMME credit providers to enter the MSE market in significant numbers.

In theory, the NCR's functions and powers in terms of the Act place it in a position to play an important role in the facilitation of access to SMME credit. The measures taken and their success will largely depend on the commitment of and priorities set by the NCR. However, from the commercial and consumer-protection orientation of the Act, the tone of the public hearings on the Bill and the MFRC's track record on SMME promotion, it is unlikely that the NCR will give developmental credit agreements the attention that they deserve.

As noted above, the analysis presented is limited by the relative 'newness' of the Act. In addition, it does not give a full analysis of the economics of the SMME credit market. Future research will be required to assess the impact of the Act on the unbanked MSE credit market as the Act begins to modify commercial practice. This research should adopt a cross-disciplinary approach involving researchers with a sound understanding of the economics of the SMME credit market, and should incorporate empirical research drawing on the views of credit providers, micro and small entrepreneurs, policy makers and NCA officials.

## 6 CONCLUSION

The National Credit Act cannot alone solve the problem of MSE access to credit and it certainly cannot provide the panacea for bridging the divide between the first and second economies. The barriers to lending to unbanked MSEs are symptomatic of deficiencies in the socio-economic environment that cannot be fully addressed by credit policy and legal interventions alone. Increasing MSEs' access to credit will require a holistic approach that must involve the participation of a number of role players. These include the full range of wholesale and retail credit providers: government institutions, commercial firms, non-governmental organisations and community-based organisations. Broader social and economic reforms are also necessary to overcome these barriers, including improving the quality of the education system; improving MSEs' access to markets, which are the lifeblood of the success of any enterprise; and alleviating poverty in general.

While acknowledging the limitations of legal interventions, it is clear that the National Credit Act has an important role to play. Whether it will play its part optimally is difficult to say at this point: it is still too early to tell what its impact will be on unbanked MSEs. However, while the Act recognises the plight of those who previously did not have access to credit and gives special attention to SMME credit provision, our view is that the Act is unlikely to dramatically increase the availability of credit to micro and small entrepreneurs currently unable to obtain credit from formal institutions. The orientation of the Act remains the commercial end of the market and consumer protection rather than developmental credit. It therefore to a large extent continues within the 'market development' approach that informed the design of the 1992 and 1999 Exemptions.

The problem of access to credit for MSEs requires a bolder approach on the part of government. This is not to say that it should advocate a policy that encourages the indiscriminate provision of credit to MSEs. What is required, rather, is a more interventionist approach in order to ensure that developmental credit gets the attention that it needs. Such an approach would need more directed legislative mechanisms but would also include programmes to expand and support the institutional framework for micro credit. Interest rate ceilings and exemptions from administrative requirements are unlikely to be enough to steer much more than the existing tiny proportion of the multi-billion Rand credit industry to MSEs.

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