Transforming the South African Credit Market through Group Lending Mechanisms

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Abstract

This article examines how group lending can be used to improve access to credit by the poor households. Literature describes asymmetric information as endemic to the failure of the credit market to provide credit. The article aims at developing a specialized lending mechanism as a benchmark of dealing with asymmetric information. Approaches on international practices are used to determine how asymmetric information is dealt with in the provision of credit. Primary data was obtained in the Soshanguve informal settlement through conducting unstructured interviews with informal stokvel members. Random sampling was used to draw a sample of 30 respondents from three stokvels composed of 80 members. The findings reveal that group lending mechanisms improve social capital and reduce the barriers that deter access to credit.

Keywords: group lending, credit, stokvels, banks, poor households, asymmetric information

Introduction

Access to credit plays a significant role in the lives of the poor households, particularly those that are plagued by financial shocks like illness and funerals. This role is central to contemporary debates surrounding strategies for poverty reduction and economic development. The majority of the people in South Africa live in informal settlements and/or rural areas where poverty is still rife. Wilson (1996) points out that some survive below the minimum poverty level, usually the equivalent of US $1 per day. This makes these people to be exposed to even minor shocks which have detrimental effects on them (Johnson and Rogaly, 1997). It is, therefore, difficult for the poor households to survive in the long run. Currently, the households find it difficult to access credit from the formal credit market due to the asymmetric information problem associated with adverse selection and moral hazard. This problem restricts access to credit and discourages the market from servicing the poor households who are regarded as unprofitable and risky. Improving access to credit and removing the constraints that have deterred the households from accessing credit can assist them to cushion themselves against the effects of financial shocks, thus reducing their vulnerability, poverty, and improving their living standards in general. The poor households, therefore, resort to group lending as an insurance mechanism of sorting between risky and non-risky members and to enforce and monitor contracts and regular payments. Studies show that the persistence of social interactions among informal groups as a way of improving social capital and deepening friendships and the benefits of contributing money together give the households a head start in their financial status (Whiteford and McGrath, 2000; Johnson and Rogaly, 1997).

In spite of the dynamic formal credit market or financial sector which provides a wide range of financial services, particularly credit, in South Africa, the sector seems to be inefficient in its current form to provide credit to the poor households. There is, therefore, a need to address this problem so as to improve access to credit thereby improving the living standards of the households. The main aim of this article is to deal with the asymmetric information by developing a specialized lending mechanism as a benchmark to transform the credit market and improve the provision of credit to the poor households in South Africa. The article resumes by analyzing formal credit and asymmetric information. It provides an analysis of how asymmetric information hampers the provision of credit in South Africa, particularly to the poor households**.** Furthermore, lack of collateral to secure credit as well as high transaction costs provide constraints in the credit market. The article proceeds with the discussion on micro lending and asymmetric information. Micro credit has emerged as an alternative to conventional banking and a tool for dealing with asymmetric information and developing the poor households. Despite the rapid growth of the providers of micro credit, it is shown that the need for micro credit by the households is coupled with limited availability due to the nature of information asymmetries. Of importance, in the last section of this article, is the significance of group lending mechanisms in dealing with asymmetric information and improving access to credit by the poor households. The article reveals that group lending appears to be better equipped in dealing with the issues of adverse selection and moral hazard, collateral constraints as well as high transaction costs.

Research method

The research is based on a review of accumulated literature involving the systemic identification, location, and analysis of documents containing information related to the credit market and group lending. The findings were based on personal unstructured interviews and audio tape recorder as data gathering techniques. Fieldwork was conducted between March and July 2008 in the Soshanguve informal settlement. Unstructured personal interviews which elicited descriptive data were first conducted with the three presidents of the three stokvels to guide explanations and discussions and thereafter with 30 members, 10 from each stokvel. A stokvel is an umbrella term used for informal savings and credit organisations in South Africa and other African communities for survival and operates mainly in the black areas with social, economic and entertainment functions. It is made up of a group of people who agree to contribute a specific amount of money to a pool of savings or common fund, which may be awarded, on a rotational basis, to one member weekly, fortnightly or monthly, depending on the type of stokvel (Verhoef, 2000). The three informal stokvels composed of 80 members, each with 25, 30, and 25 respectively. The stokvels were selected through random sampling since the population is homogeneous. The sample is representative of the population in the area. Several visits to the stokvel were made to establish a trust relationship with the members. Access to the stokvel was gained through a relative who happened to be the chairperson of the stokvel who then introduced other members.

Descriptive method was also employed in the article to process data that comes to the researcher through observation. Observation involves assessing attitudes or opinions toward individuals, organisations, events or procedures (Leedy, 1993; Gay, 1990). Observation was done between April and June 2008 through attendance of the meetings with the stokvel members to acquire information on how such stokvels operate and how issues like asymmetric information, collateral, and transaction costs are dealt with in the provision of credit. The meetings were first held separately with the presidents at different times and thereafter with the selected stokvel members. The stokvel constitutions/rules were also made available for scrutiny. The observation has been done with close scrutiny, and thereafter, a careful record of what had been observed has been made to determine how informal stokvels reduce asymmetric information and improve the provision of credit among the poor communities. Interviews were also recorded on the audio tape recorder and thereafter transcribed for more formal analysis. Data analysis took place while the interviews were still underway as well as at the end of the interviews. A comparison has been done to discover the connections between themes, and finally these themes and concepts were integrated into a provisional theory that could offer comprehensive and accurate interpretation of group lending and the provision of credit. Because of the homogeneity of the population, the sample offered rich evidence on how the poor people in the informal settlement in Soshanguve arrange informal groups to access credit and how it improves their living standards in general.

There has developed a substantial literature internationally on credit and asymmetric information. A theoretical approach on international practices was used to determine how asymmetric information is dealt with in the provision of credit to the poor households in other countries. Pioneering work in Bangladesh, Indonesia, Kenya, and Ghana, among others, became important catalysts in the provision of credit through group

lending mechanisms. Their practices can be instrumental in developing specialized lending mechanisms for the poor people who have been marginalized by the credit market in South Africa.

Formal credit and asymmetric information

The banking sector is the main provider of financial services. Financial services entail a broad range of financial products like credit and savings (Fourie et al, 1999). Access to credit is a vital component of poverty alleviation, employment creation, and enterprise promotion or business development (Rousseau and Venter, 1999). When credit is accessible, the households are able to stabilise household conditions and bridge financial shocks that would have detrimental effects on them. Despite a strong need for credit by the poor households, the banks in South Africa have not been able to adequately cover the credit needs of the households who are regarded as risky and unprofitable. An essential fundamental variable that is needed to price credit is the underlying risk profile of the client. This implies that the risk to pay back or to perform, which is associated with the client, is calculable and quantifiable and/or can be hedged and/or tradable. Pricing financial instruments to reflect their full costs and provide a reasonable return is necessary for any financial operation. Critical in this analysis is to demonstrate that asymmetric information is endemic to the failure of agents like banks and financial or credit markets as a whole to obtain and process information and to price financial instruments like credit.

Asymmetric information and the provision of credit

Information plays a central role in credit/financial markets, particularly in the provision of credit. Asymmetric information is defined by Mishkin (1999; Teixeira, 2001-03) as a situation in which one party to a financial contract has more or better information than the other. In such situations, the ignorant party may look for signals from the informed party, and this can lead to a variety of outcomes. The information intensity of financial contracts regarding the assessment of various systemic events underlies the importance of the distribution of information among the parties acting in the financial sector. Asymmetric information, therefore, hampers decision-making in financial contracts. There are limitations on human knowledge or lack of information particularly in the short-run to make informed decisions. The critique associated with Stiglitz and Weiss (1981) emphasises the existence of problems of asymmetric information and costly enforcement. This means that it becomes difficult and costly for the credit market, particularly banks, to acquire information about borrowers. The lack of information and collateral, therefore, lead to high transaction costs of extending credit. This makes it difficult for banks and borrowers to conduct lending and borrowing activities when the relevant information which is required is not available. If a bank possesses knowledge that permits accurate predictions to be made about the risk status of borrowers, then the accuracy of this prediction should be reflected in differential lending practice to low- and high-risk borrowers. Banks do not know with certainty, which borrowers will, and which ones will not repay their loans. Alternatively, borrowers are

also uncertain and not in a position to judge the soundness of banks and are, therefore, vulnerable (Mishkin, 1999).

Adverse selection and moral hazard contribute to an increase in asymmetric information and hamper rational decision-making. Without the information on prospective borrower's ability to invest loaned funds, or their creditworthiness, a situation may arise where a bank (lender) may choose a risky borrower. Bone (2003) points out that due to this lack of information, the particular characteristics of borrowers are unknown to the banks. This is referred to as adverse selection. The ignorant party lacks information while negotiating an agreed understanding of or contract to the transaction. An example of adverse selection is when people who are high risk are more likely to buy insurance, because the insurance company cannot effectively discriminate against them, usually due to lack of information about the particular individual's risk but also sometimes by force or law or other constraints. Adverse selection occurs before the financial transaction takes place, when potential bad credit risks are the ones who most actively seek out a loan, for example, those who are the most likely to produce an undesirable or adverse outcome are most likely to be selected as borrowers (Mishkin, 1999). This is a feature of the lemon problem described by Akerlof (1970) where quality and uncertainty are related in the automobile market. An example of used cars captures the essence of the problem. The automobile market is used here for its concreteness to understand these problems and to relate quality and uncertainty. There are good and bad cars (referred to as the "lemons" in the USA) (Akerlof, 1970). The buyers in the market buy a new car without knowing whether the car will be good or lemon. Since it is impossible for a potential buyer to tell the difference between a good used car and a bad one, sellers may sell both of them at the same price. The sellers in the market have more knowledge about the quality of a car than the buyers, and the buyer cannot tell the difference between a good and a bad car or the true value of the car. The individual will be able to assign a meaning to or form a good idea of the quality of the car after owning it for a certain period of time. It is therefore, quite likely that lemons will be traded more than the good cars. The bad cars tend to drive out the good in much the same way that bad money drives out the good. Partially informed buyers of used cars may not purchase a car at the lowest price, because they know that they are not fully informed about quality, and they fear that a low price car may also be a low quality car (Akerlof, 1970).

The existence of goods of many grades possesses interesting and important problems for the theory of the markets. There is an incentive for sellers, in this case, to market poor quality products. The seller knows more about the product than the buyer. As a result, there tends to be a reduction in the average quality of goods and services even for those of perfectly good quality and also in the size of the market. It should be perceived that there may be potential buyers of good quality products and potential sellers of such products in the appropriate price range, but the presence of people who sell inferior products tends to drive out the legitimate business. In this case of automobile "lemons", the buyer is faced with the problem of identifying quality as cars are sold dishonestly and there exists the possibility of bad cars driving the market out of existence (Akerlof, 1970). The buyer is cheated in terms of the amount that he pays for the car. It is, therefore, important to note that asymmetry of information (about quality) can cause a market to degenerate to the point where high quality goods are squeezed out of the market, leaving only low quality goods being offered for sale. In this case, the true value

of information (eg, about the cars) cannot be predicted. More specifically, a buyer cannot know the value and worth of a piece of information before buying. If the seller exhibits the information before selling, it has in effect been given away. Thus, the buyer is at risk, never knowing the exact nature of the information. It is not only a problem of private information but also the quality of available information. Mishkin (1999) notes that in the case of credit markets, particularly informed lenders may not make loans at a high interest rate because they know that they are not fully informed about the quality of borrowers, and they fear that someone willing to borrow at a high interest rate is more likely to be a low quality borrower who is less likely to repay the loan. Therefore, this lack of knowledge about the creditworthiness of the borrower and his ability to repay the loan create uncertainty in the provision of credit and the lender is uncertain as to whether the borrower will or will not be able to repay the loan.

Moral hazard also contributes to asymmetric information and an increase in financial risk. Moral hazard may be defined as actions of economic agents in maximising their own utility, and where they do not enjoy the full benefits of their actions due to uncertainty and incomplete or restricted contracts (Baye and Jansen, 1995). Incomplete contracts mostly arise in situations where the transaction costs of achieving complete contracts are too high relative to the return envisaged in enacting the contract. The ignorant party lacks information about the performance of the agreed-upon transaction or lacks the ability to retaliate for a breach of the agreement. A good example is when people are more likely to behave recklessly if insured, either because the insurer cannot observe this behaviour or cannot effectively retaliate against it by failing to renew the insurance. Moral hazard issues, therefore, arise between banks (lenders) and borrowers because their interests are not necessarily compatible. Moral hazard, on the one side, refers to the tendency to take riskier decisions if protection from losses is guaranteed, and the possibility that individuals who are in debt will change the effort that they put into making the project successful and/or the type of project they undertake, for example, by changing the riskiness of the project. According to Mishkin (1999), moral hazard occurs because a borrower has incentives to invest in projects with high risk in which he does well if the projects succeed, but the lender bears most of the loss if the project fails. The lender is thus subject to the hazard that the borrower has incentives to engage in activities that are undesirable from the lender's point of view, that is, activities that make it less likely that the loan will be paid back (Mishkin, 1999).

On the other side, moral hazard arises when borrowers are not in a position to judge the soundness of banks (as lenders), much less to influence their management, and banks may also not be able to judge the risks associated with the investment projects that borrowers plan to undertake. The lender is aware of his/her immediate and contigent commitments as far as lending is concerned. Although borrowers are not aware of it, a lender offers a different product to them. The conflict of interest between the borrower and bank (lender) stemming from moral hazard implies that many banks will lend less than they otherwise would, indicating inefficiency so that lending and investment will be at sub-optimal levels. They will ration the volume of loans instead of raising the lending rate because not all information is reflected in prices (or interest) ((Teixeira, 2001-03).

Principal-agent relationship and the provision of credit

It is also demonstrated in this article that asymmetric information can exist in the principal-agent relationship when the agent has private knowledge regarding the contract which the principal does not. The principal is uncertain as to whether the agent will act in his (principal's) best interest. The term agency describes a relationship in which two parties, the principal and the agent agree that one will act as a representative of the other (Laffont and Martimort, 2001). The principal is a person who wishes to accomplish something, and the agent is the one employed to act on the principal's behalf to achieve it. The principal employs an agent to represent him or act on his behalf in dealing with third parties or persons. An agent agrees to do the job in exchange for compensation. Therefore, the principal-agent relationship means a relationship in which the parties have agreed that the agent is to represent the principal in negotiating and transacting business. It is important, according to Laffont and Martimort (2001), how the owners of firms (principals) succeed in aligning the objectives of agents with profit maximisation. The principal must, for various reasons, delegate several tasks to the agent. The principal, however, cannot be sure that the agent acts in his (principal's) best interest. As soon as it is acknowledged that the agent may have different objectives, delegation becomes more problematic when information about the agent is imperfect or asymmetric.

The problem of adverse selection and moral hazard, alluded to in the previous section, contribute to the principal-agent problem. The problem of delegating a task to an agent with asymmetric information is that the agent can either take an action unobserved by the principal (which provides the agent with an opportunity to cheat after a contract has been signed), that is, moral hazard, or the agent has some private knowledge about his cost or valuation that is ignored by the principal (where an agent lies prior to a contract taking place), i.e., adverse selection. This means that transaction costs are mainly high because of the lack of information about the actions of the agent. Asymmetric information, no matter the form, negatively affects market transactions. At a minimum, asymmetries make the market to operate less efficiently in that prices will not represent real costs and benefits. In reality, some borrowers fail to repay loans and this reduces bank profits. If banks know that a particular borrower will not repay the loan, they will not agree to lend money to that person. Therefore, the bank is not able to control the behaviour and actions of the borrowers (Stiglitz and Weiss, 1981). The bank may continue to struggle to extend credit to the poor households and to achieve the low default rates unless they possess a thorough knowledge of the borrowers which is difficult and expensive to acquire.

Collateral and transaction costs

Collateral serves as a guarantee or compensation for the lender or bank for taking the risk in case the loan will not be repaid. When insolvent, the borrower is said to default on the loan, in which case the lender becomes the owner of the collateral (Coetzee 2002-04). The need for collateral provides constraints for the lender to serve the credit needs of the poor households who do not have such collateral or valuable assets that can be used to secure credit. This makes most of the banking products and distribution channels to be unsuitable to the needs of majority of the poor households. High transaction costs also

limit the provision of credit. Ironically, the efficiency of financial or credit market is reduced by these costs. Generally, in the financial markets, in allocating resources and acquiring information about investments, it becomes difficult and costly to evaluate borrowers, firms, managers and market conditions (Diamond, 1984). Higher transaction costs in the financial market result in higher interest rates, which will, therefore, result to the fewer or lower volume of transactions in a given market, and extremely high transaction costs could lead to absence of exchange and thus, to non-existence of the market (market failure). The banking services are costly and have a complicated mix of charges, withdrawals and transaction fees. Pricing financial instruments like credit to reflect their full cost and providing reasonable return to the bank is essential for any bank operation. The poor households need small loans but the banks prefer to deal with large loans to minimise administration costs (Schoombee, 1998). The banks are concerned that pricing of small loans requires significantly higher rates than typical commercial lending products because of client characteristics and the relatively small size of transactions. The absence of information about the abilities and character of the poor households (as borrowers), lack of collateral and creditworthiness of the borrowers lead to high transaction costs of providing credit. In this situation, these problems provide constraints to the banks in serving the poor households. In view of this, the article concludes that the credit market or banking sector in South Africa seems inefficient in its current form to effectively provide credit to the poor households.

Micro lending and asymmetric information

Micro lending emerged as an alternative to conventional banking and micro credit has become a major tool of development among the poor segments of society and an appropriate solution to the problem poses by asymmetric information. Micro lending, which vital components include access to credit, savings, and insurance schemes involves the distribution of small-scale loans (micro credit) to the poor households (Meagher and Wilkinson, 2001). The micro lending sector differs from the banking sector on client features, loan portfolio, culture and institutional structure. The poor households need small loans or micro credit to bridge the effects of financial shocks and improve household conditions in general. The availability of such micro credit can contribute greatly to the development of the households and help them to build assets, stabilise consumption, and shield themselves against financial shocks.

Sunday Times (12 November, 2006) reported that there are 13,2 million of South Africa's population who do not have access to banking services and 16,5 million are unbanked. The Micro Credit Summit 2005 emphasized the development of new financial products, strategies and methods to provide financial services, especially credit, to the poor households around the world (Schussler, 2004). The purpose was for the micro lending industry to combat poverty with the aim of improving access to credit for 100 million of the world's poor households and 500 million of all the unbanked people. The financial system in South Africa has, in response to this, undergone significant changes and transformation to accommodate a rapid growth of the micro lending providers who employed different strategies in providing credit to the poor households. In response to the increasing need for micro credit, the providers started to design financial products, developed new concepts, strategies and methods to focus on the financial needs of the

poor households. Some micro lending institutions started to provide short-term cash loans payable in full at the end of the month while others began to provide term borrowing for periods from three to thirty six months (Meagher and Wilkinson, 2001).

However, these strategies and methods were inappropriate for providing credit to the poor households. The micro-lenders in South Africa focus only on the formally employed people so that their salaries could be tapped or serve as collateral to ensure repayment of the loans. The loans are advanced at high interest rates. Some started to offer micro/small loans which are not secured by property, but by a pledge of the borrower's pension or provident fund. Majority of the poor households do not meet these requirements and do not have collateral or valuable assets to secure credit and are also unable to afford high interest rates. The households are micro borrowers who need small loans to bridge the effects of financial shocks and to survive. The problem is that credit instruments of the micro-lenders focus mostly on urban areas and are inadequate vehicles for delivering such credit to the poor households in informal settlements and/or rural areas. The lenders limit access to credit by consumers who do not have established relationships with them (the lenders) as well as credit records. Lenders are concerned with the costs of providing credit. Burke and Hanley (2002) point out that an important source of transaction costs is the gathering and processing of information required to screen loan applicants who are not known to lenders. This lack of information about borrowers exacerbates the information asymmetries problem. As indicated above, lack of information about abilities and character of borrowers, their creditworthiness, together with lack of collateral increase transaction costs and this provides constraints in the provision of credit. It can, therefore, be concluded that the micro lending sector in South Africa, though sophisticated and vibrant, still remains less developed and unable to expand credit provision to the poor households. The households continue to be marginalized and pushed farther away from accessing credit.

Significance of group lending mechanisms in the poor communities: findings and discussions

It is evident in the forgone sections that the structure of the South African credit market presents limitations in the provision of credit and seems inefficient in its current form to effectively provide credit to the poor households due to asymmetric information. In view of this, the poor households resort to group lending which seems to be a likely solution to the problems and in improving access to credit. This section determines whether group lending mechanism can improve this situation. This section provides insight on how group lending can be used as a point of departure to overcome the problem of asymmetric information associated with adverse selection and moral hazard and resolve physical collateral and high transaction costs. Bosch (2002; Mashigo, 2007) define group lending as a process whereby individual loans are disbursed to small group of borrowers who are collectively responsible for loan repayment. Group dynamics provide insurance against default at a relatively low cost.

International lending practices

This section provides evidence on how group lending mechanisms deal with asymmetric information problem. Today some leading developing countries internationally have created financial mechanisms and systems that serve the increasing number of poor people. According to Bosch (2002), they generate repayment rates that compare favourably with the loan performance of many banks or credit markets. Countries such as Bangladesh, Indonesia, Kenya and Ghana use innovations like group lending and savings-first-approach (or compulsory savings) aimed at reducing poverty through credit granted to borrowers who comprise small groups while using joint guarantees (Wilson, 1996). Bangladesh, through its Grameen Bank (GB), popularized a group lending model where community members voluntarily form small groups (Johnson and Rogaly, 1997; Rahman, 1997). This initiative was taken due to the inability of most villagers to obtain credit from credit markets and also at a reasonable rate. The bank was established from the lessons drawn from informal financial institutions that lend money to poor groups. The Grameen Bank has reversed conventional banking practice by removing the need for collateral thus creating a specialized banking system based on mutual trust, accountability, participation and creativity. In this case, while loans are granted to individuals, all members of the group are held responsible for repaying the loans. If one member defaults, all in a group are denied subsequent loans (Rahman, 1997). The enforcement problem is solved by strict screening of members because of the perfect and comprehensive knowledge they possess about each other as well as peer pressure exerted on each one to repay loans. In addition to these informal relationships that serve as insurance, there are also threats such as social sanction for defaulting. The Grameen Bank programs require borrowers to contribute to an emergency fund (as forced saving) which becomes an insurance in cases of default. The savings/fund serves as substitute for or becomes collateral for the bank for taking the risk in case the loan will not be repaid. This reduces the asymmetric information problem and thus transaction costs of acquiring information about borrowers. Some of the successes of the GB were felt in Kenya, Indonesia and Ghana. Kenya also fashioned its financial system in a group lending method where groups improve social ties by holding compulsory weekly meetings regarding savings and credit. While credit is disbursed to groups, as in Bangladesh, the emphasis is on savings which is mobilized weekly into a pool. The savings then serve as collateral for credit. Additionally, Kenya supports community credit programs by providing training to group members on loan management and financial discipline (Kimanthi, 1997).

In addition to group lending as the mechanism that enables the provision of credit to the poor, Indonesia uses the savings-first- approach. More emphasis was placed on the poor development programs where credit markets operating procedures were simplified and strict lending rules were amended. This provided the opportunity for even the poor households to access credit. For financial viability, and in response to the risk of loan default, village authorities were made to share responsibility for compliance with the terms of loan contracts. Credit markets encouraged compulsory savings from individual borrowers by requiring that a 10 percent of loan amounts be pledged (Embassy of Ghana, 1997). Without savings, no credit is disbursed. Ghana, in dealing with perceptions of high risk, high transaction costs, low returns and asymmetric information and improving

access to credit by the poor households, created semi-informal or rural banks to manage high proportions of rural credit and savings. The rural banks are owned and managed by communities and operate only in a clearly defined rural area (Embassy of Ghana, 1997) and are also permitted to offer banking services limited to loans and to checking savings and time deposits.

Informal stokvels in South Africa

There exist similar informal groups, as in the countries discussed above, in the poor communities in South Africa in the form of stokvels, which seem to be efficiently structured to deal with asymmetric information problem. These are regarded as the primary sources of credit (and savings) available to the poor households who have been marginalised by the formal credit market or financial sector. In these informal sources of credit, the problem of information asymmetries is dealt with by minimising adverse selection and moral hazard, reducing high transaction costs and removing the need for collateral in securing credit. Individuals form small groups by selecting creditworthy peers who act as guarantors for each other by assuming joint liability for the loans. The selection is based on the knowledge the individuals have about one another, for example, according to geographical location, i.e., people belonging in the same neighbourhood or the same church can join groups together. This screening mechanism can lead to strengthening of the joint liability.

In their informal financial arrangements, the households use approaches that rely on informal or traditional knowledge systems for their survival. Traditional knowledge refers to mutual long-standing traditions of certain indigenous or local communities (Wikipedia, 2007). These traditions include the extension of credit where mutual understanding and an environment of trust, loyalty and respect (as in Bangladesh) between people involved in the borrowing and lending activities exist. Social norms and customs play a significant role in financial relationships. The types of stokvels that have been found to exist in the poor black communities such as Soshanguve informal settlement include those that provide credit as well as savings to the households in order to bridge the effects of financial shocks like funerals, deal with food insecurity, expensive events as well as day-to-day expenses. It was found that all of the households are members of a funeral stokvel and revealed that monthly contribution made by the stokvel members amounts to R50 ($5.05), and in case of death of a member or family member, a lump sum of money is made available to the bereaved family to cover funeral expenses. The households do not qualify for formal insurance schemes and as such the stokvel serves as an insurance scheme in cases of death in the family. A fairly large number of the stokvel members (68 percent) who were interviewed are also members of kitchen/food stokvels. These households, who mostly consist of women, make informal arrangements in the form of kitchen or food stokvels where they accumulate enough money to counter food insecurity or to buy food as well as household utensils. It was also found that most members, who are single female parents, support and raise their children. Each member contributes R30 ($3.03) on a monthly basis with an objective of purchasing food or kitchen utensils on a rotational basis. The importance thereof is that purchases made are cheaper because food is bought in bulk and each member is entitled to food (groceries) and/or kitchen utensils of a certain amount as stipulated by members

themselves. Of the total number of members, 28 percent are members of entertainment stokvels which help them to cope with predictable but expensive events such as marriages (and birthday parties) that they cannot avoid. They mutually agree to make a monthly contribution of R30 ($3.03) and when a member or family member is getting married (or it is his/her birthday), a lump sum of the contribution is used to buy food and refreshments for those who will be attending the event. The households also use entertainment stokvels for other purposes such as providing for education expenses for some parents who cannot afford to pay school fees and other related expenses for their children. If there is a pressing need for money, members agree among themselves to make money available to a member who is urgently in need of it. The accumulated amount which was not spent during the year helps the members to cater for end of the year festive season expenses that they would not have been able to afford (Mashigo, 2007).

Half of households are also members of the money stokvel where R40 ($4.04) monthly contribution is made and a lump sum shared between members numbering less than ten on a rotational basis so that each can receive a total amount at least twice a year. Alternatively, the lump sum may also be accumulated into a savings account and shared between members at the end of the year. This is decided and agreed upon by the members. The importance of this stokvel is that when a member experiences financial problems, he/she approaches the money stokvel for a loan and indicates when to pay back. Credit is available to the members without interest because they are close to and know each other very well. This reduces the transaction costs of extending credit. Defaulting is very minimal because members normally repay the loans to maintain reputation, trust and respect. Respondents mentioned that none of them would want to be seen by others as irresponsible or be banned from the stokvel and therefore adheres to the loan agreements. Collateral problems are absent because the long-term relationship that exists between them and the peer pressure serve as substitutes for physical collateral.

The main aim of informal stokvels is to pledge mutual support to each other and their strength is based on communal bond of the group. The effectiveness of the stokvels is that they provide both savings and credit facilities where group members are encouraged to develop their solidarity or social capital for sustainability purposes. In this case, they are motivated to save money and this makes it possible for them to access credit. Social capital has become a popular innovation for dealing with information asymmetries such as adverse selection, where banks cannot screen the risky borrowers from the non-risky and moral hazard, where the banks cannot monitor the behaviour of borrowers (Seibel and Torres, 1999). Individuals select creditworthy peers who act as guarantors for each other by assuming joint liability for the loans. Repayment is enforced by harnessing the social capital in groups. Social capital is a network of trust, respect, reputation and reciprocity for improving a neighbourhood or investments in social relations by individuals to gain access to financial and other resources. Mashigo (2007), found that it is a norm in the poor communities that stokvel members socialize through weekly, fortnightly, or monthly meetings (as in Kenya) as stipulated in their informal stokvel constitution or rules to discuss financial matters and other related issues. These are flexible and simple rules or constitutions formulated by the stokvel members themselves and according to which the stokvels operate, that is, how much and when to contribute, for whom and when the benefits will be realized. This implies member control

and mutual monitoring over the activities of the stokvels as is the case with Ghana where rural banks are owned and managed by communities.

The information obtained from the respondents was that the constitution encourages members not to skip any financial contribution as this will result in, for example, non-payment in the case of death in the family. However, respondents emphasized that violation of the rules does not normally happen because of personal relationships, trust, loyalty and reputation among members. Any member who is found to be violating the rules is banned from the stokvel. The members know that they depend entirely on the stokvels in case of financial distress and, therefore, adhere to the set rules. This helps to reduce asymmetric information in the provision of credit (and savings) because it improves the flow of information among member borrowers and lenders and ultimately improves the livelihoods of the households and reduce their poverty levels. It has been alluded to in this article that it is normally costly for credit markets to acquire information about borrowers. This, however, differs significantly with the situation of informal stokvels where the problem of asymmetric information does not exist because of local inside knowledge which exists between the members. Borrowers and lenders possess a comprehensive knowledge about each other through the long-term relationships that exist between them and regular meetings that are held to discuss financial matters.

These informal stokvels have become popular means of maintaining financial independence among the poor households in South Africa and have also been found to exist and known by different names in other developing countries. The importance of these stokvels lies in their potential to transform the credit market by dealing with the risk associated with lending and borrowing contracts, removing the need for collateral and reducing high transaction costs. The poor communities regard the stokvels as being responsive to their financial needs and prefer them to the formal credit sector. The households are able to bridge the effect of financial shocks and improve their household conditions in general. The informal stokvels, given the support and consideration commensurate with their significance in dealing with asymmetric information problem, can be used as a first point of reference when designing credit instruments for the poor households in South Africa.

Advantages of group lending mechanisms

When faced with asymmetric information in selecting borrowers, credit markets may be dominated by risky and non-risky borrowers. Borrowers differ in the likelihood that they will default and it is costly to determine the extent of the risk. Borrowers who are high risk or potential bad credit risks are more likely to take loans and most likely to produce an undesirable or adverse outcome. As the interest rate increases, there is a high probability of default. The risky borrowers tend to drive the non-risky ones out of the market. A lender is, therefore, unable to discern the extent of risk of a particular loan and applicants will consist of borrowers with projects in different risk categories (Hoff and Stiglitz, 1990). Group lending may enhance the likelihood that borrowers undertake the actions desired by lenders and limits the consequences of information asymmetries. In forming groups, enforcement costs are low because of peer social sanction. An incentive of group lending is that social selection homogenizes the group, that is similar types, for example, non-risky members group together to ensure loyalty and trust. Their selection is

based on creditworthiness and commitment of members. Their probability of default will be low as they will jointly be liable to repay the loans which result in expected gain. The risky groups will also group together and this will enable credit markets or lenders to charge different fees to non-risky and risky types.

Monitoring is an important mechanism used by groups to reduce moral hazard because it allows a group to know who can or cannot repay the loans. This cannot be done by credit markets or banks. Groups know that when an investment project fails, there is zero return. Compulsory saving is another mechanism that improves access to credit and reduces default rates. The Indonesian and Grameen models use this as substitute for collateral where groups are forced to save money before loans are disbursed. Once the group defaults, then the savings serve as compensation for the lender. A mechanism for securing high repayment rates in the credit markets is to begin by lending small amounts and upon satisfactory repayments then increase the loan size irrespective of whether lending to individuals or group. When loans are not repaid then no further lending will be made. The informal stokvels in South Africa operate more or less in the same fashion as in these countries. The financial contributions that the stokvel members (group) make weekly, fortnightly or monthly are a form of savings mobilization which can play a significant role in accessing credit from the credit markets. The evidence provided in this research should be carefully studied by the South African government, financial authorities and policy makers in order to develop special lending mechanisms or credit instruments to minimize transaction costs and expand the scale of credit portfolios and loans to the poor households.

Conclusion

It has been argued in this article that the credit market in South Africa is inappropriately structured to provide credit to the poor households due to asymmetric information. The main concern has always been the low risk returns. The market, particularly banks, perceives the transaction costs as too high and return too low relative to the risk. It is also difficult for the market to evaluate the actual risk and profitability of an investment project because they lack crucial information that borrowers may or may not disclose. Collateral constraints exacerbate the risk and without which there is no compensation for the lenders in case the borrowers default on the loans. It is in this context that the credit market regards the poor households as risky and unprofitable and the households are, therefore, marginalized.

International practices have shown that it is possible, through the relevant lending mechanisms, to provide credit to the poor communities. For example, the legal and regulatory environment in countries such as Bangladesh, Ghana, Kenya and Indonesia, have permitted the establishment of specialized lending mechanisms or banking and financial institutions that target the poor communities. Examples of such are rural or community banks that are able to make savings and sound credit judgements because of their knowledge of the local community. This is done through the establishment of informal groups which are linked to the village bank and which (informal groups) are utilized to deal with asymmetric information. Groups decrease the intermediation costs and help to cut out the use of collateral through peer group lending.

There exist informal sources of credit such as stokvels which seem to be capable of reducing asymmetric information in the provision of credit in South Africa and improve access to credit by the poor households. The significance of these stokvels is that they generally incur very low transaction costs where credit is available without interest and reduce the need for collateral where peer pressure and monitoring, social ties and savings substitute such collateral. The credit market (or banks) in South Africa has to consider compulsory savings which the poor households mobilize through informal stokvels and this can serve as collateral to secure credit. Furthermore, the informal rules or constitutions which stokvel members formulate and according to which the stokvels operate can be taken into account when creating by-laws or reforming banking laws in South Africa. These stokvels can be used as the first point of reference in transforming the credit market and improving access to credit by the poor households.

Finally, group lending mechanisms such as social/peer selection, social norms and customs, compulsory savings and peer monitoring, if given the necessary support and consideration by the government and financial authorities, can be used as a first point of reference to transform the credit market and reduce poverty levels in South Africa. The effectiveness and efficiency of these mechanisms need government intervention through judicial policies as well as the creation of an enabling policy environment.

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