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SMEs, employment & the financial sector

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SME and Employment

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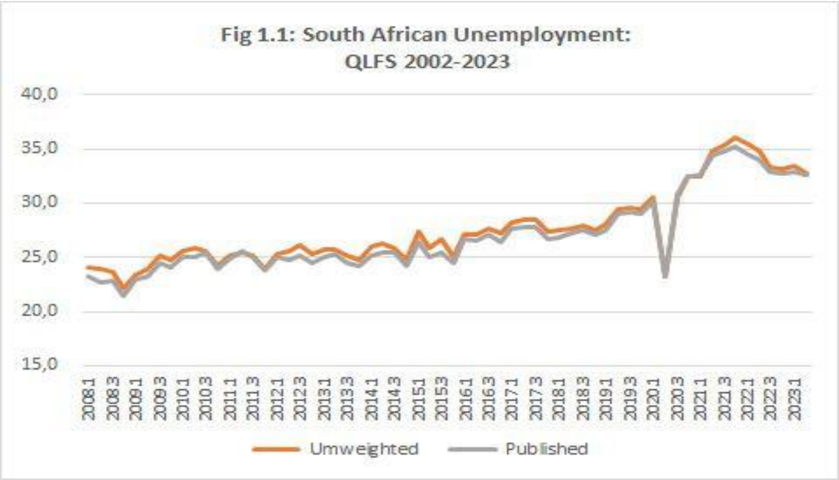


- **Unemployment at 32% = nearly 8 million people unemployed**
- **710,000 small businesses generate 30% of total employment**
- **Share of small formal business** in total employment fell from 35% in 2010 to 30% in 2022 [SME: 55% down to 47%]

SME contribution to employment

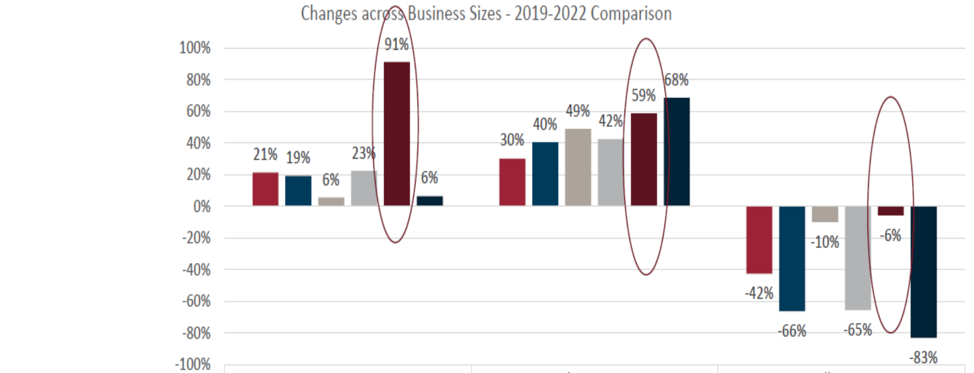
Country	% of businesses	GDP	Employment
South Africa	99%	52%	29%
USA	> 99%	44%	48%
UK	99.7%	51%	54%
Germany	99.5%	54%	63%
Nigeria	**99.8%**	**49%**	**84%**

Source: European Commission, U.S. SBA, FMITI, PwC research

- **Unemployment in SA is at a critical level**, possible one of the most critical challenges in SA today; and have progressively gone worse over the last decade
- **SME sector play an important role in creating** employment, but this share declined over the last 2 decades; and is much lower than comparatives
- **SME policy has to be a priority** across government (and including finance departments), for employment levels to improve

Huge pressure on SMEs over the last decade: *Covid, Riots, load shedding, procurement bias & corruption …*

Business impact 2019-2022: Large, Medium, Small



	Large Business	Medium Business	Small Business
Total income	21%	30%	-42%
Total Inventory opening values	19%	40%	-66%
Employment costs	6%	49%	-10%
Interest paid	23%	42%	-65%
Net profit or loss before taxation	91%	59%	-6%
Total capital expenditure	6%	68%	-83%

AURIK Enterprise Development

Quarterly Financial Statistics Survey - September 2019-2022

- Small businesses decimated, large & medium businesses recovering

  … small business cut back (massively) on capex, inventories & employment (with micro-strategies to save jobs)

  … <2% / 10% of SMEs getting bank loans

  … therefore SMEs cannot restart operations, restock inventories, retool .. <u>*deal with impact of load shedding*</u>

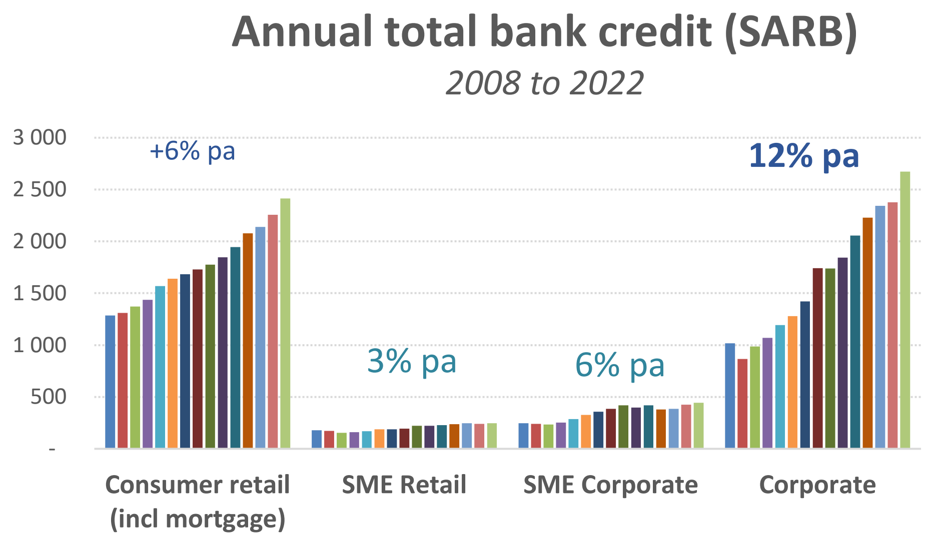
- In KZN, more than 1.5 million jobs (4.5 million people) in at risk (31% in small business)

- **Last decade was devastating to the SME sector,** from Global Financial Crisis (2008), Covid, riots (KZN), procurement corruption, load shedding,

- **Impact on SMEs,** owners and employees, unemployment and society in general

…. aggravated by ineffective / misaligned government interventions

Bank finance and SME growth



The story of credit in SA …

	Credit growth rates	
	Annual	Inflation adjusted
Consumer (ex mort)	10.6%	3.1%
Mortgages	4.4%	(3.1%)
Consumer retail	6.3%	(1.2%)
SME Retail	2.7%	(4.8%)
SME Corporate	5.8%	(1.6%)
Corporate	11.6%	4.2%

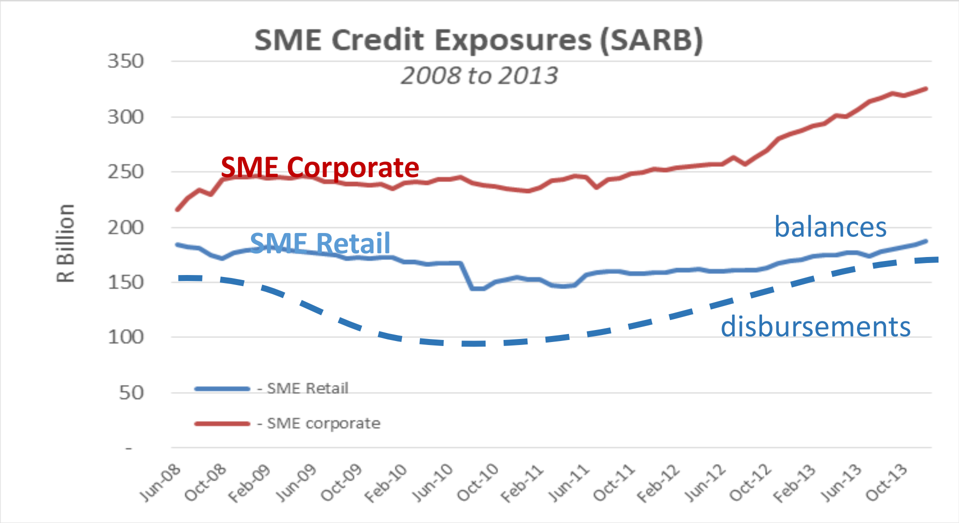
- Strong growth in consumption credit and corporate credit …. with negligible growth in SME credit; and *negative growth in SME Retail (adjusted for inflation)*
- Credit predominantly channelled to the corporate sector … and to high cost consumer credit
- Banks has kept a stranglehold on any businesses in SA (with the tacit support of NT and SARB) … *while achieving record profitability*

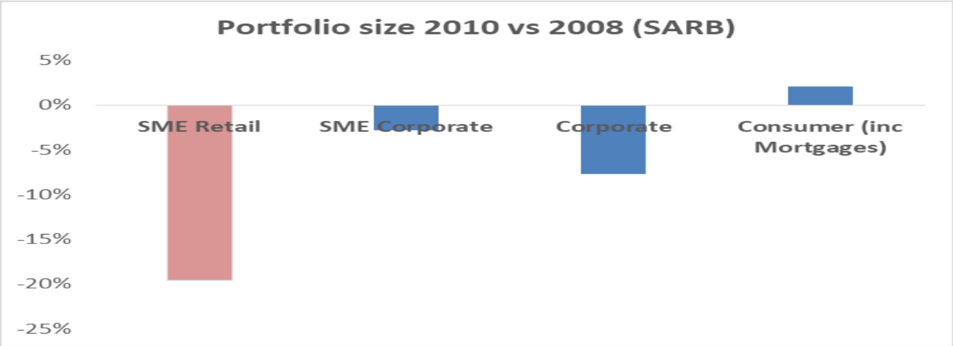
"Why do we save, banks simply channel our savings into finance for the corporate sector ... or into high cost consumer credit ... to maximize banking profits and bonusses"

- Noting, that a decline in credit stocks (outstanding balances) implies a substantial decline in credit flows = massive contraction of liquidity from businesses,
- … at exactly the time when sales decline and payment terms tighten = squeezed from both ends

Dynamics of credit to SMEs?

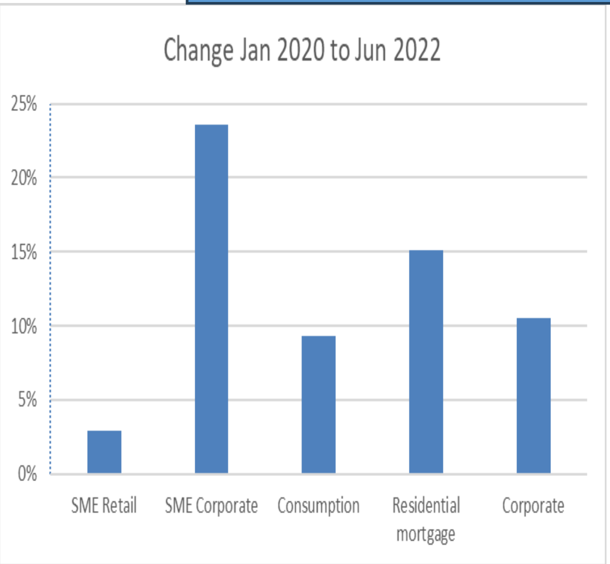
2008 Global Financial Crisis

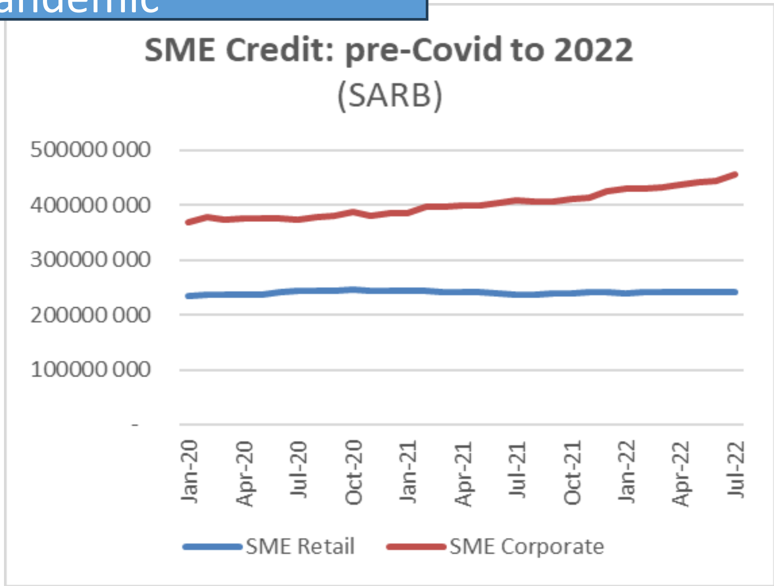




		2022	#
SME Retail:	*Loans < R12.5 mil*	**R245 bn**	300,000+
SME Corporate	*Loans > R12.5 mil* *Buss T/O < R300 mil*	**R445bn**	< 5000

Covid Pandemic





- **Between 2008 and 2010 SME Retail credit exposures had declined by 20%.** Over the same period SME Corporate declined by 3% (Corporate by 8% and Consumer Retail by 2%). The implication is that there was a massive *contraction in credit flows* to the SME Retail sector –contracting an estimated +40% (R40bn+) for the year
- **Causes**: Banks reduced new lending, cut back on unused facilities, tightened credit criteria, implemented strategies to avoid certain sectors + consumers more cautious
- **Since Covid period**, SME Retail credit slowest to recover, undermining business recovery and employment creation

Why is the SME sector so under-served?

… banker's perspective

Lending to SMEs

- SME credit analysis more difficult and more costly, less automated than consumer credit, contract enforcement difficult and costly – less profitable [??]
- Transaction sizes much lower than corporate, more risky, less profitable (but diversified)
- Constraints: (a) Audited financial statements; (b) Ownership risk; (c) Collateral availability & valuation … limited bank expertise in SME credit

➔ Availability of credit information; Debt enforcement constraints;

➔ Limits on automation & centralisation of decision-making; High risk perceptions; Limits on profitability … *yet, credit loss rates not excessive!*

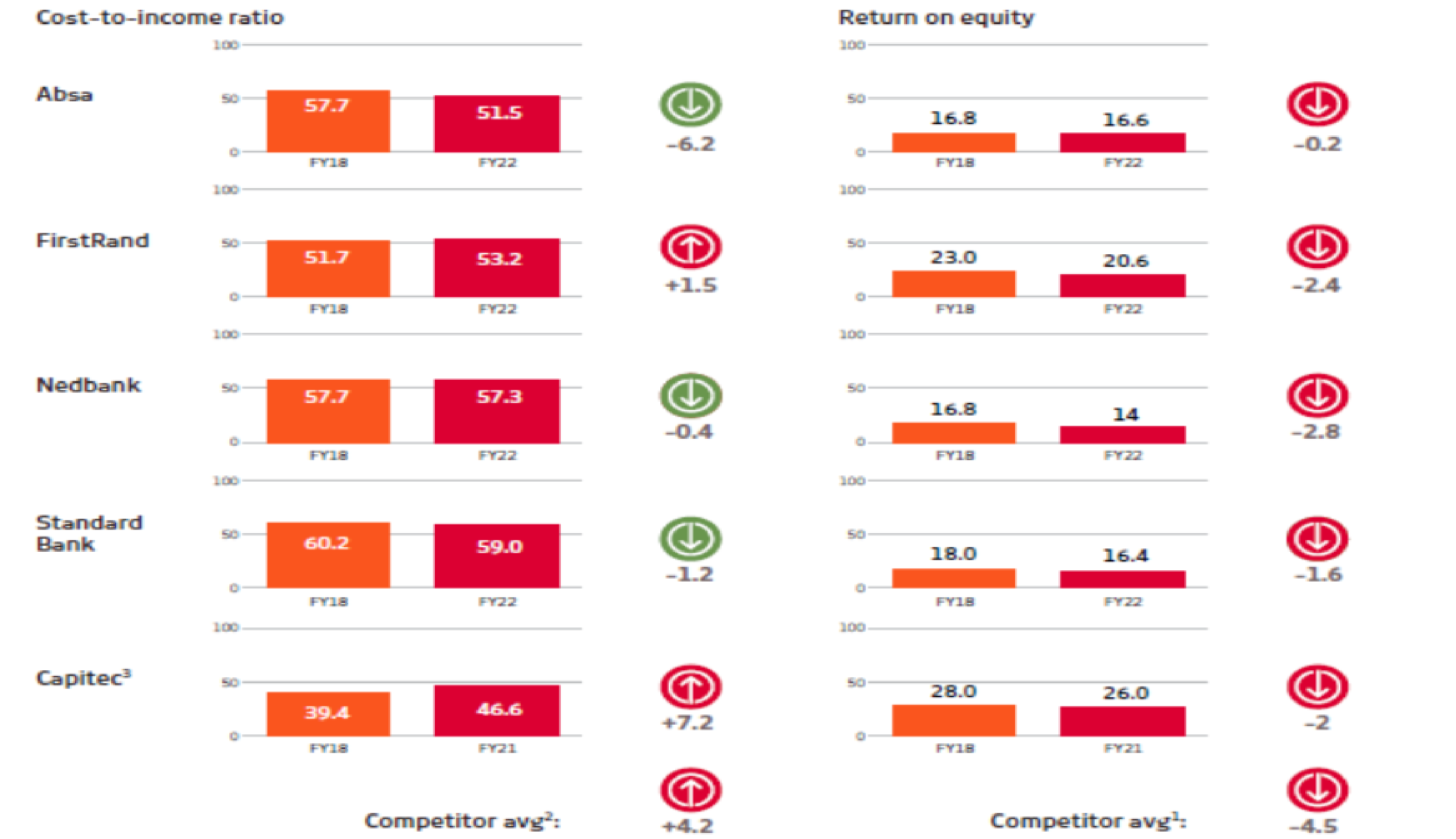
Lending to consumers, based on payslips & credit bureau reports, automated, secured against employment, at healthy margins

Lending to corporates based on audited financials, for huge amounts, very profitable

Bottom line:

- ❑ Easier to make money from transaction banking, from consumer credit (much higher rates) and from large corporate facilities
- ❑ SME really a political game = how to make government think that banks are supporting SMEs, while keeping the real exposure as low as possible
  - ➢ *Yet, SME credit loss rates not excessive*
- ❑ Without real regulatory pressure, there is no reason to think any of this will change

Profitability of SA Banks



[1] Adjusted to Absa's fiscal year for FirstRand and Capitec.
[2] Average for pt difference FY18–FY22 for competitors.
[3] Capitec FY21 reflects February 2022 results.

Absa Group Limited Integrated Report 2022

An SME owner's perspective

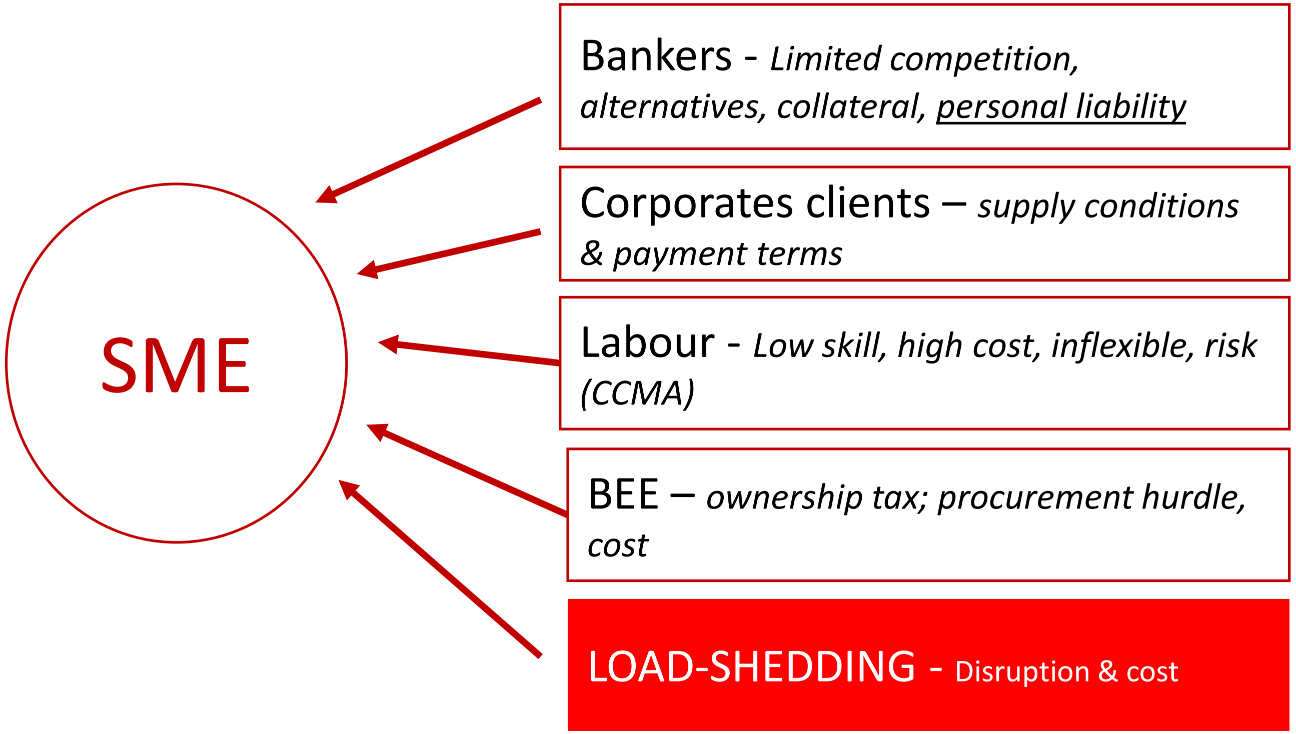
❖ As result of an external shock (GFC, Covid etc), SMEs faced with squeeze from 3 sides: (a) decline in turn-over, (b) squeeze from corporates, (c) as well as decline in bank finance … while having to maintain staff

…. *bank requirements during Covid was structured to increase hurdles*

❖ Challenges operating in SA: Labour requirements & skills; BEE requirements (ownership limitations) + procurement requirements + **load-shedding**

❖ **Requirement to put personal assets at risk, in order to save business in Covid environment**

Economic down-turns in theory also create opportunities, eg for take-overs and consolidation … but these are *dependent on availability of external finance*



A unique set of business challenges

Policy & support framework

Institutional support for SMEs & SME finance

In principle, an extensive framework for SME support institutional support, from Dept of Small Business Development, dtic, SEDA, SEFA, SEFA Inc, Covid Relief etc

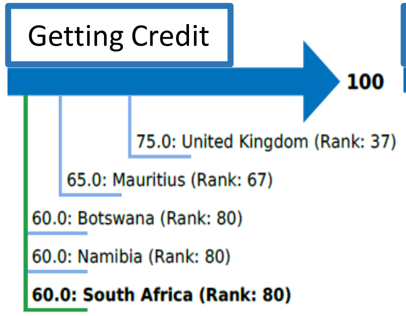
In practice, SMEs declining and employment in SMEs declining … interventions seemingly terribly ineffective?

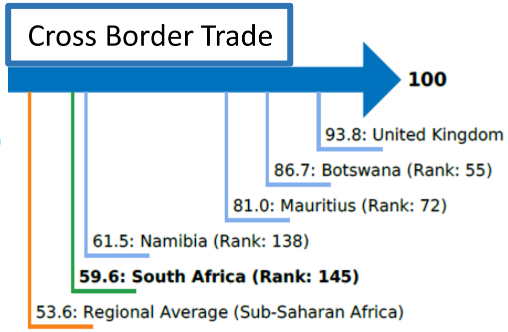
Only highlight in a dismal picture

Systemic issues

- **"Doing Business" rank:** 84 / 190 countries [Credit 80 / Construction permits 98; Contract enforcement: 102]
- **Credit information & SME scorecards** (critical for lowering cost & automated decisioning): Limited credit information sharing, scorecards under-developed compared to international. No commitment, continued obstruction, despite years of talk.
- **Contract enforcement**: 600 days, cost 33% of claim
- **Heavily regulated, not business friendly** and biased to corporate interests & transformation objectives

DOING BUISINESS in SA	Score	Rank
Starting a business	*81%*	139
Construction permits	*68%*	98
Electricity	*68%*	114
Getting credit	*60%*	80
Cross border trading	*59%*	145
Contract enforcement	*56%*	102
Insolvency	*54%*	68





And what about financial sector authorities? …

Where does National Treasury and SARB stand in in respect of SME finance … ?

- SARB has narrow mandate, focused on financial stability & inflation targeting
- NT Policy & Priorities: Nearly no mention on SME finance in 2013 policy; New draft more extensive … but does this mean anything?
- SARB & National Treasury gives little to no attention to SME finance, mostly following bankers' lead
  - *… limited disclosure, no accountability*
- Bankers commonly play NT / SARB off against any other institution; ensuring that they take no responsibility or accountability for SME finance

IMPORTANT FOR NT AND SARB TO EXPAND ROLE, WITH GREATER INDEPENDENCE FROM BANK INTERESTS

- Increase prominence in NT and SARB *policy objectives*
- Regular publication of specific *SME finance statistics*, disaggregating credit flows, approval rates, loss rates and individual bank performance
- *Regular, independent research* on the status of SME finance, and independent analysis of key obstacles, and bank credit behavior
- *Full review of SARB regulations* impacting on SME finance, creating greater flexibility in financing SMEs, effective & rapid implementation of open banking
- Recognition of role of *non-bank credit providers*, expand regulatory space, address anti-competitive banking practices
- *Credit information sharing on businesses is terrible* must be expanded, overriding ongoing obstruction by bankers
- *Much better design of interventions* … Covid Guarantees was a case study in bad design
- Establish effective credit guarantee scheme (close Khula Guarantee down), under SARB oversight
- *Full and objective review on tax burden on SMEs*; and duties that obstruct trade

Banking behaviour will not change without leadership from Treasury & SARB

International Perspective

... SA is very far from best practice

Policies:

- **SME policy, performance & access to finance** is a much higher priority in finance ministries & central banks in nearly all comparative markets.

  Eg: (a) European Central Bank: multiple research reports and surveys; (b) US Federal Reserve, Broader mandate; Annual SME credit surveys; survey, various research reports; (c) UK: Cruickshank, Van Steenis; Policy statements; Stats

- **Many examples of regular SME data analysis and fundamental research,** with regular reports on SME credit access & conditions (Fed, ECB, others)
- **Legal frameworks for non-bank finance** in may markets, including special conditions for NBFIs that do SME finance
- **SME lending targets and conditions** imposed on banks, forcing increased lending to SMEs, directly and through intermediaries (eg India, Indonesia)

Institutional:

- **SME Development Banks**, either wholesale or retail, many financially sustainable
- **Credit information sharing**, sometimes through central bank credit registers (not best practice); Broad application of scorecards & credit automation in SME finance (*SA falling behind*)
- **Movable collateral registers;** with special contract enforcement / recovery approach
- **Examples of successful Guarantee Funds**, little awareness in SA of best practice (Chile, Taiwan, but also many others). Market based vs collateral substitutes.
- **Contract enforcement**, foreclosure regimes, insolvency regimes

Bottom line

Both the 2008GFC and Covid crisis impacted massively on SME sector, and on employment; aggravated by bad policy design, badly designed interventions, weak implementation. The employment implications are dire, and will not be recovered unless SMEs recovers.

Unfortunately, the vested interests are huge, particularly banks and corporates. There are also some really complex policy trade-offs, particularly in the space of BEE and labour policies

There are easy wins, strangely neglected, eg (a) SME credit information sharing; (b) Regular statistics on SME finance by SARB, (c) Open banking etc. But the vested interests are seemingly too strong, even to permit monitoring & accountability.

The cost on employment is staggering, we can only hope that someone discover a backbone, decides to do something meaningful. There is no alternative to the role of SMEs in a market based economy

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“Annexures”

SME Guarantee Funds

Government Guarantee Funds: Austria, Belgium, Canada, Chile, Colombia, Czech Republic, Denmark, Estonia, Finland, France, Georgia, Greece, Hungary, Ireland, Israel, Italy, Japan, Korea, Malaysia, Mexico, the Netherlands, Norway, Portugal, Russian Federation, Serbia, Slovak Republic, Slovenia, Spain, Switzerland, Thailand, Turkey, United Kingdom, United States …

Thailand	
Portfolio	**$ 12 bn**
# guarantees	**330,617**
Average	$ 37,000

Taiwan	
Portfolio	**$ 24 bn**
# guarantees	**161,370**
Average	$152,651

Malaysia	
Portfolio	**$ 783 mil**
# guarantees	**8,999**
Average	$87,000

Chile	
Portfolio	**$ 505 mil**
# guarantees	**32,165**
Average	$15,700

The Covid-19 Guarantee Fund?

CHILE

It was clearly a failure … but why?

1 – Compare to the significant impact of the leading international guarantee funds

2 – **SA Covid Guarantees ignored international experience**. Terrible design … structured like SOE / Govt guarantee mechanisms, to avoid any claims on guarantees ≈ leave all the risk on banks

3 – **Claim threshold** too high ≈ banks only benefit once losses escalated well beyond the level of "commercial tolerance" ≈ no incentive for increased lending

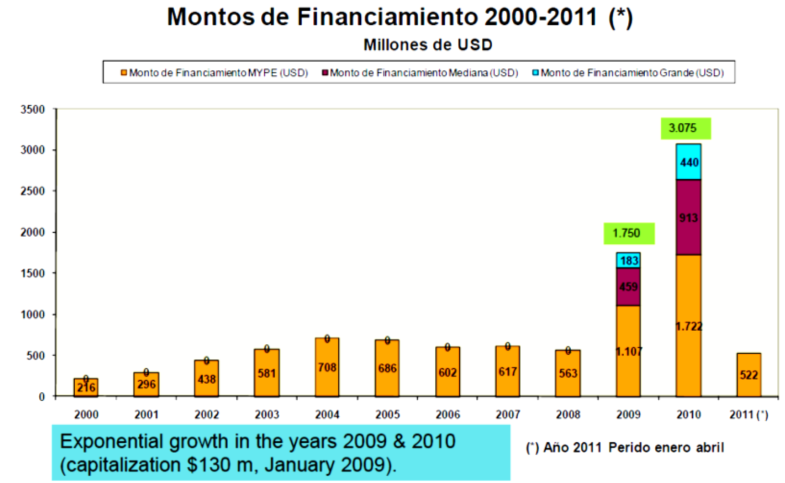
4 – **Scope** across SME Retail & SME Corporate automatically implied that larger business were primary beneficiaries (lower risk)

5 – **Entry criteria** excessively strict, excluding businesses that should reasonably have qualifies

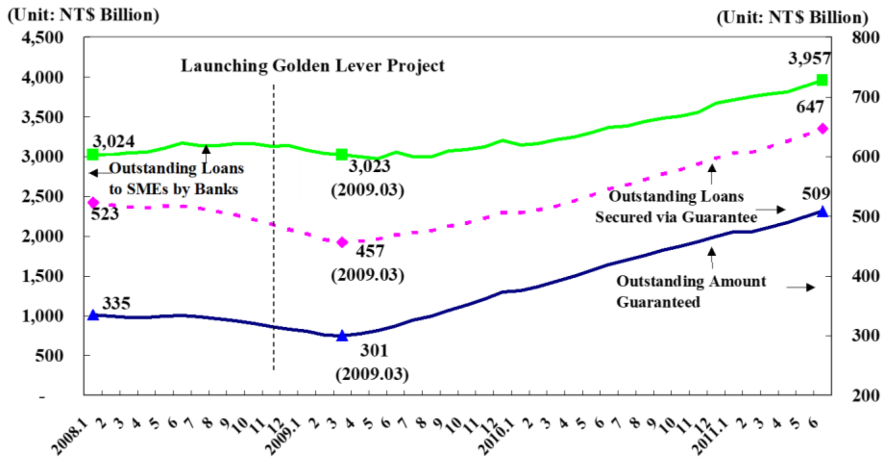
6 – **Banks really do not want a guarantee fund**, or external monitoring or scrutiny ≈ maximise scope for deniability and waffle

7 – Too early, too impatient: The Guarantee Fund will really be needed when recovery starts, when businesses want to recapitalise / or expand / or take others over … too early to shut it down … *why not "repurpose", to deal with weaknesses?*

So, what do we have: A debate about whether banks already helped everybody that needed help; Or whether businesses are simply cautious and really don't want loans; Or there are just not enough SMEs out there which deserve loans … and these arguments are made **without any basis in hard stats** … an abundance of fiddling while Rome is burning

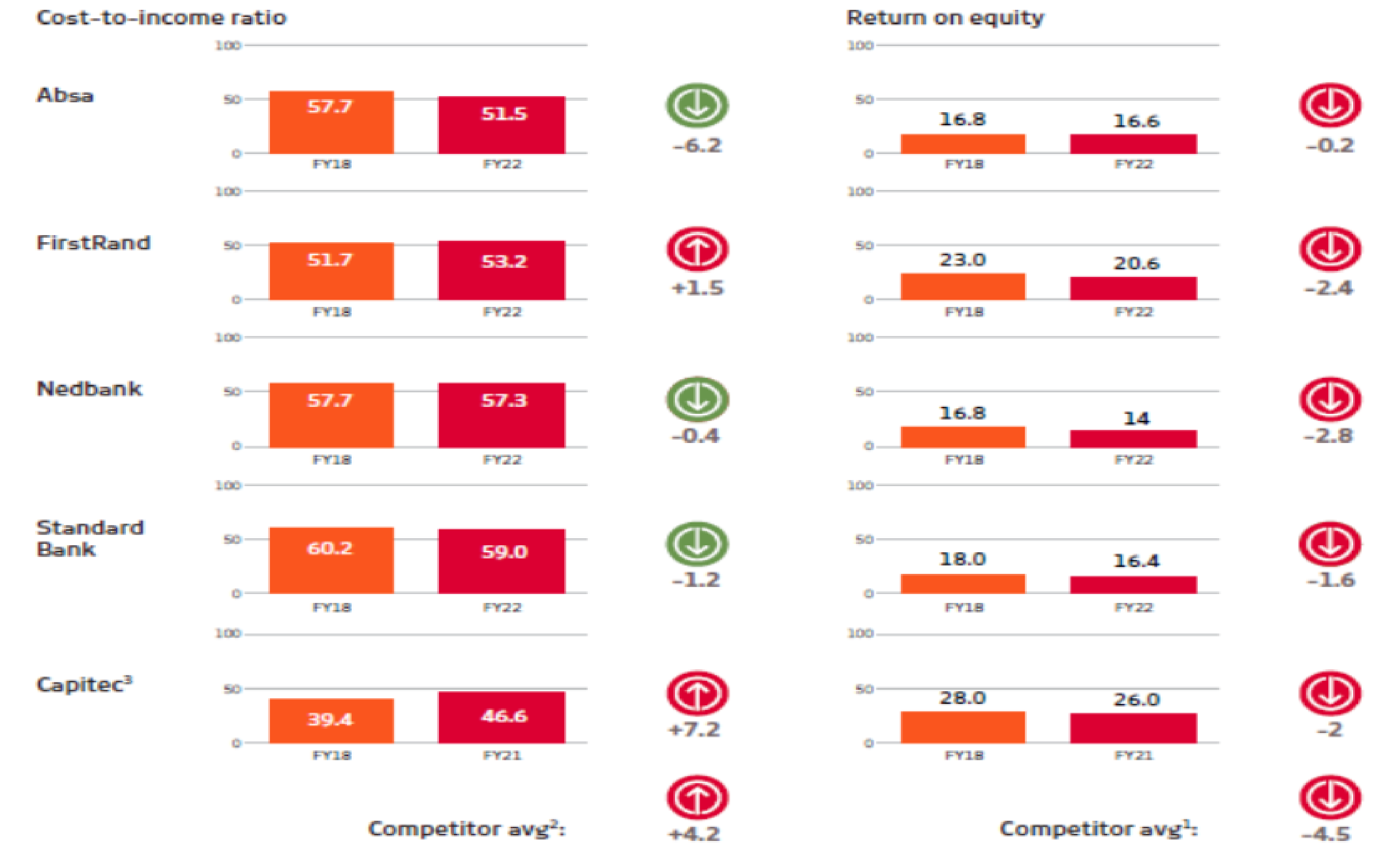


Chile: Portfolio cover, risk based pricing, strong commercial foundation & risk management framework.



***Taiwan**: Countercyclical effect after credit contraction, through improved guarantee terms & qualifying criteria*

Profitability of SA Banks



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